
Integrity Risk in Europe

Greece, The Netherlands Rated Riskiest Countries

Audit Integrity recently launched ratings coverage on European companies. Over 4,000 companies in seventeen countries, representing over 80% of the total market capitalization, now have Accounting and Governance Risk (AGR[®]) ratings. As with the North America region, these ratings will be updated quarterly, and supplemented with daily news and events.

A related Insights piece, dated 28-May-2009, entitled “An Objective Look at International Financial Reporting Standards (IFRS),” provided background on the analysis and acceptability of using IFRS financial reports as the basis for AGR ratings. The conclusion was that while differences exist within Europe on the application of IFRS, the data is comparable and consistent for the calculation of AGR ratings.

A broader observation is that no matter what the accounting standards, financial reporting is always subject to manipulation and abuse. Both GAAP and IFRS standards provide a multitude of opportunities to provide misleading or fraudulent information. Identifying unusual anomalies and outliers in financial ratios is an effective approach to identifying high risk companies.

As recent events in Europe and around the world have taught us, there is a great need to scrutinize the transparency of financial reports. As discussed below under Methodology, Audit Integrity has taken the fraud framework that has proven to be effective in North America and applied it largely unchanged to Europe.

Results have been validated in two ways thus far:

1. Litigation Cases – an analysis of recent European corporate litigation cases has indicated a clear link between AGR ratings and litigation. As measured by the AGR Litigation Model, the lowest rated 10% of companies account for 60% of the litigation.
2. Equity Returns – as with North American results, low rated companies underperform the market and high rated companies outperform. For the period of 2006 – April, 2009, the spread between the best and worst rated companies (the top and bottom 10%) amounted to 7.58% per year.

These results are consistent with repeated testing and validation of North American ratings. Companies showing significant variance and volatility in key accounting and governance metrics, as a group, have much greater incidence of litigation, regulatory actions and financial restatements, and perform well below the market on equity performance.

It should be noted that the opposite is also true – companies with an absence of “red flags” consistently outperform the market and have fewer negative events. A reputation as a “trustworthy” company carries with it a multitude of benefits.

Summary of Findings

Due to the relatively recent widespread adoption of IFRS, AGR ratings can be calculated back to 2006. Based on the most recent four quarter average AGR rating, the countries rated by Audit Integrity have the following average AGR Score:

