

Financial Sector Alerts Positioned Gradient Analytics Ahead of Pack

Alert List Included Countrywide, Novastar, Washington Mutual, Wachovia, AIG

Underlying Evidence of Impending Crisis Seen on Financial Statements As Early As 2002

FOR IMMEDIATE RELEASE

Scottsdale, AZ (October 13, 2008) — As the U.S. Administration and Congress search desperately for solutions to the biggest financial crisis since the Great Depression, Gradient Analytics said today that the magnitude of the current crisis has been greatly intensified by lax accounting, weak governance, and poor oversight.

Quality of earnings is essential to give investors, regulators, and the American public the information necessary to identify and respond to important economic developments. The current crisis was allowed to fester for several years because the results of operations reported by many firms in the financial sector bore little resemblance to economic reality.

Dr. Donn Vickrey, co-founder and Editor in Chief Gradient Analytics

Gradient has highlighted accounting chicanery at a variety of firms in the financial sector since 2002. Gradient's coverage was intensified in the second half of 2007 after observing the severe disconnection between economic reality and GAAP financial statements at a number of mortgage lenders. After highlighting the risks with renewed coverage of Washington Mutual in September 2007, on 11/07/07, Gradient explained in detail the accounting gimmicks that were being used by a number of lenders to obscure their true economic performance. (See Issue Commentary of 11/07/07 at <http://www.gradientanalytics.com/commentary.do?action=View>).

Gradient's quantitative models also warned of significant declines in the financial sector since April 2007. Despite the uptick in the market seen in both January and June 2008, Gradient warned that its models were signaling an "extreme negative bias" that portended more downward price pressure for the sector (See ViewPoint of 06/11/2008 at www.gradientanalytics.com/commentary.do?action=View)



A Review of Key Reports

American International Group (AIG)/February 2008

One of Gradient's most recent and prescient calls was on AIG. In February 2008, Vickrey was one of the first analysts, if not the first, to raise flags about AIG's ability to weather the financial storm.

(Its) 8K filing contained enough statistical jargon, numerical nonsense, and mathematical mumbo jumbo to render the message almost indecipherable. ... The bottom line is that the company violated GAAP. ... The question is: why? And are management's latest estimates reliable? And just how much is at risk?

Ten months later, the answer appears to be as much as \$200 billion, including the \$120 billion that taxpayers have had to front to keep AIG's doors open, plus a \$79 billion potential overstatement of shareholders' equity.

AIG was just the latest in a long line of warnings involving firms in the financial sector. Gradient began writing critically of lenders as early as December 2002 with a report on Washington Mutual, followed by analysis on Countrywide, H&R's Options One, NovaStar Financial and New Century.

Beginning in September 2007 Gradient significantly expanded its coverage on high-risk firms in the financial sector. These reports questioned not only their accounting methods but also their loan-loss reserves and other methods of obscuring the true extent of financial distress.

Washington Mutual/October 2002 and September 2007

As early as October 2002, Washington Mutual's problems were becoming evident. Gradient first commented on these issues in October 2002, when we observed that:

Nonperforming loans, which WM defines as loans with four or more past-due payments or doubtful collectability of interest or principal, increased nearly seven times faster than total managed loans in 2001. In fact, nonaccrual loans grew from \$840 million to \$2.325 billion — a change of more than 180% — while managed loans grew by only 26.2%. Nonaccrual loans represented 1.52% of managed loans. ... The ratio of the reserve for loan and lease losses to nonaccrual loans declined to 65% in 2000. Consequently, we believe that the value of WM's loan portfolio may be overstated on its balance sheet (by approximately \$623 million at 12/31/01.)

By September 2007, nothing had changed:

Signs of impairment are everywhere—except unfortunately on the income statement and balance sheet. Despite indicators of impairment, it does not

appear that the company has made any significant adjustments to the carrying values of these loans during 2007. We believe these factors lead to a much greater likelihood of earnings disappointment in upcoming periods.

Wachovia/November 2007 and April 2008

In November 2007, Gradient wrote of Wachovia's write-down in asset-backed securities, and how it likely portended greater losses to come:

The \$1.3 billion is a considerable sum. However, Gradient believes that it may be just the beginning of a longer period of write-downs necessary to bring these assets back down to earth....Thus, while management appears to taking the right steps, we believe that there are still significant risks to earnings over the next several quarters."

Gradient continued to cover Wachovia until just last month. In April 2008, for example, Gradient warned that:

We believe there will be more to come as the company appears to be provisioning for its loan loss account in a piecemeal fashion....The continued acceleration for charge-offs will force management to make additional increases to its provisions throughout 2008.

Countrywide/December 2003 and September 2007

Gradient first highlighted questionable accounting methods that could obscure financial results reported by Countrywide in December 2003. This report cautioned clients about the possibility of "overstated earnings" resulting from "declining allowances for the impairment of mortgage servicing rights and loan losses." Gradient also wrote that:

Our most significant concern regarding quality of earnings at CFC is the use of gain on sale accounting for securitized mortgage loans. ... While gain on sale is not highly unusual in the mortgage industry, the increasing degree to which CFC relies on securitization gains as a source of profit places the firm at much greater risk of an earnings shortfall.

Gradient continued to warn of potential accounting games at CFC, with its last warning coming in November 2007. This report highlighted concerns related to a reclassification of its loan inventory into the "held for investment" category. After taking an implausibly small write-down on the underlying loans at the time of reclassification, these loans remained on balance sheet at overly optimistic values until CFC's acquisition by Bank of America.

Changing the Accounting Rules Won't Help. Enforcing Them Will

Vickrey recently cautioned in a 10/01/08 note to clients that any movement away from fair-value accounting would open the door to more financial abuse and make it even harder for investors to trust the market.

Regulators should be investigating the cooked books and failed audits of these firms, instead of loosening the accounting standards. To do otherwise is to let those responsible for this crisis continue to act recklessly not just with money from investors but now from taxpayers as well.

(Copies of the reports and discussions with Dr. Vickrey on these companies can be obtained through the media contact below.)

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