

## INDUSTRY REPORT: CONSUMER DISCRETIONARY

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CONSUMER CYCLICAL EX-AUTO, SERVICES EX-GROCERY AND DRUGS

### CONSUMER SPENDING CONTRACTION AND SLOWING ECONOMY WEAKENS CONSUMER DISCRETIONARY SECTOR

The consumer discretionary sector is taking a direct hit from contracted consumer spending, which is projected to be the weakest in the third quarter 2008 since the 1991 recession, according to economists surveyed this month. Consumer spending, which accounts for 70 percent of the U.S. economy, is being confronted with higher energy costs, higher food costs, rising unemployment, and a volatile stock market. Posing a larger threat, though, are the falling home values that are continuing across the U.S. The loss of housing wealth not only reduces equity withdrawals for consumption, but is also found to have the greatest wealth effect (the link between declines in asset classes and declines in consumer spending).

Statistics, both lagging and leading, from the following agencies are not promising:

- U.S. Bureau of Economic Analysis: Real disposable personal income (DPI) decreased 1.7 percent in July, the second consecutive month of decline this year.
- Federal Reserve Board: Consumer credit card delinquencies (at insured U.S.-chartered commercial banks) increased to 4.9% for the second quarter of 2008, comparable to rates during the last two recessions of 1991 and 2001.
- The Conference Board: The Consumer Confidence Index remains at a depressed level, at 59.8 for September 2008, versus 99.8 for September 2007. The U.S. Leading Index decreased 0.5 percent in August, down 2.1 percent and 2.7 percent for YTD and TTM, respectively. Six of the ten indicators comprising the leading index were negative contributors.

Some of the resulting impact on the consumer discretionary sector:

- National Restaurant Association: 50 percent of operators reported a same-store sales decline in July, and 57 percent of operators reported a traffic decline in July, both second consecutive months of decline.
- National Retail Federation: Expectations for sales in the 2008 holiday season from November through January to rise 2.2 percent to \$470.4 billion, below the 10-year average of 4.4 percent growth for U.S. holiday sales and the slowest since 2002, when sales crept up 1.3 percent.

As with all sectors, the Consumer Discretionary sector will inevitably have some companies that handle market turmoil more transparently and responsibly than others, which ultimately will affect their respective equity returns. Audit Integrity's statistical Accounting and Governance Risk (AGR®) and Equity Factor (EQF) models utilize forensic analysis of accounting practices and corporate governance practices to identify the companies that are at both ends of the risk spectrum and help stakeholders minimize their risk.

Below, Audit Integrity presents the top-ranked and bottom-ranked groups of companies in the Consumer Discretionary sector, based on AGR ratings and Equity Factor rankings. Companies in the top-ranked Conservative AGR category with the highest Equity Factor ranking of "5" have had consistently transparent financial reporting, strong corporate governance, and as a group are expected to surpass the market over the next 3 months on a total return basis. Conversely, companies in the bottom-ranked Very Aggressive AGR category with the lowest Equity Factor ranking of "1" have had consistently opaque financial reporting, weak corporate governance, and as a group are expected to have returns inferior to the market over the next 3 months on a total return basis. For 1-year returns, companies in the top-ranked Conservative AGR and Equity Factor 5 category have been -30.7%,

versus -13.6% for companies in the bottom-ranked Very Aggressive AGR and Equity Factor 1 categories. In addition to this current demarcation in returns, we expect lower returns from the Very Aggressive AGR category, in contrast with their higher ranked Conservative peers. This leads us to conclude that the more opaque companies have managed to mask their problems to date.

