

## **E-Memo** **Special Edition**

**TO:** INVESTORS/MEMBERS AND FRIENDS  
**FROM:** Jon Bruss and Bob Ollech  
**DATE:** August 23, 2005  
**SUBJECT:** *Making Hay While the Sun Shines? Or Bankers Stuck between a Rock (the SEC) and a Hard Place (Accountants)?*

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When Bob was a youngster growing up in central Wisconsin's dairy country, he spent a few days each summer "bucking bales" for a local farmer. The job involved plucking hay bales from a baling machine towed by a tractor and stacking them on a wagon. It was hot and dusty work for a "city kid" but the pay was good and Bob was always invited to supper at the end of the day. The farmer's wife was a superb cook and supper always included a big slice of pie topped with an equally big scoop of ice cream. The farmer harvested and stored hay in the middle of the growing season even though his cows had plenty to eat. Why? He knew that winter would come and that his lush summer fields would soon enough be covered with snow. His goal was have plenty of "hay in the barn" to last until Spring when his herd could again forage in his pastures.

What does that have to do with banks? Not much, but it sets the stage for a discussion of what we view as counterproductive accounting rules and regulations which are increasingly leading many bankers to make short-sighted decisions with regard to loan loss reserves and earnings. We also see more than a few banks skimping on reserves in order to report higher earnings, at a time when they should be thinking about preparing for tougher credit conditions that almost certainly lie ahead. Those are topics that directly affect bank stock prices, so we pay attention.

Since many of our readers are not bankers, here is a quick review of how banks account for loans and loan loss reserves. Banks gather deposits and lend them out to businesses and individuals. Most of those loans are repaid, but some inevitably go bad. Accordingly, banks create a contra-asset account on their balance sheets called *reserve for loan losses*. In theory, this *reserve*, or valuation allowance, is equal to the amount of loans that would be uncollectible if the loan portfolio were liquidated. On the balance sheet, it is deducted from total loans. Banks add to reserves by expensing amounts from earnings; when a loan goes bad it is "charged-off" and the reserve is reduced. When we were regulating and running banks, banks added to their reserves at a steady pace, which resulted in rising reserves when the economy was humming and loan losses were low and a drawdown of reserves when credit quality declined and losses mounted. Over the course of an economic cycle, everything worked out and the SEC and accountants were content.

Over the past few years (including the last few years of our stint at owning and managing banks), the SEC has taken a hard line on "earnings management," the practice by some companies of manipulating earnings to meet Wall Streets' forecasts. As any CFO could tell you, there are many ways to maneuver the components of earnings to arrive at the desired "number" each quarter (in fact we know a CFO at one publicly traded and well-respected manufacturing company who, when asked by his CEO where earnings would be for the quarter, replied, "Well Mr. Blank, where do you need them to be?"). Some of the most common methods include deferring or capitalizing expenses, accelerating recognition of revenues or creating special accounting reserves when an acquisition is made and then recapturing amounts from those reserves in future periods. Financial analysts liken these techniques to a cookie jar wherein company CFOs take out a "cookie" or two when operating earnings fall short of projections and putting back a few cookies when earnings are running ahead of expectations. WorldCom, Enron and a host of other companies used these techniques to manage their reported earnings to meet Wall Street's expectations and the stock market, at least temporarily, rewarded them with higher stock prices (until it became evident that some CFOs were not just "managing" earnings, but were actually making them up). Thanks to the SEC and New York's gadfly attorney general, Elliot Spitzer, this practice is less common today, which might also have something to do with the aversion of CFOs to spending time in a small room with bars on the doors and windows.

Major accounting firms, still smarting from scandals of their own, have kowtowed to the SEC, carrying their interpretation of what constitutes earnings management to the extreme, at least when it comes to banks. This has caused fits for many bankers, most of whom are trying to prudently manage their loan portfolios and related reserves. These bankers, relying on their analysis of credit trends and their experience over previous credit cycles (the memories of which, for some, are

quite painful), often want to build and maintain reserves at a level greater than current loan loss rates might suggest is needed. Their accountants, however, are increasingly likely to view the building of loan loss reserves as manipulating earnings and want to stamp out the practice!! We are all for accounting transparency and accurate financial reporting, but we think banks deserve a bit of a break from the “new” rules due to the nature of their business. In an ideal world, if there were any loan losses at all, they would come along in a certain and predictable fashion each quarter. The world isn't perfect, of course, and loan losses are notoriously “lumpy” rather than predictable. Smart bankers know that tomorrow's bad loans are made in today's good times and that the time to build reserves is when credit quality is good and the economy is strong - in essence putting up hay while the sun shines. They know that when the economy turns south, losses will rise. Better they believe, like Bob's farmer friend, to have a barn full of hay (at least figuratively) when winter inevitably comes. The SEC and accountants say that this practice distorts earnings. It is more accurate, they think, if reserves are allowed to dwindle when losses are low and are then rebuilt when losses rise. To us, that is a short-term, backward-looking view which simply adds to the volatility of earnings and distorts results.

We think this stance is silly (in fact, were we not so polite, we might give it the term commonly used to describe a waste byproduct of the farmer's cattle) and discourages bankers from making prudent decisions. We've heard more than a few bankers complain that their accountants “wouldn't let them” add to reserves unless higher loan losses were imminent. Those same accountants have also demanded that “excess reserves” be recaptured into earnings, if loan losses are lower than expected. Letting the bean counters dictate management policy decisions strikes us as foolish, but we see it happen more frequently than we'd like. We like conservatism and consistency from the banks in which we invest our client's money. And we also like bankers with the backbone to do what makes sense.

To bankers, we say, manage your accounting firm; don't let it manage your bank. Policy decisions belong with your bank's board and senior management, not your accounting firm. Your loan portfolio may be performing well now and your losses may be low, but before you give yourself too much credit, remember that the wind has been at your back. The pristine credit quality measures that the banking industry is currently enjoying are, according to the FDIC, the best the industry has experienced in 22 years. This is the time to weed through your loan portfolios, turning out the marginal credits while there are still plenty of “greater fools” at other banks who are ready and willing to take them off your hands. And this is the time to critically evaluate the adequacy of your loan loss reserves. To those bankers who have relied on low loan loss provisions to boost your quarterly earnings, we and the rest of the bank investor community can read your results and gauge the quality of your earnings (which, in case you were wondering, helps to explain why your stock trades at a lower earnings multiple than the stock of your more prudent peers).

To the staff of SEC and to partners at public accounting firms, recognize that banks are cyclical businesses, but also realize that they are different from manufacturers and service companies. Loans and related reserves must be managed prospectively and experienced bankers are in the best position to evaluate the need to build reserves, even when loan losses are low. Prudently adding to reserves when times are good is not manipulating earnings, it's common sense.

So where do the banks in which we invest stand with regard to loan loss reserves? There are a few with reserve levels that are less than what we'd like to see (we'd like reserves equal to 1.5% of loans and at least two times the total of non-performing loans), but, in aggregate, our banks' reserve levels are comparable with the broader universe of banks. Where our banks have excelled is in controlling the volume of nonperforming loans and minimizing loan losses, not just recently, but over an extended period of time. We are nothing if not consistent in the analysis of key risk indicators in banks. We remain strongly focused in credit risks and the adequacy of reserves and capital, just like the managers of the banks in which we invest.

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