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Fool on the Hill: Where Has Corporate Integrity Gone?

By Whitney Tilson

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Integrity: "Adherence to moral and ethical principles; soundness of moral character; honesty."

There are few things I value as highly as a reputation for integrity: both my own and that of the people and institutions I deal with. It's so important, yet so fragile. Such a reputation is built up over a lifetime, but can be destroyed in seconds. Just open the newspaper and look at the countless politicians, celebrities, and corporations that have had fine reputations tarnished by a moment of indiscretion.

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A smoothly functioning investment system depends on integrity: of financial statements, of corporate leaders, of lawyers, bankers, and the media. Recently, I've become increasingly distressed by the appalling breakdown of integrity in this system. I think my feelings have something to do with recently attending the **Berkshire Hathaway** (NYSE: [BRK.A](#) - [news](#)) and **Wesco** (AMEX: [WSC](#) - [news](#)) annual meetings, where I heard two exceptionally high-integrity people, Warren Buffett and Charlie Munger, talk about investing, management, and life in general for more than seven hours. (See my previous two columns for my notes on these meetings.)

It's sad that the refreshing honesty of these two men stands in such stark contrast to the excessive

promotion -- if not deception or worse -- by so many other CEOs and those in the investment business. Beyond the daily hype on Wall Street and in the media, here are a few of the things I've read about just in the past two weeks that are making my stomach turn.

Exploiting the vulnerable

When wealthy, educated people get caught up in an investment bubble and lose a lot of money -- as

many did in 1999 and 2000 -- my sympathy is limited. But those who prey on people at the other end of the spectrum are truly evil. Consider a cover story in today's *New York Times*, *Immigrants Are Targets of Investment Schemes* (free registration required), which details how unscrupulous immigrants swindled fellow countrymen out of their savings.

By itself, this is not unusual: So-called affinity fraud, according to the article, is "the second most common investment fraud in the country." But in this case, the brokers weren't from some fly-by-night operation, they were from UBS PaineWebber!

Another example of exploiting the vulnerable involves the often-notorious lending practices of many subprime mortgage lenders such as Associates First Capital, now owned by **Citigroup** (NYSE: [C](#) - [news](#)). (Consumer Reports wrote about this issue and a Treasury Under Secretary testified about it to Congress).

"Can we ever trust Wall Street again?"

That was the title of the cover story of the latest issue of *Fortune*, which has three revealing articles on:

- ⌘ The IPO con game of 1999 and 2000 ("Betrayal on Wall Street"). Excerpt: "Instead of selling shares to those willing to pay the most, Wall Street handed the underpriced stock to a privileged group of institutions that trade heavily with the investment banks." The SEC, among others, is currently investigating whether the banks illegally tied excessive brokerage commissions to allocations of hot IPOs. Friends of mine reported getting such offers, so I don't doubt the charges.
- ⌘ The fall from grace of the queen of Internet hype, Mary Meeker ("Where Mary Meeker Went Wrong"). Excerpt: "Of the 15 stocks Meeker currently covers, she has a strong buy or an outperform rating on all but two. Among the stocks she has never downgraded are **Priceline** (Nasdaq: [PCLN](#) - [news](#)), **Amazon** (Nasdaq: [AMZN](#) - [news](#)), **Yahoo** (Nasdaq: [YHOO](#) - [news](#)), and **FreeMarkets** (Nasdaq: [FMKT](#) - [news](#)) -- all of which have declined between 85% and 97% from their peak."
- ⌘ The demise of Winstar ("Hear No Risk, See No Risk, Speak No Risk"), the competitive local exchange carrier that went from a \$10 billion market cap in March 2000 to filing for bankruptcy less than a month ago. In February, Salomon Smith Barney's famed analyst Jack Grubman called the stock "severely undervalued" and reiterated his \$50 price target. CSFB's Mark Kastan maintained his \$79 price target until only 12 days before Winstar filed for bankruptcy. Meanwhile, the article exposes that **Lucent** (NYSE: [LU](#) - [news](#)) -- about which I wrote three columns last year -- was not only providing Winstar with financing to buy its equipment, but also *other companies'* equipment.

Cisco's inventory write-off and future growth projections

Cisco (Nasdaq: [CSCO](#) - [news](#)) CEO John Chambers should get an Oscar for his ability to keep a straight face as he:

- ⌘ claimed "Cisco does better during tough times;"
- ⌘ projected Cisco's return to 30% to 50% growth rates; and
- ⌘ insisted that \$2.2 billion of inventory had *no value*.

I'm particularly delighted to hear that last point, and I'm hereby making him an offer that would be illogical for him to refuse if the inventory were truly worthless: I will buy all of it, saving Cisco the storage and other costs of carrying it, for \$100. Oh, heck, make it \$1,000 -- I'm feeling generous. Something tells me my phone won't be ringing.

IBM's pension fund accounting

At the Wesco annual meeting, Charlie Munger railed against the way corporations use inflated return assumptions for their pension funds to boost current reported earnings. He specifically named **IBM** (NYSE: [IBM - news](#)), which he said recently increased its pension fund's assumed rate of return from an already-high 9% to 10% annually. If IBM and other companies were forced to lower this number to 6%, they would have to take huge charges to earnings.

IBM has used many tricks like this to keep earnings per share steadily rising over the past few years despite anemic revenue growth, one of the reasons I named the company in my column, "Stocks to Avoid." (I discussed it further in a subsequent column.) No wonder a friend of mine who manages a hedge fund -- and who has shorted the stock in the past -- called IBM "the world's biggest accounting cheater." That's a bit of hyperbole, perhaps, but not much in my opinion.

Computer Associates' never-ending shenanigans

On May 4, **Computer Associates** (NYSE: [CA - news](#)) reported that, due to a "typographical error," operating earnings per share for the year ended March 31 were \$0.16 rather than the \$0.40 the company reported in its April 16 earnings release. Oops! Maybe I'd be more inclined to believe it was an honest mistake if management hadn't:

- ✧ tried to give itself an option grant worth approximately *\$1 billion* a few years ago;
- ✧ announced an earnings shortfall in the middle of the night over the 4th of July holiday weekend last year. (Hoping no one would notice? It didn't work: The stock fell 42% the next trading day.); and
- ✧ recently changed the way it calculated its pro forma financials, which had the effect of hiding a huge decline in revenues and earnings tallied using generally accepted accounting principles.

Conclusion

Maybe I'm reading too much into a stream of anecdotes, or perhaps things have always been like this. But I sure have the feeling integrity on Wall Street and in much of corporate America has gone to hell.

My advice to investors is, first, to view Wall Street with an extremely skeptical eye and, second, to place management integrity at the top of their criteria for evaluating potential investments. If there's even a whiff of aggressive accounting or excessive promotion, don't even consider investing.

Want to learn more about avoiding poorly managed companies? Take the Fool's Evaluating Companies for Investment online seminar.

-- Whitney Tilson

Guest columnist Whitney Tilson is Managing Partner of Tilson Capital Partners, LLC, a New York City-based money management firm. He owned shares of Berkshire Hathaway and Wesco at the time of publication. Mr. Tilson appreciates your feedback at Tilson@Tilsonfunds.com. To read his previous columns for The Motley Fool and other writings, visit <http://www.tilsonfunds.com/>.

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