Table 1

Average AGR by Country

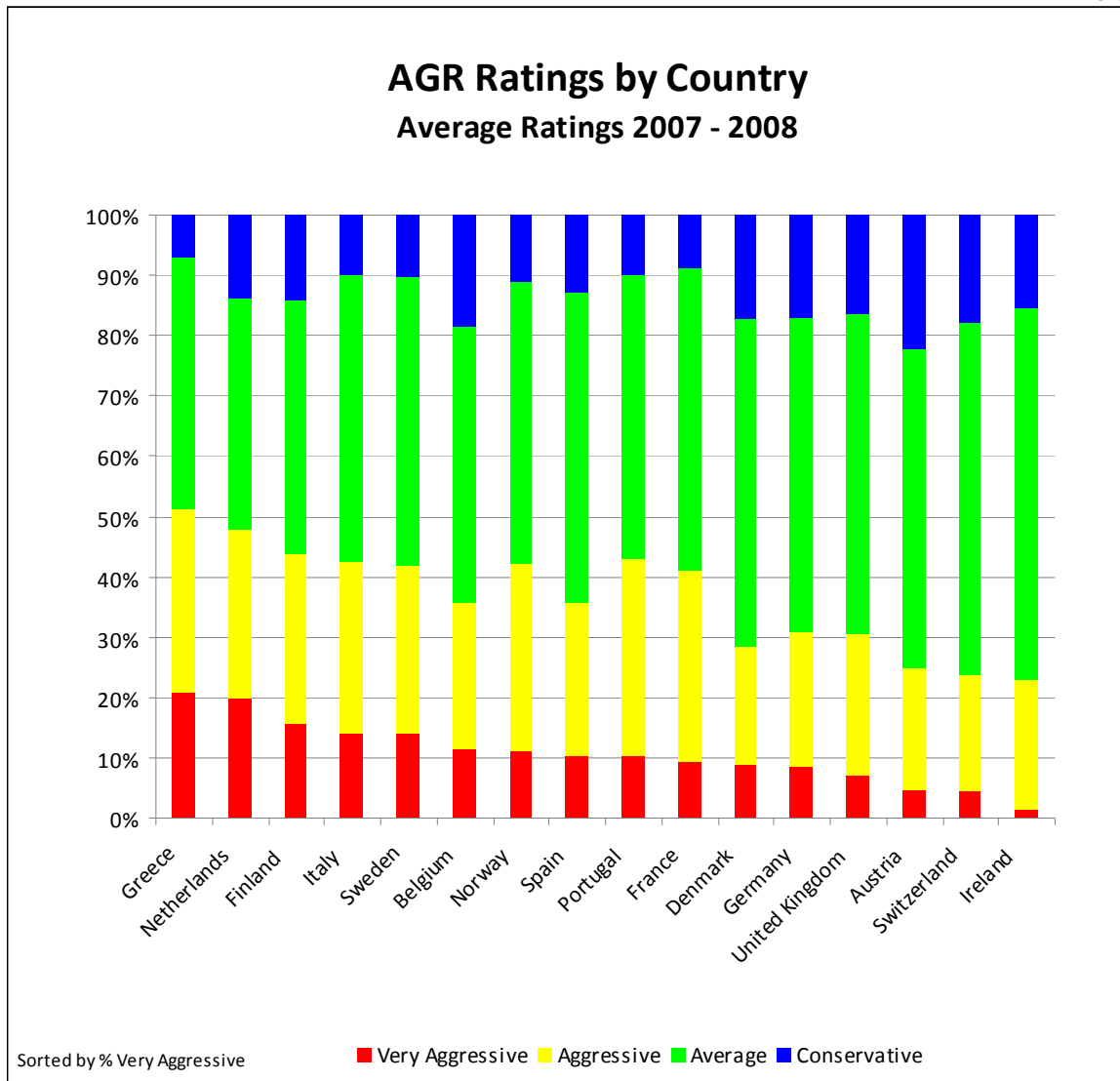
(Based on Last 4 Quarter Average AGR Score)

Country*	# of Companies	Average AGR Score
Luxembourg	23	61.5
Austria	201	59.3
Switzerland	444	58.1
Ireland	139	56.6
Germany	1,706	52.4
United Kingdom	5,620	52.3
Denmark	493	52.0
Belgium	249	50.3
Spain	366	49.4
Italy	733	47.2
France	1,392	46.6
Norway	666	46.2
Finland	477	46.2
Sweden	1,117	46.1
Portugal	123	45.2
Netherlands	355	40.7
Greece	933	38.9

* based on country where company has primary exchange listing

Distribution of AGR by country is as follows (the distribution for the entire universe by AGR Rating is – 10% Very Aggressive, 25% Aggressive, 50% Average and 15% Conservative):

Table 2



Results were similar when looking at the current quarter, most recent four quarters or the prior two year average AGR ratings. Greece and The Netherlands consistently scored the lowest. A group of companies, highlighted in yellow in Table 2 above, were grouped closely as being in a moderate risk category, while the companies highlighted in green – led by Luxembourg, Austria and Switzerland – had average or better AGR ratings.

When looking at specific industry sectors, as noted in Table 3 below, Transportation and Conglomerates (note the low number of companies included in this sector) had the lowest average AGR ratings, followed by four other sectors scoring below average – Basic Materials, Healthcare, Capital Goods and Technology. Consumer Non-Cyclical and Energy have been the least risky sectors.

