

CHAIRMAN'S CORNER

by James A. Kaplan



"Bankruptcy?" Ouch!!! We Touched a Sore Spot

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Audit Integrity recently released a new Bankruptcy Risk model. The model was developed at the request of our clients, which include D&O insurance companies, institutional investors, and other interested stakeholders.

At Audit Integrity, we deal with some unpleasant truths. Some companies go bankrupt. Some corporate managers commit fraud. So it has been, so it will continue. What is equally true is that traditional, accepted measures of fraud and bankruptcy risk have failed time and again to identify companies at risk. Audit integrity ratings and rankings are based on documented instances of bankruptcies and fraud (SEC Accounting and Auditing Enforcement Releases.) Our intent is to provide a valuable indicator of critical corporate risks.

The purpose of the Bankruptcy Risk Model is to predict the likelihood of bankruptcy among publicly-held companies over a rolling 12-month period. The model combines traditional quantitative inputs, including financial solvency measures and market valuation (option) models, with our own proprietary AGR[®], which quantifies accounting transparency – in other words, whether the company's published numbers can be trusted.

Each of these components uses historical data and tests that include in- and out-of-sample accuracy measures. Our statistical approach produces some very positive results, as noted in the [White Paper](#) available for review at <http://www.auditintegrity.com/>.

From my personal perspective, I was surprised to note that the impact of the U.S. Government "carpet-bombing" the world with liquidity had substantially reduced the rate of bankruptcy since the first Quarter of 2009, when overall probabilities were as much as three times higher than the September results.

I was also surprised by the reaction to our announcement. For the past six years Audit Integrity has identified corporations most at risk of litigation, earnings restatement, and SEC enforcement actions, but apparently the term "bankruptcy" is more incendiary than all of these combined.

Clearly, the word "fraud" has a similar effect. Audit Integrity did not state that companies with higher bankruptcy risk are committing fraud, but rather, that fraud risk metrics are part of our statistical process because these indicators of aggressive accounting have proven to be predictive of bankruptcy. Time will tell which of today's companies are actually committing fraud.

In our bankruptcy model announcement we mentioned a number of large companies that had the highest probability of filing for bankruptcy over the coming year. Notwithstanding our report that the probability of bankruptcy was actually very low, a few of the companies listed were totally outraged at being identified as most likely to file. In one case, Hertz Global Holdings, Inc. filed action against us. In another case, CBS publicly declared that our Bankruptcy Risk report was based on "flawed pseudo-analysis".

Both CBS and Hertz complained that we had ignored numerous qualitative issues including analysts' opinions. This seems odd, since by definition, quantitative analysis is purely statistical and deliberately excludes any and all subjective evaluation.

Statistical analysis, a branch of applied mathematics concerned with collecting and interpreting data to be used in estimating the probability of a particular outcome, is, and has been, widely used in a host of applications. I would guess that CBS collects and analyzes statistical information regarding their consumers; if they do not, this might be contributing to their poor performance.

As independent publishers of information, we pride ourselves on the use of applied mathematics to generate objective results. We are beholden to no one. Our job is to ferret out the truth in an environment where companies are incented to obfuscate.

However, since Hertz and CBS both objected to the lack of qualitative opinion in Audit Integrity's report, I am prepared to offer my own personal perspective as a CFA and investor. I have highlighted the qualitative elements in the statements below to differentiate them from the statistical.

I must warn our readers that this will be the first and last time I depart from the "pseudo-analysis" we call "statistical."

Hertz Global Holdings, Inc.

- Hertz Global Holdings is a highly overleveraged business whose revenues are dependent on business and leisure travel.
- I *doubt* that we will see a meaningful rebound in Hertz revenues over the coming year.
- A good portion of their assets are tied up in Goodwill/Intangibles, which represents a low-quality asset and poor collateral.
- Their primary tangible asset is their fleet of autos, which *may or may not* be fairly valued, since used auto prices have dropped significantly over the last two years.
- *In my opinion* the likelihood of a bankruptcy filing, as rated by Audit Integrity's model, seems very conservative.

CBS Corporation

- I *believe* CBS has a broken business model.
- Revenues have not grown for many years.
- CBS's media dominance is being eaten away by a host of competitors including cable and Internet providers as additional sources of entertainment and information.
- CBS struggles with the high cost of operation while new entrants in the space are far leaner.
- Goodwill/Intangibles represent more than 60% of assets. There is a possibility of an impairment charge if revenues and earnings continue to slip.
- Interest on long-term debt of approximately \$7 billion is eating up operating income.
- Unless CBS can substantially reduce its cost structure while continually restructuring its debt, I *believe* trouble lies ahead, and it could be sooner rather than later.

I hope both Hertz and CBS will be satisfied with the qualitative opinion I have provided to complement Audit Integrity's quantitative analysis. Please note, "*This essay reflects the opinion of the author and not necessarily the opinion of Audit Integrity, Inc.*"

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