



“The Art of Corporate Deception”

September 25, 2008

First, I have to get one thing off my chest: I actually like our Secretary of the Treasury, Henry Paulson. He is hard-working, straightforward, smart, and generous (he gives substantial time and money to The Nature Conservancy). However, in spite of his likeability, I struggle with his close connection with Goldman Sachs (NYSE:GS) and his ability to be objective as he and others work out the “bailout” of our credit failure.

Credit is derived from the Latin *credere*, which means “to believe.” Our markets are suffering a severe credit meltdown – a lack of belief. This comes as no surprise to me or my associates at Audit Integrity. As our Company name implies, we audit the integrity of public corporations. “Integrity” is defined as common honesty, basing one’s actions on an internally consistent framework of principles.

Deception, on the other hand, is the act of misrepresentation, or a misleading falsehood. The shareholders, and, for that matter, debt holders of U.S. securities have awakened to the fact that they have been deceived by the corporations whose investment products they purchased. This awakening is damaging the credit of the deceivers, but is also impacting those who have performed with integrity, including the U.S. government.

I am convinced this immediate crisis will wind itself down, though not without some pain. The question is whether, as stakeholders in corporate America, we have learned a simple lesson: that integrity is a critical factor in the success of any enterprise, and the lack of integrity will bring everyone down. So far, as we remain embroiled in the “credit” meltdown, I see no sign of enlightenment. I scanned Bloomberg.com on September 22, 2008, and it took only about five minutes to discover that deception was still alive

and well. The results made me sick to my stomach.

The first article is titled “Goldman Sachs Says It May Raise Capital to Help Acquire Assets.” Chief Financial Officer David Viniar was quoted as saying, “We will continue to look for opportunities to buy assets at what we think are good prices.” Wow. I believe Mr. Viniar would like to buy assets at good prices, but in fact, it turns out that Goldman is trying to sell assets “at good prices” and is being offered only bad prices.

In other words, Goldman is faced with two major problems – and not the bargain shopping opportunity that Mr. Viniar describes. Goldman had, as of its last SEC filing, \$78 billion of “Level 3” assets (those assets that have no liquidity and are reported using prices set by the Bank itself). This portfolio of illiquid assets is reported to be the largest held by any Investment Bank. Goldman has been desperately trying to rid itself of toxic assets and to reduce overall leverage. I am sure that Goldman is always looking for “good deals” to acquire, but for the time being, their focus is on ridding themselves of bad ones.

By the way, the need to get rid of bad assets will accelerate as Goldman morphs into a regulated bank. Their current leverage of 25 to 1 (total assets/equity) is a long way from meeting the capital requirements of current banking regulations. Leverage will have to be brought down to half the current sum to even get close, and that assumes a lot of junk will be sold along with some tasty assets. Here, too, they are experiencing a selling need rather than a buying opportunity.

The second article, also dated September 22, 2008, is titled “Paulson Debt Plan May Benefit Mostly Goldman, Morgan (Part II)” and reads,

“Goldman Sachs Group, Inc. and Morgan Stanley (NYSE:MS) may be among the biggest beneficiaries of the \$700 billion U.S. plan to buy assets from financial companies... according to Bank of America Corp.” Enter my comments on Mr. Paulson. How can we credit him with complete objectivity in choosing a course of action, given the fact that the bulk of his career was spent at Goldman Sachs and, in fact, for many years his name was synonymous with the Company?

But we're not done. The article goes on to deceive the reader even further, stating that “Bank lobbying groups today asked Congress and the U.S. Securities and Exchange Commission to suspend a rule that forces companies to put a price on difficult-to-value assets such as subprime mortgages.

“We are suggesting that the SEC issue a temporary order to negate the negative impact of the so-called fair-value rule when the economy slumps, Scott Talbott, senior vice president of government affairs at the Washington-based Financial Services Roundtable, said in an e-mail.

“Companies including American International Group Inc. (NYSE:AIG), the insurer that accepted \$85 billion in a U.S. takeover, have said the rule by the Financial Accounting Standards Board requires them to record losses they don't expect to incur. The world's largest banks and brokers have reported more than \$520 billion in asset writedowns and credit losses since last year.”

Are we, the readers, to believe that the homes we paid \$500,000 for two years ago are still worth \$500,000, although the highest offer we can obtain is only \$350,000? Given the fact that both Goldman Sachs and Morgan Stanley – Investment Banks -- have already lowered the valuations of assets they are struggling to sell, how can anyone believe that identical junk assets are worth more if held by a Commercial Bank? This raises real concerns about how these assets are to be priced

if sold to taxpayers. Any price above the actual market price would constitute a direct taxpayer subsidy of the financial entity being “bailed out.” In truth, when we talk about deception, the corporations mentioned in this Chairman's Corner pale in comparison to some of the largest banks and finance companies. Commercial Banks, at their discretion, determine the value of their own loans. Commercial Banks have far more discretion when valuing their own assets compared to Investment Banks, which still have a lot. Most Commercial Banks hold assets consisting primarily of Residential Real Estate loans, Commercial Real Estate loans, Consumer loans and Commercial loans. Commercial Banks have broad latitude regarding the pricing of these securities.

Part II of this Chairman's Corner will focus on some very creative artists in this field, including Wells Fargo (NYSE:WFC), Bank of America (NYSE:BAC), and Capital One Financial (NYSE:COF).

James A. Kaplan
CHAIRMAN

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