



Panic Reflex and More Corporate Deception

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Before continuing our discussion of corporate deception, I want to address the actions of our government in recent days.

Last July, over 1,400 wildfires were burning at once in California. That's certainly analogous to current conditions in our domestic and international financial markets. Unfortunately, as our leaders scramble to pour money on one economic blaze after another, they are missing the point that panicked moves are not inspiring confidence in the market.

The U.S. government as well as international players are tossing money around at an unprecedented rate. Given the current global meltdown, we can appreciate the necessity of a decisive response, but will these recent actions restore investor confidence or merely, like a shot of heroin, leave us desperate for more?

I note in an article from MarketWatch.com dated October 20, "Investors Fleeing Market, Their Return Uncertain," that the past few months have seen historic levels of mutual fund redemptions.

The story goes on to say that 1.8% of Equity funds have been liquidated, and over 2.5% of Bond funds. This flight is not "hot money" seeking higher returns elsewhere, but rather, long-term investors who have capitulated.

The prevailing mood of long-term investors is best summed up by a quote from a MarketWatch reader: "They say long-term investment, but is that 10 years, 20 years? I've been disappointed too many times."

I know the 'shot' feels good for a short time, but these knee-jerk reactions leave me with a sense that we have truly spun out of control. Furthermore, as the United States continues to radically take on more debt, either directly or through guarantees, how long will it be before the markets being to worry about our national solvency?

This meltdown has been long in coming. Short-term fixes have exacerbated the problem in unintended ways. In order to restore credit to the markets we need to focus on some serious long-term fixes, including:

- Better regulation;
- Improved shareholder rights;

- Higher disclosure standards;
- Vigorous prosecution of management wrongdoing; and
- Reduced compensation methods that overly reward success without punishment for failure.

The Art of Corporate Deception – Part II

In Part I of this Chairman's Corner, I focused on credibility. The word "credit" is derived from the Latin word "*credere*," which means "to believe." In Part I, I identified three companies that have been very clever in creating "credit" for themselves in spite of many factors that don't support it. One of these is Wells Fargo (NYSE: WFC).

Wells Fargo's management is the absolute master of creativity. On my frequent trips to Wall Street I hear, "Wells Fargo is a conservative company," or "Wells Fargo doesn't have the same problems as other banks." Congratulations to Wells' management – but these statements aren't true. I tick off the list:

1. Wells' Tier 1 capital is no stronger than that of other Regional Banks.
2. They have altered their accounting to mask the deterioration in non-performing loans (NPLs).
3. In spite of this attempt to conceal risk from their shareholders, Real Estate NPLs are still high and growing.
4. Wells made the same mistake in aggressively marketing ARMS, and is a leader in this declining market. They also made some very risky decisions to play in the subprime market.
5. Wells Fargo's ratio of Loan Loss Allowance over Loans is no more conservative than other banks.
6. Insiders have sold a substantial amount of stock recently at prices much higher than current prices.
7. Share Repurchases have masked the impact of Insider Selling.
8. Wells' purchase of Wachovia represents the worst of "big bath" accounting.
9. Wells Fargo has substantial latitude in determining Loan Loss Reserves for

Commercial loans. Even though this market has deteriorated substantially, no meaningful write-downs have occurred.

The list could go on, but I fear it would exhaust me and my readers.

Please don't refer to Wells Fargo as "conservative" in my presence. However, I will certainly accept the term "clever" to describe Wells Fargo.

Let's turn our attention to Bank of America (NYSE: BAC). Again, for reasons that lie outside the facts, Bank of America is considered to be "better" than its competitors. Let's look at the facts:

1. Tier 1 capital is no stronger than other Money Center Banks.
2. Bank of America is the leader in Home Equity loans, a very risky asset.
3. Bank of America's Loan Loss Allowance over Loans is not more conservative than other banks.
4. Insiders have sold a substantial amount of stock at much higher prices than the market.
5. Share Repurchases have masked the impact of insider selling.
6. Bank of America's purchase of Countrywide added substantial assets at risk to their balance sheet, as well as engaging in a "big bath" accounting.
7. Bank of America has substantial latitude in determining Loan Loss Reserves for Commercial loans. Even though this market has deteriorated substantially, no meaningful write-downs have occurred.

The patterns of Bank of America's accounting and governance, with some exceptions, appear to mirror those of Wells Fargo. In this case it is more accurate to change the description of Bank of America from "better" to "bigger," which is a factual characterization.

We at Audit Integrity have rated Wells Fargo and Bank of America as **Very Aggressive**, with Wells Fargo ranking in the fourth percentile and Bank of America ranking in the lowest 15 %. Clearly we don't share the perception of "conservative" or "better." Results reported by Audit Integrity for the last six years have

shown that facts eventually overcome perception, and the market's reaction is harsh.

Of course, in these two instances, the government has already accomplished the free market's job, and, at taxpayer's expense, has bailed Wells Fargo and Bank of America out of the mess they helped create.

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CHAIRMAN

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