#### Highest Ranked by AGR Rating

Company	Ticker	Industry	Market	Period	AGR Rating	AGR	Financial	Models			1-year
			Cap(\$m)	Ending				Score	Condition	EQ	
CarMax, Inc	KMX	Retail (Specialty)	3,451.1	5/31/2008	Conservative	82	Average	5	1	2	-27.3%
OfficeMax Incorporated	OMX	Retail (Specialty)	1,079.8	6/28/2008	Conservative	81	Average	5	2	2	-63.7%
Buffalo Wild Wings	BWLD	Restaurants	644.8	6/29/2008	Conservative	82	Strong	5	3	3	12.8%
Dover Downs Gaming & Entertainment, Inc.	DDE	Casinos & Gaming	265.6	6/30/2008	Conservative	81	Strong	5	3	2	-27.7%
Denny's Corporation	DENN	Restaurants	252.5	6/25/2008	Conservative	81	Weak	5	3	2	-32.8%
Haverty Furniture Companies, Inc.	HVT	Retail (Specialty)	250.5	6/30/2008	Conservative	82	Average	5	3	3	22.7%
Shutterfly, Inc.	SFLY	Photography	248.4	6/30/2008	Conservative	85	Weak	5	2	4	-70.7%
Einstein Noah Restaurant Group, Inc.	BAGL	Restaurants	225.5	7/1/2008	Conservative	83	Average	5	4	4	-42.3%
Luby's, Inc.	LUB	Restaurants	207.5	5/7/2008	Conservative	85	Average	5	4	4	-33.4%
Builders FirstSource, Inc.	BLDR	Retail (Home Improvement)	200.2	6/30/2008	Conservative	84	Weak	5	3	3	-44.6%

Average Return = **-30.7%**

#### Lowest Ranked by AGR Rating

Company	Ticker	Industry	Market	Period	AGR Rating	AGR	Financial	AGR Models			1-year
			Cap(\$m)	Ending				Score	Condition	EQ	
McDonald's Corporation	MCD	Restaurants	72,046.9	6/30/2008	Very Aggressive	27	Strong	1	1	1	20.3%
The Home Depot, Inc.	HD	Retail (Home Improvement)	48,915.8	8/3/2008	Very Aggressive	24	Strong	1	1	1	-19.3%
eBay Inc.	EBAY	Retail (Specialty)	29,327.7	6/30/2008	Very Aggressive	8	Average	1	1	1	-42.8%
Starbucks Corporation	SBUX	Restaurants	11,200.1	6/29/2008	Very Aggressive	23	Average	1	1	1	-44.9%
Urban Outfitters, Inc.	URBN	Retail (Apparel)	6,104.8	7/31/2008	Very Aggressive	30	Strong	1	1	1	61.1%
Tiffany & Co.	TIF	Retail (Specialty)	5,217.0	7/31/2008	Very Aggressive	29	Strong	1	1	1	-29.0%
Darden Restaurants, Inc.	DRI	Restaurants	4,248.5	5/25/2008	Very Aggressive	40	Average	1	1	1	-31.9%
Eastman Kodak Company	EK	Photography	4,057.8	6/30/2008	Very Aggressive	14	Average	1	1	1	-42.1%
Gildan Activewear Inc.	GIL	Apparel/Accessories	3,091.9	7/6/2008	Very Aggressive	31	Average	1	1	2	-36.5%
The Warnaco Group, Inc.	WRC	Apparel/Accessories	2,412.8	7/5/2008	Very Aggressive	40	Strong	1	1	3	29.1%

Average Return = **-13.6%**

The related AGR metrics are also indicative of the companies that are high risk and have opaque financial reporting in the Consumer Discretionary sector. The Corporate Governance and High Risk Events metrics are effective in building a complete picture of forensic risk, as they measure management motivation and behavior, in order to determine which companies are worthy of investor trust.

For Corporate Governance metrics, high Executive Compensation is prevalent for the riskiest companies. A substantial number of companies have been flagged for high Incentive Compensation, for both CEOs/CFOs and Other Officers. For CEO and CFO Incentive over Annual Compensation, 50% of the bottom 10 Very Aggressive AGR rated companies have been flagged, over 3.5 times the 13.8% occurrence found in the total sector. Likewise, for Other Officers Incentive over Annual Compensation, 40% of the bottom 10 Very Aggressive AGR rated companies have been flagged, over 3.5 times the 10.8% occurrence in the total sector. For High Risk Events metrics, Share Repurchases are frequently flagged. For Share Repurchases, 60% of the bottom 10 Very Aggressive AGR rated companies have been flagged, 3 times the 20% occurrence in the total sector.

