The Impact of Statement No. 91 on Financial Reports of Financial Institutions

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Abstract

SFAS No. 91 restricted the previously acceptable methods of accounting for loan origination fees and costs to the deferral method. The purpose of this paper is to discuss the provisions of SFAS No. 91 and examine its impact on financial reports of affected entities. We analyzed a sample of 90 financial institutions' annual reports. Our examination reveals that the majority of studied entities did not experience material impacts in their financial reports as a result of compliance with the provisions of SFAS No. 91.

Introduction

Business newspapers, professional accounting journals, newsletters, and newlines make frequent references to the growing concern for savings and loan associations, and financial institutions. Financial problems and failures in financial institutions, especially savings and loan associations, are no longer considered unique, [Farrel,1989; Croket,1988]. In the early 1980s, financial deregulation and the high interest rates forced financial institutions to pay market interest rates for their savings. To minimize the effect on net income, the practice of charging origination and loan commitment fees has become common among financial institutions,[Hill and Ingram,1989].

In December 1986, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 91: "Accounting for Non-refundable Fees and Costs Associated with Originating and Acquiring Loans and Initial Direct Costs of Leases." The Statement restricted the previously acceptable methods of accounting for loan origination fees and costs to the deferral method. Although, SFAS No. 91 led to better uniformity and consistency in financial reporting of entities, it has generated widespread interest and criticism. Critics of SFAS No. 91 have pointed out its failure to properly reflect the

economic substance of many types of credit transactions and its significant adverse impact on the reported earnings of financial institutions [Soroosh,1985; Ellis,1987; Remic,1987; and Krasnoff, 1987].

Because SFAS No. 91 requires a substantial accounting change and new disclosure, it has been impossible to predict exactly how its initial application would affect the income statements and balance sheets of financial institutions. Since, financial institutions have already adopted and implemented SFAS No. 91 for their fiscal years beginning on or after December 15, 1987, it is now possible to assess the impact of the Statement on the financial reports of affected financial institutions. Our paper addresses several aspects of the possible relationship between SFAS No. 91 and its economic effects. We will discuss the provisions of SFAS No. 91 and examine the impact of its implementation on financial reporting of financial institutions.

Provisions of SFAS No. 91

SFAS No. 91 deals with the timing of revenue and expense recognition and the balance sheet classification of any deferred fees and costs. It

attempts to provide uniformity and consistency in accounting and reporting for non-refundable fees and costs associated with lending activities and loan purchases. According to the Statement, recognition of all non-refundable fees in the year of acquisition is no longer acceptable. These fees and related costs should be deferred and subsequently recognized. The FASB set forth the following guidelines in SFAS No. 91, [FASB,1986,paras. 4-10].

1. Loan origination fees are considered to be an integral part of the overall lending process and, accordingly, they should be deferred and recognized as an adjustment of yield over the contractual life of the loan, using the effective interest rate method. These fees include all nonrefundable fees regardless of their descriptions such as application fees, points, and fees for placement, arrangement, and management.

2. Loan commitment fees generally are to be deferred and recognized over the lives of related loans, using the interest rate method. There are two exceptions to this rule. First, when the probability of exercising the commitment is remote, based on historical experience (e.g., standby letters of credit), the fee should be recognized over the commitment period, using straight-line method. The second exception is for commitment fees determined retroactively as a percentage of the unused line of credit. These fees should be recognized as income immediately at the determination date.

3. Direct loan origination costs are to be deferred and amortized as a reduction of the loan's yield over the contractual life of the loan. Direct loan origination costs generally include incremental direct costs incurred in transactions with independent third parties. These costs also cover certain costs directly related to specified activities performed by the lender such as costs of evaluating borrower's financial condition, collateral, security arrangements.

4. Direct costs of unsuccessful loans and all indirect lending related costs are to be expensed as incurred. These costs are for activities such as

advertising, soliciting potential borrowers, supervision, and administration.

