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Risk List Q&A

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Audit Integrity is in the business of handicapping financial risk. The company's Accounting & Governance Risk ranking, or AGR, is designed to give investors and other interested parties an understanding of the financial risks public companies face that they cannot get from credit ratings or any other sources. Following is an explanation by Jack Zwingli, the company's chief executive, of how the model works and its response to critics.

What does the Audit Integrity Risk List aim to measure?
The Risk List identifies companies at greatest risk from financial distress. Bankruptcy is the most extreme example of distress, but other risks include defaults on bonds or loans, inability to pay creditors, layoffs, major restructurings or asset sales, or other steps companies take to deal with a weakened financial condition.

How does the Accounting & Governance Risk model differ from traditional risk models, like those used by credit rating agencies?
One very significant flaw in credit risk analysis is a reliance on the validity and accuracy of corporate financial data. When companies lack transparency in financial reporting and use accounting gimmicks--or worse--to make numbers look better, the credit ratings do not represent the real risk to investors. The AGR provides a different perspective on corporate risk. Using forensic accounting and corporate governance risk measures, the AGR rating identifies companies where the financials may not represent an accurate picture of their underlying financial health.

Are companies dubbed the riskiest by your AGR model expected to go bankrupt?
No. The highest risk companies from a bankruptcy standpoint have about a 10% to 15% chance of going bankrupt, based on our current ratings. Bankruptcy is the most extreme risk related to weakened financial condition. Creditors, insurers, auditors and investors are at risk when a company's financial health deteriorates. This is the intent of the Risk List--to identify companies that have the greatest risk to investors and other stakeholders based on weakened financial condition. The ability to avoid bankruptcy does not mean that stakeholders will not pay the price for weak financial health.

What sort of clients use the model and for what purposes?
Anyone exposed to risks associated with weaknesses in financial disclosure or deteriorating financial health has an interest in the AGR risk measure. That includes Investors, of course, but also insurers, auditors, regulators and creditors. The AGR rating and AGR-based risk models are used to identify companies with a much greater potential to suffer from stock losses, litigation, defaults, regulatory actions, bankruptcy and other negative events related to weak or unreliable financials. Our clients use AGR ratings as a core part of their ongoing risk assessment.

How can individuals apply the model to their own investing behavior?
Investors with a conservative approach can avoid high-risk companies by filtering out those with poor AGR ratings [which appear on Forbes.com company tear sheets] from their investment selection process. Others use AGR ratings to identify companies that merit further research and to protect against negative surprises. Many incorporate ongoing monitoring of AGR ratings to lessen exposure to risky companies by selling or lowering price targets on companies with declining risk scores.

How has the Audit Integrity AGR been tested in the real world for predictive value?
AGR ratings and AGR-based risk models (to measure the risk of litigation, bankruptcy and equity loss) are all tested regularly against real-world results. We look at companies that have been sued by shareholders, suffered corporate bankruptcies, been the subject of regulatory actions and measure equity returns to track

the effectiveness of the AGR rating in identifying risk. These are all objective measures, and the AGR rating has consistently proved to be an effective forward-looking indicator of risk. Many of these studies are available at www.AuditIntegrity.com.

What are the model's weaknesses and limitations?

Any approach, qualitative (people) or quantitative (models), will not catch all risks, as we have seen with the tech and housing bubbles over the past decade. A prudent investor will evaluate a number of risk factors, with AGR ratings providing a very different perspective on corporate risk. While the AGR rating looks at dozens of risk factors, there will always be more nuanced analysis that is difficult for statistical approaches to measure. The AGR model is an effective way to identify groups of companies, like those in the Risk List, that are at greatest risk of financial distress or other negative outcomes. An investor, or other stakeholder, should use AGR ratings as one aspect of risk, to be supplemented by other research or more in-depth analysis.

How do you respond to the criticism that your risk model fails to consider industry-specific metrics?

Actually, industry comparisons are at the heart of AGR ratings. Companies are compared against industry peers, with those having unusual--or outlier--values being flagged as risky. We only use publicly available data, and calculate risk metrics that are comparable across companies. There may be valid objections from companies that believe their peer groups used are not comparable. That will be the case for any analysis that uses industry comparisons, which by their nature are imperfect. We use the peer groups that we have found to be most effective and provide our clients with the ability to review the peer groups and industry averages used in the analysis.

How do you respond to the criticism that your risk model is backward-looking because it uses historical data?

The AGR rating is updated quarterly, based on the latest financial statement data. We also provide daily and weekly updates of key information on our website. The results from this approach have proven to be very effective. In our ongoing validation of our ratings and models--as well as validation done by academics and many of our clients--AGR ratings have been found to be effective forward-looking indicators of risk. Investors and others should review information that has come out since the latest financial statements were filed, and factor that into their decisions.

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