Table 3
Average AGR by Sector
(Minimum Market Cap > \$50mm US\$)

Sector	Number of Companies	Average AGR Score
Consumer/Non-Cyclical	134	53.6
Energy	93	53.5
Financial	260	51.3
Utilities	74	51.1
Services	611	50.1
Consumer Cyclical	105	50.1
Technology	264	48.7
Capital Goods	272	48.7
Healthcare	150	47.5
Basic Materials	194	46.1
Conglomerates	22	44.5
Transportation	79	44.4

Table 4
Riskiest Companies by Sector - Mid and Large Capitalization Stocks
(Based on Last 4 Quarter Average AGR Score)

Sector	Company Name	Exchange	Ticker	Current AGR	Average AGR
Basic Materials	SSAB Svenskt Stal AB	STO	SSABA	1	1.00
Capital Goods	Atlas Copco AB	STO	ATCO A	3	3.25
Conglomerates	TUI AG	FRA	TUI1	6	7.50
Consumer Cyclical	Koninklijke Philips Electronics NV	AMS	PHIA	11	5.25
Consumer/Non-Cyclical	Cadbury plc	LON	CBRY	3	2.00
Energy	BP plc	LON	BP.	13	10.50
Financial	Deutsche Boerse AG	ETR	DB1	1	1.00
Healthcare	ALAPIS S.A.	ATH	ALAPIS	6	3.75
Services	Vodafone Group plc	LON	VOD	2	1.75
Technology	Nokia Oyj	HEL	NOK1V	4	2.25
Transportation	FirstGroup plc	LON	FGP	11	7.00
Utilities	Scottish and Southern Energy plc	LON	SSE	1	2.50

A list of the lowest rated companies by sector is included as Attachment A, and summarized above in Table 4. These are the companies that have exhibited the riskiest accounting and governance behavior over the past year. As noted above, and based on prior experience, these are companies that are more likely to suffer from negative events such as regulatory actions, litigation and negative stock returns.