5. The loan-by-loan basis of accounting for fees and costs is required. However, the aggregation and portfolio estimation is permitted if an institution maintains a significant number of homogeneous loans for which principal prepayments can reasonably be estimated.

6. The contractual life of the loan should be used in determining the periodic amortization of deferred fees and costs. Expected loan prepayments should not be utilized in the calculation of the average life for the purpose of shortening the life of the loan.

Profile of Financial Institutions

SFAS No. 91 considers that all lending activities are the same, regardless of the type of loan or the type of financial institutions lending the funds. Thus, the Statement should have its greatest impact on savings and loan associations, banks, financial companies, credit unions, mortgage bankers, insurance companies, and leasing companies. However, since the Statement also applies to purchased loans, debt securities, syndication of loans, and leasing transactions, many companies other than traditional financial institutions may be affected.

We analyzed a sample of 90 financial institutions' Annual Reports for their fiscal years ended December 1987 and 1988. Exhibit 1 presents information regarding the size and relative importance of total loans, deposits and loan fees. Two measures of size are reported: total revenues and total Assets. The relative importance of loans, deposits and fees was measured by the proportion of loans, deposits, and fees to total assets and revenues. From the information in exhibit 1, studied financial institutions vary not only in size, but also in relation to the proportion of fee income reported. Exhibit 2 compares net fees for two years of 1987 and 1988 in the form of mean, standard deviation, maximum, and minimum. It shows, on average, a 12 percent reduction in net

Exhibit 1
Size Characteristics of Studied Entities*

	<u>Total Assets</u>	<u>Total Revenues</u>	<u>Loan/ T.Assets</u>	<u>Deposits/ T. Assets</u>	<u>Fees/ T.Rev.</u>	<u>Fees/ Loan Int.</u>
Mean	\$8294	\$1056	.7093	.7971	.0124	.0139
STD	29105	4175	.1298	.1364	.0244	.0272
Maximum	207666	32024	.9448	.9473	.1079	.1184
Minimum	5.2	.52	.2012	.0426	.0000	.0000

* Non-ratio items are in millions of dollars.

Exhibit 2

Comparison of Loan Fees before and after
Adoption of SFAS No. 91

Panel A: Net Fees*

	<u>1987</u>	<u>1988</u>	<u>% of Change</u>
Mean	\$44.75	\$39.58	-12
Standard Deviation	188.31	170.50	- 9
Maximum	927	856	- 8
Minimum	-.01	0	-

* In millions of dollars.

Panel B: Fees/ Total Revenues

	<u>1987</u>	<u>1988</u>	<u>% of Change</u>
Mean	.0151	.0124	-18.0
Standard Deviation	.0261	.0244	- 6.5
Maximum	.1082	.1078	- .36
Minimum	.0000	.0000	-

Panel C: Fees/ Loan Interest Income.

	<u>1987</u>	<u>1988</u>	<u>% of Change</u>
Mean	-.0177	-.0139	-21.0
Standard Deviation	-.0304	-.0272	-10.5
Maximum	-.1219	-.1184	- 2.9
Minimum	.0000	.0000	-

fees from 1987 to 1988. Although this reduction may not be significant for the studied financial institutions, it has an inverse relationship to growth of firms. Obviously, studied entities did not collect lower fees, rather they did not recognize all collected fees as revenue or the fees were offsetted against incurred origination and commitment costs as required by SFAS No. 91.

Timing of Adopting SFAS No. 91

SFAS No. 91 is applicable for entities with fiscal years beginning after December 15, 1987 and should be adopted for interim periods within those fiscal years. The affected companies are allowed to adopt the Statement either retroactively (restating prior years) or prospectively (dealing with the current period), however, the Board encouraged for both early and retroactive adoption. Those who criticized the Statement have argued that implementation of provisions of the Statement would lower earnings for many financial institutions at least for the first few years of the adoption, [FASB, 1986, para. 31]. For example, the Board had received 822 letters from individuals and entities criticized the Statement. We reviewed those letters and found that most of them lobbied against the issuance of SFAS No. 91. Therefore, one might argue that firms which anticipated negative impact might be more inclined to adopt the Statement earlier rather than later. As a result, we expected to see a greater proportion of studied financial institutions do not attempt early adoption. As Exhibit 3 shows, this is supported by the data, seven of analyzed financial institutions adopted the

Statement early than it was mandatory by the FASB and only eight firms adopted retroactively.

