

ARE WE GETTING OUR MONEY'S WORTH?

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Audit Integrity recently published a report on the [Banking industry dated April 5, 2007](#), identifying ten companies with the most transparent accounting and the highest management integrity, and ten companies with the worst.

The report speaks for itself. However, in view of recent events, I feel compelled to add my two cents' (Note: not \$20,000,000!) worth.

Two recent articles, coupled with a recent earnings release from Washington Mutual, rang my bell. As shareholders, we are compensating our company managers handsomely. Are we getting our money's worth?

The two articles, appearing almost back-to-back – "Executive Pay: CEO's of Large Public Companies – More Pieces, Still a Puzzle"¹ and "Not Yet Circling Wagons"² – caught my attention.

I noted the article entitled "Executive Pay" included four of the ten companies ranked at highest risk in the Audit Integrity Banking Industry report. The table below outlines their chief executives' 2006 compensation as follows.

CEO Compensation of High-Risk Companies

<u>Company Name</u>	<u>Ticker</u>	<u>CEO</u>	<u>Cash</u>	<u>Stock</u>	<u>Options</u>	<u>Stock+Options</u>	<u>Total</u>
Capital One Financial	COF	Richard Fairbank	151,484	0	18,000,013	18,000,013	18,151,497
National City	NCC	David A. Daberko	4,536,671	1,497,678	1,176,750	2,674,428	7,211,099
Washington Mutual	WM	Kerry K. Killinger	5,575,572	8,529,143	3,983,252	12,512,395	18,087,967
Wells Fargo	WFC	Richard M. Kovacevich	10,038,521	0	16,826,149	16,826,149	26,864,670

I was surprised to find such high levels of compensation compared to the median level of \$10,000,000-plus for all big-cap executives. Not a good sign, particularly in light of substantial stock and option awards that are dependent on short-term performance. But the final straw that broke this camel's back was the quote by Wells Fargo's CEO, Mr. Kovacevich, in the *Journal* article dated April 11.

Mr. Kovacevich exclaimed, "It wouldn't be the first time our stock has been penalized out of ignorance."

That's a bold statement for a CEO who is paid \$26,000,000-plus per year by shareholders who expect to be provided fair and accurate information.

When measured by Audit Integrity's forensic testing, Wells Fargo's financial reporting shows signs of having been opaque and inconsistent. Wells Fargo's Accounting & Governance Risk (AGR[®]) rating has been Aggressive or Very Aggressive for the last seven quarters. The most recent 10-K provides little comfort; the company is repurchasing shares, increasing loans outstanding (both actions increase

¹ *The New York Times*, April 8, Section 3, Page 1

² *The Wall Street Journal*, April 11, page C1

leverage), and reducing provisions for credit losses as a percent of loans outstanding, while non-accruing loans are accelerating.

Wells Fargo continues to take on additional risk in spite of a very difficult and potentially risky environment. The full statement, from Page 38 of Wells Fargo's 2006 10-K, filed March 1, 2007, reads as follows:

"To estimate the possible range of allowance required at December 31, 2006, and the related change in provision expense, we assumed the following scenarios of a reasonably possible deterioration or improvement in loan credit quality.

Assumptions for deterioration in loan credit quality were:

- ❖ for consumer loans, an 18 basis point increase in estimated loss rates from actual 2006 loss levels, moving closer to longer term average loss rates; and
- ❖ for wholesale loans, a 30 basis point increase in estimated loss rates, moving closer to historical averages."

Maybe Mr. Kovacevich is sending a less than candid message to his company's owners. According to figures compiled by Foreclosure Radar, foreclosure sales in California neared \$2 billion in the last six months, a 264% increase. This near-record high is a far cry from "historical averages." As a shareholder, I would not be comfortable I would get my money's worth from Mr. Kovacevich's management strategy -- but at \$26,864,670 per annum, he already has!

Mr. Kovacevich is not alone. Mr. Killinger, CEO of Washington Mutual, while being paid a mere \$18,000,000-plus dollars last year, has taken a similar tack. WaMu's latest financial summary shows a substantial jump in non-performing assets quarter over quarter, with a reduced provision for loan losses. Washington Mutual's management has also decided to further leverage the company by repurchasing shares. Someone is bearing the risk of this strategy – and it's not the CEO.

By the way, the Audit Integrity report also rated the ten best companies in the Banking industry in terms of accounting transparency and governance. Including all compensation methods, their CEO's had a median total salary of \$1,276,000. These companies, for the most part, have lower total market capitalizations than those on the Ten Worst list, but their CEO's are faced with the same decisions to make, and show no signs of having compromised their companies' transparency and integrity. As an investor, I question whether a CEO should be compensated an extra \$15-\$25,000,000 per year just to keep up appearances.



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