

The Risk List Revisited

Asher Hawkins and Neil Weinberg, 06.10.10, 06:03 PM EDT

Stocks of troubled companies from past list rise, but dangers remain.

1 Pacific Ethanol	19 Republic Airways Holdings	System
2 MPG Office Trust	20 China Infrastructure Investment	37 Bon-Ton Stores
3 Nextwave Wireless	21 Quality Distribution	38 Eastman Kodak
4 Jackson Hewitt Tax Service	22 Ampal-American Israel	39 Evergreen Solar
5 Zale	23 MGM Mirage	40 Lee Enterprises
6 NewLead Holdings	24 Delta Petroleum	41 Beazer Homes USA
7 YRC Worldwide	25 American Realty Investors	42 Gray Television
8 Westwood One	26 Cumulus Media	43 US Airways Group
9 Rite Aid	27 Strategic Hotels & Resorts	44 Perfumania Holdings
10 Cinedigm Digital Cinema	28 Horizon Lines	45 MTR Gaming Group
11 Hovnanian Enterprises	29 Medivation Inc.	46 Clear Channel Outdoor Holdings
12 Sanyo Electric (ADS)	30 Pacer International	47 Mercer International
13 Trans World Entertainment	31 BioFuel Energy	48 Ashford Hospitality
14 Crown Media Holdings	32 Bluegreen	49 TravelCenters of America
15 Borders Group	33 Globalstar	50 China BAK Battery
16 TerreStar	34 Animal Health International	
17 Transcontinental Realty Investors	35 Palm Harbor Homes	
18 Great Atlantic & Pacific Tea	36 Spanish Broadcasting	

It's not impossible to uncover what a company is hiding with clever accounting tricks--but it's pretty darn tough.

Often, balance sheet shenanigans that would send investors for the exits are discovered only after a company's already facing serious consequences in the guise of regulatory problems, class action litigation, a plunging stock price or outright bankruptcy.

Lehman Brothers is one such example of historic proportions. The investment bank employed accounting gimmickry to move \$50 billion off its balance sheet in the two years leading up to its late 2008 collapse, which was only revealed after its demise by the [bankruptcy examiner](#).

Small investors often hope to protect themselves from such risks by hiring professional money managers who, ostensibly, are better equipped to spot accounting red flags before it's too late. All too often, however, such pros lack the resources to undertake accounting sleuthing themselves and risk getting blindsided along with everyone else. That's where Audit Integrity comes in.

Earlier this year we asked the Los Angeles, Calif., accounting boutique to analyze nearly 3,000 of the largest publicly traded U.S. companies for financial danger signs. We published a shortlist of ten "flashing financial danger signs."

Since then, none of the 10 has gone under. In fact, the stocks of seven have actually risen. On our [January list](#) we warned investors away from Westwood One at \$4.24 a share. Recent price: \$13.46.

The Risk List



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Do these results debunk the model? We don't think so. Audit Integrity's model indicates even the riskiest companies were far more likely to remain in business during the intervening period than to go under. What's more, financial markets have been extremely accommodating the past several months--especially for the riskiest asset classes.

"The market has been forgiving up until the last few weeks," says James A. Kaplan, Audit Integrity's founder. "Now it's beginning to focus on risk again."

Five months later, we've worked with AI to update and expand the Forbes Risk List by analyzing 2,200 companies and publishing a shortlist of 50 that pose the greatest concern. The group consists of non-financial companies with public market values of at least \$50 million and with \$150 million or more in assets. Among the 100 firms at the top in risk, AI figures the average probability of any one going bust over the next 12 months at 8%.

AI's risk model incorporates many of the factors that go into other credit rating models, like balance sheet strength and earnings. 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 run into trouble with regulators, financial restatements, class actions or severe financial distress.

Kaplan, AI's chairman, 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 things like an unusually large number of acquisitions, divestitures, restructurings and share repurchases, or heavy reliance on stock price gains in determining the boss's pay.

From this research, Kaplan created his firm's Accounting & Governance Rankings. He says his findings about the causes--and growing incidence--of corporate financial fraud are supported by recent research from the Committee of Sponsoring Organizations of the Treadway Commission, a group supported by major accounting organizations.

See Also: [Why Corporate Fraud Is On The Rise](#)

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.

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