



The Question of Defaults: Moody's is Damned If They Do and Damned If They Don't

March 12, 2009

The *Wall Street Journal* article published March 10, entitled “Moody’s Aims to be Ahead of Defaults,” was a real eye-opener, as was the response to the article,.

Moody’s Corporation has taken a bold and positive step in publishing a list of Companies with the highest probability of default. The Moody’s Bottom Rung consists of the riskiest 15%, approximately, of all Companies they track.

It is interesting to note that Moody’s has been widely criticized for publishing the Bottom Rung, with many Wall Street champions declaring it a “publicity stunt.” I struggle with this response from the marketplace. Moody’s should be encouraged to provide more transparency and information to stakeholders, particularly in view of the legitimate criticism that accepting compensation from the Companies they rate creates a conflict of interest.

Of course, the Companies on the Bottom Rung are unhappy that their solvency has been called into question, but they have no one but themselves to blame for their position.

Although not always perfect, Moody’s corporate listing model is objective and has been proven to be statistically significant. The Companies on the list have made poor corporate decisions, have taken on excessive risk, or are simply suffering from an extreme economic downturn. Moody’s should not be pilloried for pointing out the potential consequences of their excesses.

It appears that Wall Street wants to hear only cheerleaders, not Cassandras, regardless of the merit of the message. At the risk of being another Cassandra, I took Moody’s analysis a step farther. This additional step goes beyond Moody’s more traditional analysis. However, I believe, and the evidence supports, the view that poor accounting and governance positions are a strong indicator of future under-performance – including insolvency.

Eliminating 13 non-publicly traded Companies in the top 30 on the list, I took a look at the Accounting and Governance Risk (AGR[®]) scores of the remaining 17 Companies:

| Company | Ticker | Period Ending | AGR Rating |
|----------------------------------|--------|---------------|------------------------|
| AMR Corporation | AMR | 9/29/2004 | Average |
| Citadel Broadcasting Corporation | CDL | 9/29/2004 | Aggressive |
| Dana Holding Corporation | DAN | 9/29/2004 | Aggressive |
| Eastman Kodak Company | EK | 9/29/2004 | Very Aggressive |
| Ford Motor Company | F | 9/29/2004 | Very Aggressive |
| General Motors Corporation | GM | 9/29/2004 | Aggressive |
| Georgia Gulf Corporation | GGC | 9/29/2004 | Average |
| Idearc, Inc. | IAR | 9/29/2004 | Aggressive |
| Lear Corporation | LEA | 9/27/2004 | Aggressive |
| Level 3 Communications, Inc. | LVLT | 9/29/2004 | Average |
| Rite Aid Corporation | RAD | 8/29/2004 | Average |
| R.H. Donnelley Corporation | RHD | 9/29/2004 | Aggressive |
| Source Interlink Companies, Inc. | SORC | 10/30/2004 | Aggressive |
| Tenneco Inc. | TEN | 9/29/2004 | Average |
| US Airways Group, Inc. | LCC | 9/29/2004 | Average |
| Visteon Corporation | VC | 9/29/2004 | Aggressive |
| Western Refining, Inc. | WNR | 9/29/2004 | Aggressive |

Not surprisingly, 11 of the 17 Companies, or 65% of the sample, had an AGR[®] rating of **Aggressive** or **Very Aggressive**. This distribution is almost double the expected distribution of 35%*.

Accounting and Governance risk measures are independent measures not incorporated in Moody's ratings. I am not surprised, however, that a high correlation exists. Low management integrity, coupled with accounting manipulation, often leads to serious problems including potential default.

The following page contains a detailed list of accounting and governance metrics flagged by our Audit Integrity analysis for those Companies that fell in the bottom 20% of all Companies ranked by Audit Integrity. This analysis shows that AGR[®] is a valuable tool in assessing potential default risk of corporations even before they drop to the "Bottom Rung."

* Audit Integrity rates the bottom 10% of Companies as **Very Aggressive**, and the next 25% as **Aggressive**. These two categories combined would total 35% of Companies reported.

| Company | Ticker | Period Ending | AGR Rating | AGR Score | AGR Percentile | EQ | Flagged Metrics |
|----------------------------------|--------|---------------|-----------------|-----------|----------------|----|--|
| Citadel Broadcasting Corporation | CDL | 9/30/2008 | Aggressive | 52 | 20 | 2 | <ul style="list-style-type: none"> ✓ Average Ratio of Incentive Comp to Annual Comp of the CEO & CFO ✓ Ratio of CEO to CFO Total Compensation ✓ Reporting Number Amended Filings, Trailing 12 Mths ✓ Board Chairman is also CEO |
| Eastman Kodak Company | EK | 9/30/2008 | Very Aggressive | 27 | 2 | 1 | <ul style="list-style-type: none"> ✓ Selling General and Administrative Expenses over Operating Expenses ✓ Goodwill over Total Assets ✓ Research and Development Expenses over Operating Expenses ✓ Accounts Receivable over Sales ✓ Asset Turnover ✓ Corporate Number of Quarters with Share Repurchases, Trailing 12 Mths ✓ Average Ratio of Incentive Comp to Annual Comp of the CEO & CFO ✓ Board Chairman is also CEO |
| Ford Motor Company | F | 9/30/2008 | Very Aggressive | 40 | 7 | 2 | <ul style="list-style-type: none"> ✓ Accounts Receivable over Sales ✓ Asset Turnover ✓ Pension Assets Expected Return Domestic ✓ Pension Compensation Expected Rate of Increase Domestic |
| General Motors Corporation | GM | 9/30/2008 | Aggressive | 44 | 11 | 2 | <ul style="list-style-type: none"> ✓ Pension Assets Expected Return Domestic ✓ Board Chairman is also CEO ✓ Average Ratio of Incentive Comp Annual Comp of the CEO & CFO ✓ Average Ratio of Incentive Comp to Annual Comp of the CEO & CFO |
| Lear Corporation | LEA | 9/27/2008 | Aggressive | 48 | 15 | 2 | <ul style="list-style-type: none"> ✓ Selling General and Administrative Expenses over Operating Expenses ✓ Goodwill over Total Assets ✓ Other Current Assets over Current Assets ✓ Board Chairman is also CEO ✓ Average Ratio of Incentive Comp to Annual Comp of the CEO & CFO |
| R.H. Donnelley Corporation | RHD | 9/30/2008 | Aggressive | 47 | 14 | 2 | <ul style="list-style-type: none"> ✓ Accounts Receivable over Sales ✓ Intangible Assets over Assets ✓ Asset Turnover ✓ Ratio of CEO to CFO Total Compensation ✓ Board Chairman is also CEO ✓ Corporate Number of Quarters with Share Repurchases, Trailing 12 Mths ✓ Average Ratio of Incentive Comp to Annual Comp of the CEO & CFO |

Audit Integrity Client Services
Phone: (877) 880-8820
E-mail: support@auditintegrity.com
Website: www.AuditIntegrity.com

Audit Integrity, Inc. and its affiliates, Directors and Officers of the company may own stock or options to purchase or sell stock in the companies mentioned on our website and in our publications and may elect to increase or decrease the size of these positions at any time. Audit Integrity, Inc. however, is not directly or indirectly compensated for the specific views, opinions or recommendations expressed in its research reports. This document is for information purposes only and is not to be considered a solicitation to buy or sell any security. Neither Audit Integrity nor any other party guarantees its accuracy nor makes any warranties regarding its usage. Modification or reproduction of this report is forbidden without explicit permission. Copyright © 2009 Audit Integrity, Inc.