<b>AGR Metrics for Corporate Governance and High Risk Events</b>	<b>% of Bottom Ten</b>	<b>% of Total Sector</b>
CEO and CFO INCENTIVE OVER ANNUAL COMPENSATION RATIO	50.0%	13.8%
<ul style="list-style-type: none"> <li>High ratio indicates that company executives have incentives toward short-term profits and stock gains over longer-term health of the company. Executives can be motivated to manipulate company books in order to boost earnings and thus increase the value of executive options.</li> </ul>		
OFFICERS INCENTIVE OVER ANNUAL COMPENSATION_RATIO	40.0%	10.8%
<ul style="list-style-type: none"> <li>High ratio indicates that company executives have incentives toward short-term profits and stock gains over longer-term health of the company. Executives can be motivated to manipulate company books in order to boost earnings and thus increase the value of executive options.</li> </ul>		
NUMBER of REPURCHASES , TTM	60.0%	20.0%
<ul style="list-style-type: none"> <li>Ofentimes reflect attempts by management to artificially give the impression of growth and boost the company's earnings per share or, alternatively, to offset earnings per share dilution associated with employee stock option programs.</li> </ul>		

Certain AGR metrics for Accounting are also common for the riskiest companies in the Consumer Discretionary sector. In particular, Prepaid Expenses, Accounts Receivables over Sales, Asset Turnover, and Deferred Income Taxes are Accounting metrics that are frequently flagged. For Prepaid Expenses over Operating Expenses, 30% of the bottom 10 Very Aggressive AGR rated companies have been flagged, almost 2 times the 15.4% occurrence in the total sector.

<b>AGR Metrics for Accounting</b>	<b>% of Bottom Ten</b>	<b>% of Total Sector</b>
PREPAID EXPENSES OVER OPERATING EXPENSES	30.0%	15.4%
<ul style="list-style-type: none"> <li>High ratio may indicate an artificial decrease in operating expenses in order to boost current earnings.</li> </ul>		
ACCOUNTS RECEIVABLE OVER SALES	30.0%	16.9%
<ul style="list-style-type: none"> <li>High ratio can signal a questionable revenues, under-reserving for uncollectible or doubtful accounts. In combination with inventory build-ups, underfunded unearned revenue accounts, or other evidence of account manipulation can in total indicate high risks of revenue recognition problems.</li> </ul>		

ASSET TURNOVER	30.0%	23.1%
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- Low ratio can indicate inefficient operations, and can adversely affect profit margins. High ratio can indicate "creative accounting" and overstated revenue recognition.

DEFERRED INCOME TAX ASSETS CURRENT OVER OPERATING EXPENSES	10.0%	6.2%
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- High ratio can be indicative of management forecasting unrealistic future earnings/losses or being aggressive in recording restructuring costs.

Revenue recognition, expense recognition, and asset-liability valuation, in combination with corporate governance and high-risk events, have verifiable value in differentiation between the relative risks of companies. Audit Integrity's AGR utilization of forensic analysis of accounting practices and corporate governance practices distinguishes between the companies of most and least risk. Companies which are forthcoming to their stakeholders will consistently have full and accurate disclosure of their financial position, with proper accounting treatment and governance practices, and are able to produce positive returns. In contrast, companies which have misled stakeholders with obfuscation and aggressive accounting and corporate governance are putting investors at substantial risk, and can result in negative returns. Notwithstanding the current market stresses, our AGR and EQF models and related AGR metrics are effectual in either the presence or absence of strained economic conditions.

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**LOWEST RANKED COMPANIES BY AGR RATING****McDonald's Corporation (MCD)**

While the restaurant industry is seeing slowing revenue growth and higher food and labor costs, McDonald's continues to perform well. Earlier this month, the hamburger chain said its worldwide same-store sales, or sales at locations open at least a year, grew 8.5 percent in August. Although higher food costs are likely to hurt margins, it is venturing (as are numerous other fast-food chains) into the higher-profit beverage market with specialty coffees products.

**Red Flags**

Corporate Number of Share Repurchases, Trailing 12 Mths  
Accounts Receivable over Sales  
Asset Turnover  
Depreciation Expense over Property, Plant and Equipment  
Average Ratio of Incentive Comp to Annual Comp of the CEO & CFO

**The Home Depot, Inc. (HD)**

As the home improvement industry has been particularly hard hit by the nation's collapsing housing market and faltering economy, the second-largest retailer in the U.S. has closed underperforming stores this year and has had declining profits for the past eight quarters. It also has begun to implement price cuts from 5% to 50% on some 1,200 items, or about 4% of its products. The company refutes analyst claims that while this may help drive traffic, it may threaten to hurt profit margins as it may spawn a price war. It maintains that its overall strategy of growing gross margin stays the same, with no effect on its gross margin or current earnings forecast. The company's chief financial officer has reiterated the caution about the home-improvement market for the remainder of 2008 and into the first half of 2009 though.