Methodology

Given differences between U.S. GAAP and IFRS, which are discussed in greater detail in the related IFRS Insight paper, the Audit Integrity database segregates companies in the European countries into their own region, and peer comparisons for the European companies are restricted to those within this region. Coverage has been initiated on the 17 European countries in the MSCI EAFE Index, and comprises approximately 4,000 rated companies, the greatest proportion of which is headquartered in the United Kingdom (approximately 1,500 companies).

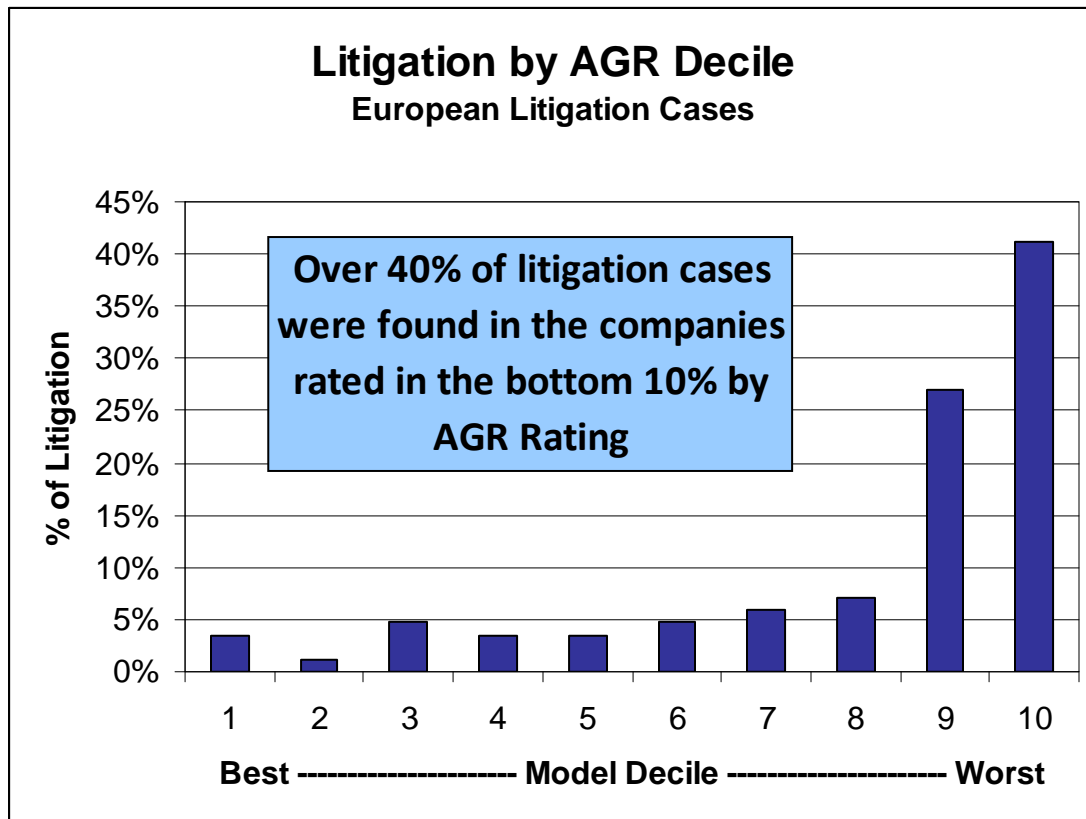
Despite a single accounting standard, reporting frequency has not yet become standard in Europe, with a large number of companies filing semi-annually rather than quarterly. Audit Integrity therefore utilizes trailing twelve month data (the 4 most recent quarterly statements, or the 2 most recent semi-annual statements), which allows for comparison of semi-annual filers and quarterly filers on equal footing, and also serves to eliminate any seasonality effects. Companies that report only annually will not be covered because the data is not robust enough for the AGR model.

