

Fair Value Accounting: Independent Banker Article, March, 2005

By

Robert F. Muth, CFP

Principal, BankLogic.Net, CPAs & Consultants

A recent statement attributed to a member of the Financial Accounting Standards Board (FASB), that Fair Value Accounting was still on their agenda and would be vigorously pursued, prompted a look back almost fifteen years to when FASB first issued a "Proposed Statement of Financial Accounting Standards Disclosures about Market Value of Financial Instruments" dated December 31, 1990. Since then, in various "fits and starts," the Board has moved to establish a financial reporting model based upon the mostly academic mantra and impetus that historical basis accounting does not provide for the true measure of a company's worth at a specific date. While this theory has some practical basis for those entities that might be for sale or subject to merger, one must question whether: (a) "fair value" provides useful information to stakeholders for a company's continuing operation; and (b) a fair-value-based accounting system can be measured and audited with any degree of accuracy and transparency. Hence, reporting financial data using this four-times-a-year faded snapshot approach would grossly misrepresent actual performance and governance.

In the Fall 1992 issue of Bank Accounting and Finance, my article, "A Community Banker's Perspective on SFAS No. 107" was published. It reflected upon the Statement of Financial Standards entitled "Disclosures about Fair Value of Financial Instruments," and was based upon my experience in performing a field test as a member of the Financial Accounting Standards Advisory Council. It was focused primarily on the difficulty in accurately measuring the fair-value of loans and deposits. The test assumptions and processes were mainly a heuristic exercise in present value calculations, made less demanding, but more troubling, by the absence of the usual accounting demands of consistency and accurately measurable base values. Broad latitude was taken in projecting interest rate scenarios which were adapted primarily to the bank's loan and certificate-of-deposit portfolios. It was noted that slight variations in projected interest rates or duration could have a significant impact on the present values that would be used in presenting quarterly and annual financial reports to the bank's constituency of shareholders, customers and employees.

The article also pointed out that the determination of a fair value for demand deposits had been largely ignored by the FASB board even though an easily determined market value had always existed for these highly prized funds. The FASB solution was to value these deposits "at book" because, theoretically, they could all be withdrawn at one time. Short of a national panic (which would obviate any and all accounting considerations), the chances for this occurrence must be deemed highly improbable. In addition, it must be pointed out that the price for bank branch sales is primarily based upon a premium paid

for deposits. This premium has varied from 10% to 18% with the deposit mix the main determinant. Of course those banks, with a large demand deposit segment would gain immeasurably if the "fair value" scenario were properly quantified. Even though most bank mergers and purchases are reported in terms of a multiple of book value or deposits, the demand deposit premium is factored significantly into community bank merger and purchase transactions.

Subsequently, FASB directed that "Fair Values of Financial Instruments" be incorporated into the financial footnotes using the descriptive introductory statement "the estimated fair value of the Company's financial instruments are as follows:" to accurately reflect on the subjectivity in the amounts presented. In distancing themselves from any accountability for the reliability and accuracy of the data, the accounting profession has always added a lengthy disclaimer to the footnote with a statement similar to the following: "While these estimates of fair value are based on management's judgment of the most appropriate factors, there is no assurance that were the company to have disposed of such items (using the report dates), the estimated fair values would have been achieved, since market values may differ depending on various circumstances." It's hard to believe, but this is the data that FASB would recommend for financial reporting purposes.

The "preference gauge" chart reflects my personal observations as to how various stakeholders might influence and/or benefit from the concept of fair-value accounting. It should be evident that "fair-value accounting" serves only to mystify the data presentation process with its assumptive methodology and presents information that is neither "fair," due to a lack of transparency, nor of "value," due to its blatant misrepresentation of providing a timely and accurate picture of financial worth.

Send e-mail to bobmuth@banklogic.net