**Red Flags**

Board Chairman is also CEO  
Corporate Number of Share Repurchases, Trailing 12 Mths  
Ratio of CEO to CFO Total Compensation  
Depreciation Expense over Property, Plant and Equipment

**eBay Inc. (EBAY)**

eBay's sluggish business prospects have helped drive the company's shares down far this year. Many sellers are irritated about recent changes eBay has made in its fee structures, and have resulted in buyers and sellers gravitating to other sites. The softening consumer economy is not helping matters. With well over half of its revenue coming from outside the U.S., its financial results will be vulnerable to the recent strengthening of the U.S. dollar. Recent analyst reports include mention that eBay's business is deteriorating, with potential layoffs of 10 percent of its 15,000 employees. Its current focus on acquisitions for its classified business is the auctioneer's latest attempt to regain momentum it has lost. eBay's classifieds business, which gets revenue from listing fees and advertising, is estimated to generate between 5% and 10% of the company's \$7.7 billion in annual revenue.

**Red Flags**

Average Ratio of Incentive Comp to Annual Comp of the CEO & CFO  
Corporate Number of Share Repurchases, Trailing 12 Mths  
Asset Turnover  
Deferred Income Tax Assets Current over Operating Expenses  
Average Ratio of Incentive Comp to Annual Comp of Officers (excluding CEO & CFO)

**LOWEST RANKED COMPANIES BY AGR RATING cont'd.**
**Starbucks Corporation (SBUX)**

Starbucks has had to close about 600 of its stores, as customers cut back on expensive coffee amidst the economic downturn and lowered discretionary spending. The cutbacks have hammered earnings, with third quarter losses of \$6.7 million, or one cent per share, compared with net income of \$158.3 million, or 21 cents, for the same period a year ago. It was the first quarterly loss in 16 years as a public company. Starbucks said restructuring charges reduced third quarter earnings by about 17 cents a share. The company expects revenue to grow about 11% in fiscal 2008, but the cost of restructuring will extend into the first half of 2009.

**Red Flags**

Deferred Income Tax Assets Current over Operating Expenses  
 Board Chairman is also CEO  
 Inventory over Revenues  
 Selling General and Administrative Expenses over Operating Expenses  
 Average Ratio of Incentive Comp to Annual Comp of Officers (excluding CEO & CFO)

**Urban Outfitters, Inc. (URBN)**

Urban Outfitters' second quarter earnings beat analyst expectations, defying the downward trend of specialty apparel retailers following the overall market downturn. The apparel retailer's profit climbed 74% to \$57 million, or 33 cents and sales surged 30% to \$454.3 million, the best gain in nearly three years. In addition, Urban Outfitters improved gross profit to 41.1% of sales, from 37.3% of sales. Company-wide same-store sales jumped 13% in the second quarter.

**Red Flags**

Operating Revenues over Operating Expenses  
 Insider DandO and Employee Selling over Assets, Trailing 12 Mths  
 Depreciation Expense over Property, Plant and Equipment  
 Average Ratio of Incentive Comp to Annual Comp of Officers (excluding CEO & CFO)

**Tiffany & Co. (TIF)**

The luxury retailer reported its second-quarter profit doubled to \$80.8 million or \$0.63 per share gain, up from \$40.5 million in the prior year, with slowing domestic U.S. same-store sales mitigated by growing sales in Asia and Europe. However, the recent troubles and job layoffs on Wall Street could mean further cutbacks in luxury spending by the wealthy. Also, its New York Fifth Avenue store, which accounts for 10% of its total sales, was previously boosted by a flood of foreign tourists taking advantage of a weaker dollar, but now faces slowing tourism income from a strengthening dollar.

