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The Vantage Point of Risk and Governance

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The purpose of effective risk assessment and governance protocols is to allow an entity to prepare for potential hazards. Over one year before the recent headlines: ***"Huron Shares Plummet Amid Accounting Scandal"*** **Reuters (Mon, Aug 3)** and concomitant class action lawsuits, Audit Integrity's proprietary AGR (Accounting and Governance Risk) score for Huron Consulting began to show significant stress followed by two periods of precipitous decline. Huron's AGR, as tracked by Audit Integrity, was in the 83rd percentile in June 2006; 37th in June 2007; 27th in June 2008; and in the 3rd percentile by January 2009. This article points out a few of the early indicators unearthed by Audit Integrity's AGR.

The events at Huron Consulting serve as a model to ferret out similar potential failures. . Consider the warning signs flagged by Audit Integrity, reported in Audit Integrity's *Chairman's Corner,* September 14, 2009 and summarized below:

- At Huron the Chairman was also the CEO and this structure does not allow for a meaningful balance between the board and management of the company.
- The Chairman & CEO's total compensation was high compared to his peers.
- Huron had a high and growing ratio of Goodwill to Intangibles and hard-to-value assets. These can be easily manipulated by aggressive accounting assumptions.
- Most importantly, due to other governance and accounting red flags, Huron had an Accounting & Governance Risk (AGR®) rating of 3 on a scale of 100. That put Huron in the worst 3rd percentile of all publicly traded U.S. companies – a ranking hard to ignore.

Huron's poor cash management and loss of liquidity was visible in the AGR for 9 of the last 12 quarters. Their strained cash ratio indicated a potential inability to cover current liabilities. Unearned revenue liabilities, also a flagged metric, could indicate an attempt to manage earnings.

Mergers, while perfectly normal, can pile on risk if they are the mainstay of a company's growth strategy. Huron consistently ranked poorly for this metric for 7 of the last 12 quarters. According to Audit Integrity's *Goodwill Impairments, Part III, Insights,* August 26, 2009, "Frequent merger and acquisition activity and the potential accounting manipulations that can accompany it – goodwill included – pose dangers to stakeholders and must be monitored carefully. For Huron's four acquisitions during 2005 – 2007, acquisition-related payments that should have been expensed according to GAAP were instead booked as goodwill. Huron's resulting goodwill: $506.5 million, a whopping 65.5% of total assets. Huron's resulting net income: overstated by $56 million (or 48%) across the periods in question."

The benefits of a statistically driven approach to an entity's risk profile

Executives need a vantage point to look down the road and be alerted to risks in their business so they can adjust course in a timely way. Very often the decline has already begun, while on the surface things never looked better. The AGR serves as a tracking device that reads and analyzes publicly filed data, current at the time, indicating a problem before it metastasizes through an entire organization.

The AGR rating is based on a quantitative model which weights specific accounting and governance metrics derived from corporate reporting. It ranges from 0 to 100, with lower AGR indicating higher risk. The AGR rating is obtained by filtering corporate data through a proprietary AGR metric engine, statistically designed to identify and measure risks within a corporation's accounting and governance practices. AGR metrics are effective risk indicators as they are derived from SEC enforcement actions, making the AGR rating a true forensic assessment of corporate wellness.

Armed with all publicly available accounting and governance data for the last ten years, Audit Integrity utilizes its proprietary algorithms to analyze over 12,000 publicly traded companies in North America and Europe. Audit Integrity identifies, with statistical accuracy, which companies are:

- 10 times less likely to face SEC actions
- 5 times less likely to face securities litigation
- 4 times less likely to face bankruptcy
- Likely to have an average annual return spread ~15% greater than that of the lowest rated AGR companies

Using close to 120 metrics in the AGR model, the metrics most predictive of risks are extracted and reported upon. The score and supporting metrics are updated every quarter, sourced by public financial releases, keeping clients current on their risk profile. The advantage of AGR specific recommendations is that they are statistically proven to enhance shareholder value.

In conclusion, boards and the executive-suite are well advised to build risk, governance and control structures so they can safely steer past headlines like those above. Good governance is not a nicety - it is a necessity. After all, sustainable returns are the primary interest of directors and officers of any corporation as this is their first responsibility to shareholders.

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