Both the European and North American regions are separately partitioned into AGR rating categories on the basis of the same percentile cutoff points referred to earlier; with the lowest 10% of rated companies receiving the Very Aggressive designation. These ratings are established at the universe level including all companies in all industry categories. The pre-defined AGR categories are: Very Aggressive (indicating possibility of malfeasance or obfuscation), Conservative (exhibiting transparent accounting), and Average and Aggressive (representing the middle zone).

Validation

While the European market does not provide as robust a validation set as in the North American market – where regulatory actions, litigation cases and financial restatements are easier to track – there is nevertheless evidence that AGR ratings provide an effective measure of corporate risk.

On a stand alone basis, the AGR rating identifies potential litigation risk, as illustrated in the following chart:

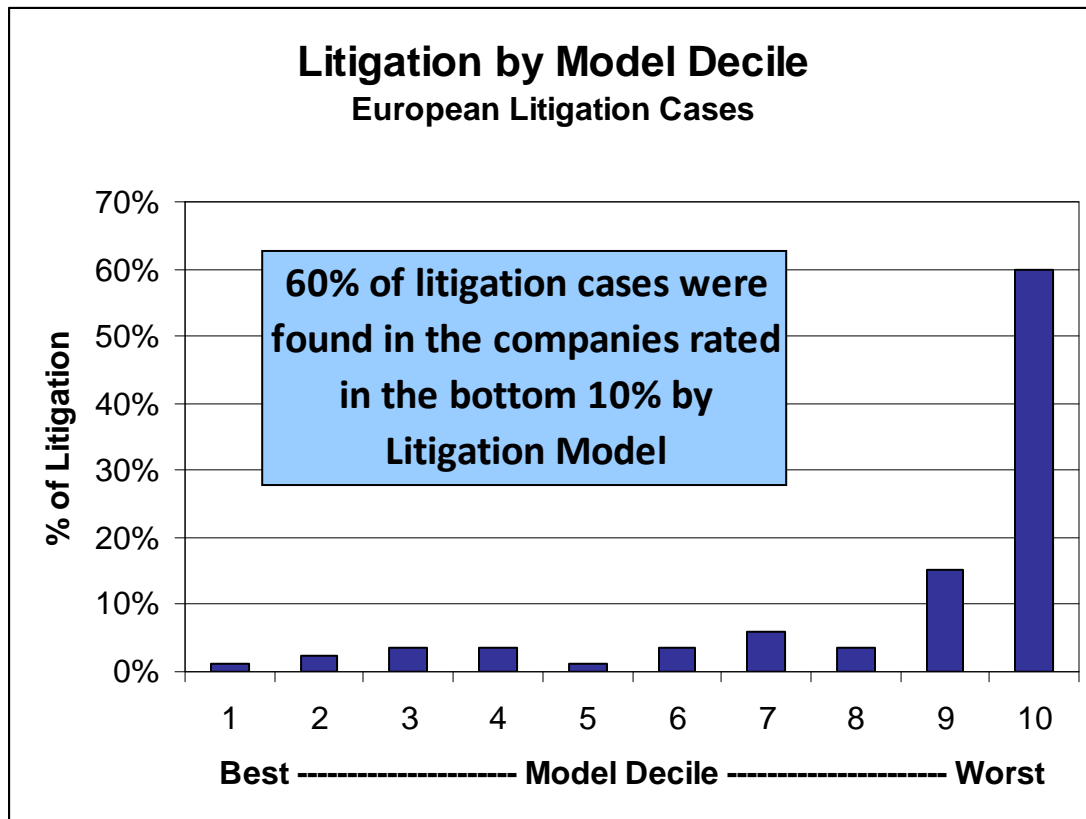


The AGR Litigation Model adds additional factors, including company size, industry and recent stock performance to provide a model designed to provide the greatest predictivity in litigation risk, the AGR Litigation Model.

In order to conduct this analysis, Audit Integrity reviewed litigation cases in Europe and created a data set for testing. The European litigation validation data set contains litigation or regulatory actions brought against the company between January, 2005 and March, 2009 for other than contract disputes. Each case was reviewed manually for inclusion.

These cases include issues related to competition, antitrust, and price-fixing, as well as ownership issues including mergers and divestitures. They also include broad ranging areas such as general allegations of fraud, self-dealing, false and misleading statements, financial statement manipulation, insider trading, and other violations of Securities laws.

For the corporate litigation cases identified in this initial analysis, the AGR Litigation Model was highly predictive of litigation risk, with the lowest rated 10% of companies accounting for 60% of the litigation cases, as illustrated in the following chart:



Equity returns exhibit a pattern consistent with what has been seen in the North American market – low rated companies underperform, high rated companies outperform. While there is not as much back test history available as in the North American market, due to the relatively recent adoption of IFRS, the results since the start of 2006 show impressive results, as shown in the chart below.