**Red Flags**

Ratio of CEO to CFO Total Compensation  
 Corporate Number of Share Repurchases, Trailing 12 Mths  
 Deferred Income Tax Assets Current over Operating Expenses  
 Asset Turnover  
 Average Ratio of Incentive Comp to Annual Comp of the CEO & CFO

**Darden Restaurants, Inc. (DRI)**

Darden Restaurants Inc.'s fiscal first-quarter net income fell 23% to \$82.1 million, despite an increase in revenue, amid weaker consumer spending. The midpriced sit-down restaurant sector has taken a hard hit from the fall in the economy coupled with a steep rise in food prices and soaring gasoline prices, which have forced many consumers to cut back on meals outside the home. Same-store sales declined 1% for the quarter at Darden's three major concepts (Olive Garden, Red Lobster, and LongHorn Steakhouse)

**Red Flags**

Board Chairman is also CEO  
 Corporate Number of Share Repurchases, Trailing 12 Mths  
 Asset Turnover  
 Average Ratio of Incentive Comp to Annual Comp of the CEO & CFO

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**LOWEST RANKED COMPANIES BY AGR RATING cont'd.**
**Eastman Kodak Company (EK)**

The photography and printing giant reported a second quarter profit decline of 14% to \$495 million, or \$1.62 a share, down from \$575 million, or \$2 a share, a year ago. Results reflect meager revenue growth of 1% to \$2.49 billion, up from \$2.47 billion, and soaring commodity prices for silver, aluminum and petrochemicals. Excluding various one-time items, Kodak had a loss of \$40 million, while analysts had expected it to report a small profit excluding one-time items, according to Thomson Reuters. Gross margins for the quarter decreased to 23.5%, more than a 200-basis point drop from the 26.1% in the prior year. Consumer digital sales, which Kodak has been focusing on for a company turnaround, rose 17% to \$756 million from the prior year, but the business continues to show losses, with a \$49 million loss in the second quarter.

**Red Flags**

Ratio of CEO to CFO Total Compensation  
 Goodwill over Total Assets  
 Board Chairman is also CEO  
 Corporate Number of Share Repurchases, Trailing 12 Mths  
 Average Ratio of Incentive Comp to Annual Comp of the CEO & CFO

**Gildan Activewear Inc. (GIL)**

Shares of this Canadian sportswear maker have fallen over concerns about rising operating costs due to soaring commodities prices, despite a third-quarter profit increase of 3 percent, helped by higher selling prices and volume. The company said it continues to expect earnings of \$1.45 to \$1.50 per share for fiscal 2008, with expectations that it will have to raise selling prices due to higher cotton and energy costs, plus higher prices for chemicals, dyestuffs and labor rates.

**Red Flags**

Selling General and Administrative Expenses over Operating Expenses  
 Ratio of CEO to CFO Total Compensation  
 Depreciation Expense over Property, Plant and Equipment  
 Average Ratio of Incentive Comp to Annual Comp of the CEO & CFO  
 Average Ratio of Incentive Comp to Annual Comp of Officers (excluding CEO & CFO)

**The Warnaco Group, Inc. (WRC)**

The apparel maker's fiscal second-quarter profit rose 41 percent to \$19.4 million, up from \$13.8 million, or 30 cents per share, in the same quarter last year. Results were helped by growth in its international, direct-to-consumer and Calvin Klein businesses. Excluding restructuring and tax charges, net income was 56 cents per share, compared with 29 cents per share in the year-ago period.

**Red Flags**

Deferred Income Tax Assets Current over Operating Expenses  
 Prepaid Expenses over Operating Expenses  
 Average Ratio of Incentive Comp to Annual Comp of the CEO & CFO  
 Intangible Assets over Assets

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### **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 approximately 8,000 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.*

*The AGR Equity Factor (EQF) is based solely on the AGR score, plus additional variables related to AGR persistence and volatility, to provide a better measure of equity risk than the AGR on a stand-alone basis. Extensive research has shown a clear relationship between Audit Integrity's primary risk measure, the AGR rating, and equity returns. Consistently, the lowest-rated companies underperform the market and highest-rated companies outperform. The results are consistent with prior research showing that corporate integrity, as measured by the AGR rating, is a significant factor in equity returns, with low correlation to other factors.*

*To validate the AGR Equity Factor, the model was back-tested over the time period of 1998-2007. Key findings include large and persistent equity returns spread between the highest and lowest-rated companies, with a 17.5% spread between the best and worst decile over the prior 10 years. From a quantitative modeling standpoint, the Equity Factor provides risk-adjusted, well behaved returns, as validated through key statistical measures.*



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