In making decision regarding whether retroactive or prospective application would be more appropriate, management should consider the advantages and disadvantages of each method. Prospective method may be less costly and time consuming than retroactive application. On the other hand, retroactive restatement will achieve consistency and comparability of financial statements that may be impaired under the prospective method. Also, entities electing to retroactively apply SFAS No. 91 should maintain a sophisticated accounting information system to generate the data necessary for retroactive implementation. More than 90 percent of examined entities implemented the Statement prospectively. The majority of the eight entities that chose retroactive restatement were the largest savings and loan associations (those in the top 20 percent in the sample in terms of size and capital). This indicates that large financial institutions with sophisticated computerized accounting information systems are in a better position to mitigate the possible negative impact of SFAS No. 91 on their earnings and capital levels by spreading the effect over several years application.

Financial Statement Disclosure

We examined four areas of the annual reports for information about the implementation of SFAS No. 91. They are the Management's Discussion, Significant Accounting Policies in the footnotes,

Exhibit 3

Timing of the Adoption of SFAS No. 91

<u>Type and Year of Adoption</u>		<u>Number of Firms</u>	<u>Percentages</u>
Prospective	1987	6	6.7
Retroactive	1987	1	1.1
Prospective	1988	67	74.4
Retroactive	1988	7	7.8
No indication of adoption		9	10.0
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Total		90	100.0

additional footnotes about new accounting changes, and the financial statements. We ranked each annual report by the quantity and quality of the information disclosure pertaining to the Statement from (1) to (5). When (1) representing no mention of SFAS No. 91 in the annual reports, (2) indicating inadequate or a brief mention of SFAS No. 91, (3) reflecting a restatement of the policy, (4) indicating a restatement along with an analysis of the impact on earnings, and (5) reflecting the calculation of actual impact on financial statements illustrated by supporting tables and schedules. Financial institutions classified under category (5) are those that made comparison between the provisions of SFAS No. 91 and their current practices and, accordingly, modified their existing accounting information systems to comply with the provisions of the Statement. The majority of entities that adopted the Statement retroactively fell in this category.

Exhibit 4 shows that 10 percent of financial institutions in the sample of 90 did not mention anything about SFAS No. 91 in their 1987 or 1988 annual reports. Almost fifty percent made inadequate or brief mention of SFAS No. 91, without any calculations of the possible impact of

the Statement on their consolidated financial statements. About 25 percent of studied entities restated their accounting policy to reflect the provisions of SFAS No. 91. Over 5 percent of companies not only restated their policy but also presented some analysis of the impact of the provisions of SFAS No. 91 on their financial statements. Over 10 percent disclosed sufficient descriptions of the new Statement, presented separate footnotes disclosure for change in their accounting policies, and modified their existing accounting information systems to comply with the provisions of SFAS No. 91. Also, they presented separate tables disclosing the dollar amounts of both origination and commitment fees and costs.

Reported Impact of the Statement

Analysis of the disclosures and financial reporting effects of SFAS No. 91 on financial institutions will provide a basis for evaluating economic consequences of the Statement. The entities that chose to apply the Statement early on would be the ones that were favorably or less adversely affected by the provisions of SFAS No. 91. We classified the reported impact in to four categories: (I) no material effect on net earnings; (II) a negative but

Exhibit 4

Ranking

<u>Quality of Disclosure</u>	<u>Number of Firms</u>	<u>Percentages</u>
1	9	10.0
2	46	51.2
3	22	24.4
4	5	5.6
5	8	8.8
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Total	90	100.0

Where:

1. No indication of the adoption of SFAS No. 91.
2. Inadequate or a brief note on the adoption of the Statement.
3. Note on the adoption and restatement of the accounting policy.
4. Note on the adoption along with disclosure of its impact on earnings.
5. Disclosure of the adoption and detailed analysis of its impact on financial statements supported by tables and schedules.