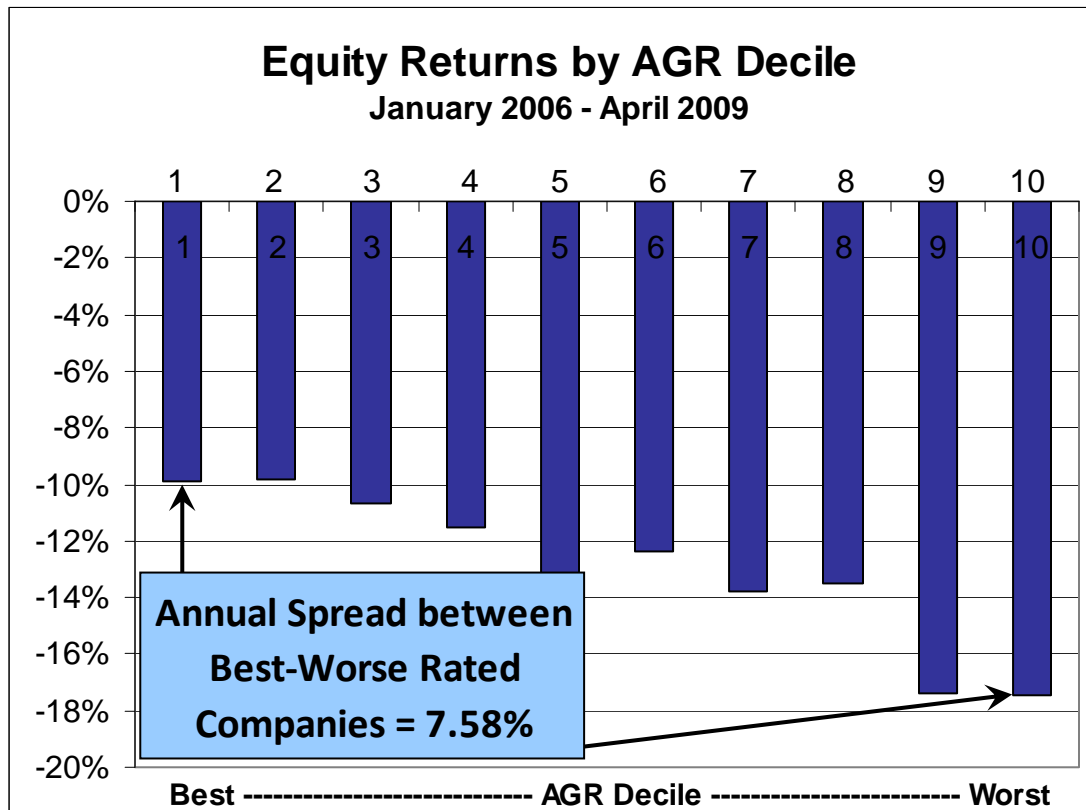
The overall results show a difference, or spread, between the highest and lowest rated companies of 7.58% annually. The results are consistent across different market capitalization ranges, with large cap (> US\$5 billion) having a less pronounced spread.

By industry sector, the best performing sectors include Services, Technology and Health Care.

Note that the average annual returns in for this time period are negative due to the severe underperformance in 2008.

These results are consistent with extensive back testing done of U.S. companies. The AGR rating has proven to be a significant indicator of equity risk, and has performed particularly well in down or volatile markets.

Additional research on equity returns performance can be found at www.auditintegrity.com.



As additional validation sets become available, Audit Integrity will continue to verify the effectiveness of the AGR ratings. What is evident in the initial testing is that the basic premise holds – fraud is fraud, and the methods for identifying companies at risk due to a lack of transparency in accounting and governance disclosure can be applied across regions.

Significant variance from industry averages and volatility in key forensic and governance metrics are warning signs that should be heeded and are indicative that further research is warranted on the low rated companies to evaluate more fully the potential for fraud and abuse, and the resultant higher risk for litigation and other negative events that impact corporate value.

Audit Integrity has begun work on additional regional coverage, and will keep our clients apprised of progress in this area.

The Audit Integrity Accounting & Governance Risk (AGR®) Model

Audit Integrity is the leading provider of accounting and governance risk analysis on public companies. Through the forensic study of the factors behind fraud, Audit Integrity proprietary modeling effectively detects and measures fraud and transparency-related risks in more than 12,000 publicly traded corporations.

The proprietary Accounting & Governance Risk (AGR) rating is a measure of corporate integrity based on forensic accounting and corporate governance metrics, and is an indicator of aggressive corporate behavior which can put stakeholders at risk. The AGR Score is based on a quantitative model which weights specific accounting and governance metrics derived from corporate reporting. The score ranges from 0 to 100, with lower scores indicating higher risk.



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Riskiest Companies by Sector - Mid and Large Capitalization Stocks
(Based on Last 4 Quarter Average AGR Score)

