

## Companies Flashing Financial Danger Signs

by Neil Weinberg

Friday, January 22, 2010 provided by



Is the recession over? Is Corporate America out of the woods? Some indicators on Wall Street seem to say yes. Yields on junk bonds are way down. A lot of companies that were on the brink a year ago have refinanced, pushing maturities of debt out to 2014 or later. And if last March you had bought an assortment of shares in the shakiest borrowers you probably would have made a huge profit. Auto parts maker ArvinMeritor was trading at 32 cents at its low on Mar. 11. It has since climbed 3,503% to \$11.53.

But financial risk is not out of the system. Last year saw 207 bankruptcies of publicly traded companies. If there's a double-dip recession, this year's count could easily be as high. Leverage is still a big feature of American business.

We asked Audit Integrity, a research boutique in Los Angeles, to rank 2,700 companies for financial risk. The group consists of all public nonfinancial companies with market values of at least \$100 million and \$150 million in assets. Focusing on the 100 firms at the top in risk, it calculates an average 8% probability of going bust over the next 12 months.

ArvinMeritor is among the high-risk companies. More likely than not, it will sail through 2010 without any financial trouble. But the risk is higher here than at 99% of public companies, in AI's opinion.

AI's risk model incorporates the usual factors that go into credit ratings, like balance sheet strength and earnings. But it also figures in a measure of "accounting and governance" quality. The idea is that historical data can uncover push-the-envelope accounting and help predict which firms are likely to undergo financial restatements, regulatory troubles, class actions or severe financial distress.

James A. Kaplan, chairman of AI, set up the firm eight years ago after building and selling two other financial data crunchers: Capital Management Sciences, a bond analysis outfit, and the online financial portal MarketWatch. His inspiration for the latest venture came in 2002 as Enron was falling apart. Was there something that might have flagged this firm as a likely target of a Securities & Exchange Commission enforcement action? While studying SEC cases he deciphered common patterns involving such things as doing lots of acquisitions, divestitures, restructurings and share repurchases, or relying heavily on stock price gains in determining the boss' pay. From that he created his firm's Accounting & Governance Rankings.

AGRs are now used by big investors, director and officer liability insurers and others to gauge the chances that a public company will restate financials, face SEC action or get hit with shareholder litigation. Forbes.com publishes AGRs on its company tear sheets. "Companies rated 'Very Aggressive' or 'Aggressive' have proved much more likely to face class action litigation and financial restatements and to suffer severe equity loss," Kaplan says.

Recently Audit Integrity began assessing bankruptcy risk as well, using not only accounting indicators like liquidity and leverage but also the AGR metrics and market measures like stock volatility. "We find governance and transparency correlate with bankruptcy," says Kaplan. Under AI's model 81% of

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the public companies that went bankrupt last year would have been classified among the riskiest 10%.

Not surprisingly, many of the companies now dubbed risky find fault with AI's methodology. One criticism is that the model doesn't capture some recent balance sheet or earnings improvements. Another is that the calculations don't give companies enough credit for making debt nonrecourse or for extending maturities. ArvinMeritor notes that its bonds are trading above par and its stock has soared.

All valid arguments. Yet at a time when markets are giddy and the riskiest assets the hottest, investors would do well to recall that bad things can happen--even to companies with credible arguments about why the naysayers are wrong.

### Eastman Kodak



**Industry:** Photography

**Market cap:** \$1.1 billion

**Headquarters:** Rochester, N.Y.

**Recent news:** Transition from film to digital photography has been costly. Sales slumped 26% in the third quarter of 2009 as the company suffered a \$111 million loss.

### The Bon-Ton Stores



Kristoffer Triplaar/Sipa Press/Newscom

**Industry:** Retail

**Market cap:** \$187 million

**Headquarters:** York, Pa.

**Recent news:** With sales declining in 2009, retailer announced a new credit agreement in November to extend loan maturities on its debt.

### US Airways



Justin Sullivan/GettyImages

**Industry:** Airline

**Market cap:** \$728 million

**Headquarters:** Tempe, Ariz.

**Previous bankruptcy:** In 2002

**Recent news:** Amid weak demand, US Airways is struggling to find the right combination of service and revenue generation. It recently reinstated complimentary drink service in the main cabin while charging for checked baggage.

## Westwood One



Peter Turner/GettyImages

**Industry:** Broadcasting and cable TV

**Market cap:** \$101 million

**Headquarters:** New York

**Recent news:** Third-quarter 2009 revenue off \$17.8 million year-on-year. In mid-December the company announced it will cut Larry King Live from its lineup after more than 30 years.

## DineEquity



Scott Olson/GettyImages

**Industry:** Restaurants

**Market cap:** \$404 million

**Headquarters:** Glendale, Calif.

**Recent news:** Sharp discounting to draw customers to its Applebee's stores resulted in 4.3% sales decline. Company now plans to remodel restaurants to attract customers.

[Click here to see the Full list of The Risk List Top 10 and Comments from the Companies](#)

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