Exhibit 5

<u>Degree and Type of the Impact on Earnings</u>	<u>Number of Firms</u>	<u>%</u>
I. No material impact on earnings	35	38.9
II. Negative but low impact on earnings	32	35.6
III. Negative but high Impact on earnings	11	12.2
IV. Positive Effect on earnings	3	3.3
V. No Indication of Adoption	9	10.0
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Total	90	100.0

immaterial impact on earnings; (III) a significant negative impact on earnings; (IV) a positive impact on earnings, and (V) no indication of adoption, (see Exhibit 5).

Exhibit 5 shows that about 40 percent of studied entities indicated that the implementation of SFAS No. 91 had no material impact on their reported net earnings. More than 70 percent of the financial institutions in this category stated that they were in compliance with the provisions of SFAS No. 91 prior to its issuance. Thus, they had substantially the same accounting system in place and the new Statement did not require any major accounting changes. Further examination reveals that the magnitude of loan fees for the remaining firms in this group, on average, was less than one percent of the total reported revenue and, accordingly, was considered immaterial and not cost/beneficial to implement the statement. Almost 33 percent of studied financial institutions indicated that the implementation of SFAS No. 91 had some negative impact on their reported earnings. However, a substantial number of their loans were adjustable rate mortgages that have lessened the impact of the statement. Over 12 percent of the sample presented a significant negative impact of the Statement on their reported earnings, especially in the first year of adoption. For example, one of the studied financial institution stated that the implementation of SFAS No. 91 has decreased fee income by 40 percent. Only 3 financial institutions in the sample of 90 had a positive effect of the adoption of SFAS No. 91 on their reported earnings. These entities had little fee income and high direct costs and had elected to apply SFAS No. 91 retroactively. Since origination and

commitment fees were virtually nonexistent, they allowed the current year's income to benefit from capitalizing and deferring their net costs.

Conclusion

SFAS No. 91 is one of the challenging accounting standards concerning financial institutions. The Statement has attempted to resolve the substantial controversy and perceived abuses in accounting for nonrefundable fees and costs associated with originating loans. The FASB's intent was to improve accounting consistency for all types of lending activities and to provide better uniformity in financial reporting of financial institutions. Nevertheless, the FASB has been heavily criticized for issuing the Statement.

Every facet of banking from loans and leases to investment securities, and stand by letter of credit are affected by the Statement. Our examination of the sample of 90 financial institutions shows that while the majority of studied entities did not experience a great impact in their financial reports and disclosures, others have noticed a significant change in their financial reporting in compliance with the provisions of SFAS No. 91. Perhaps, banks that have little fee income or those entities that have been in the practice of deferring fee income have experience an immaterial impact on their financial reporting and disclosures. On the other hand, the installment loan and credit card lines of business have realized a significant decrease in net income, as they have not been deferring origination and commitment fee income prior to the adoption of SFAS No. 91.

The FASB issued SFAS No. 91 at a time when the savings and loan industry could least afford to show losses from accounting changes. Thus, these financial institutions have attempted to mitigate the possible negative impact on their reporting earnings, while still maintaining compliance to the provisions of the Statement. The bottom-line conclusion is that the FASB might have not achieve its goals in improving accounting consistency for all types of lending activities and to provide better uniformity in financial reporting of financial institutions. Therefore, the possibility that ac-

counting issues for nonrefundable fees and costs will continue to be raised does not end with the adoption of SFAS No. 91. Perhaps, the important reason for the existence of this controversy is due to the fact that savings and loan associations have a choice between following Generally Accepted Accounting Principles (GAAP) or a Regulatory Accounting Principle (RAP) that violated GAAP but was permitted by the Federal Home Loan Bank Board (FHLBB). Specifically, RAP allows deferral of loan sales losses, while GAAP requires that those losses be recognized in the period of sale.

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