Sector	Company Name	Exchange	Ticker	Current AGR	Average AGR
Basic Materials	SSAB Svenskt Stal AB	STO	SSABA	1	1.00
Basic Materials	ArcelorMittal	AMS	MT	5	2.50
Basic Materials	Outokumpu Oyj	HEL	OUT1V	8	3.75
Basic Materials	Trelleborg AB	STO	TREL B	8	4.00
Basic Materials	Arkema SA	EPA	AKE	6	4.25
Capital Goods	Atlas Copco AB	STO	ATCO A	3	3.25
Capital Goods	OC Oerlikon Corporation AG Pfaeffikon	VTX	OERL	5	3.75
Capital Goods	ARCADIS NV	AMS	ARCAD	10	5.00
Capital Goods	ACS Activ. de Construc. y Servicios SA	MCE	ACS	2	5.75
Capital Goods	Titan Cement Company S.A.	ATH	TITK	4	5.75
Conglomerates	TUI AG	FRA	TUI1	6	7.50
Conglomerates	Siemens AG	FRA	SIE	3	7.75
Conglomerates	Deutsche Post AG	FRA	DPW	8	31.75
Conglomerates	Hexagon AB	STO	HEXA B	13	38.75
Consumer Cyclical	Koninklijke Philips Electronics NV	AMS	PHIA	11	5.25
Consumer Cyclical	RHJ International SA	EBR	RHJI	9	11.00
Consumer Cyclical	Husqvarna AB	STO	HUSQ B	14	11.50
Consumer Cyclical	Fiat SpA	BIT	F	12	12.00
Consumer/Non-Cyclical	Cadbury plc	LON	CBRY	3	2.00
Consumer/Non-Cyclical	Vilmorin & Cie SA	EPA	RIN	1	3.75
Consumer/Non-Cyclical	Carlsberg A/S	CPH	CARLB	6	5.75
Consumer/Non-Cyclical	Unilever N.V.	AMS	UNA	13	9.00
Consumer/Non-Cyclical	Pernod Ricard SA	EPA	RI	5	9.25
Energy	BP plc	LON	BP	13	10.50
Energy	Maurel & Prom	EPA	MAU	12	11.00
Energy	Cairn Energy PLC	LON	CNE	10	31.50
Energy	Galp Energia SGPS SA	ELI	GALP	3	33.25
Energy	BG Group plc	LON	BG	7	61.00
Financial	Deutsche Boerse AG	ETR	DB1	1	1.00
Financial	KBC Groep NV	EBR	KBC	1	1.25
Financial	Intesa Sanpaolo SpA	BIT	ISP	1	1.50
Financial	SNS Reaal NV	AMS	SR	3	2.00
Financial	Allianz SE	FRA	ALV	4	2.25
Healthcare	ALAPIS S.A.	ATH	ALAPIS	6	3.75
Healthcare	Galenica AG	SWF	GALN	6	5.25
Healthcare	Hygeia Diagnostic & Therapeutic Center	ATH	HYGEIA	8	5.75
Healthcare	Novartis AG	VTX	NOVN	4	10.00
Healthcare	GlaxoSmithKline plc	LON	GSK	8	12.75
Services	Vodafone Group plc	LON	VOD	2	1.75
Services	Thomas Cook Group plc	LON	TCG	3	1.75
Services	IVG Immobilien AG	FRA	IVG	3	3.00
Services	Securitas AB	STO	SECU B	1	3.50
Services	KappAhl Holding AB	STO	KAHL	7	4.75
Technology	Nokia Oyj	HEL	NOK1V	4	2.25
Technology	Hellas Online S.A.	ATH	HOL	11	4.00
Technology	Experian plc	LON	EXPN	4	5.00
Technology	Intralot S.A.	ATH	INLOT	6	8.50
Technology	SolarWorld AG	FRA	SWV	9	9.00
Transportation	FirstGroup plc	LON	FGP	11	7.00
Transportation	A.P. Moeller-Maersk A/S	CPH	MARSK B	11	8.00
Transportation	BBA Aviation plc	LON	BBA	10	8.50
Transportation	Kuehne & Nagel International AG	VTX	KNIN	12	9.75
Transportation	Finnair Oyj	HEL	FIA1S	9	10.00
Utilities	Scottish and Southern Energy plc	LON	SSE	1	2.50
Utilities	National Grid plc	LON	NG	1	3.00
Utilities	E.ON AG	FRA	EOAN	2	7.75
Utilities	A2A SpA	BIT	A2A	12	17.00