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August 3, 2010

Mr. Russell Golden  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
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File Reference: No. 1810-100, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*

Dear Mr. Golden:

As a shareholder in First Hope Bank, I am writing you about the proposed changes to the accounting standards concerning the reporting of assets held by commercial banks. Although I graduated from Michigan State University in 1966 with an MBA in finance, I have never been directly involved with the operation or management of a bank. Instead of banking, I entered the profession of commercial and industrial valuations and until my retirement, worked for American Appraisal Associates, Inc., Milwaukee, Wisconsin for 35 years. Most of my career was involved with the valuation of closely held securities, business enterprises, and assets that did not usually have access to a public or active market. During my career, I had the opportunity to manage at different times the home-office Business Valuation and Machinery and Equipment departments, as well as extensive involvement in supervising American Appraisal's operations in Atlanta, Georgia and Hong Kong. My comments on the proposed accounting changes, therefore, will be from the point of view of an appraiser instead of a banker or an accountant.

Although the proposed changes to accounting standards for financial institutions and banks are recent, as a business valuation appraiser I have been involved with fair value accounting since its inception. From the outset of fair value accounting, the basic question that all valuations need to answer has never been fully addressed: As all valuations presume a hypothetical sale of property, to whom are the subject assets to be sold and what is the purpose of the sale? In an appraisal assignment, if the purpose for the valuation is to express an opinion of value for possible sale of an enterprise, such as a commercial bank, the valuer might choose to hypothetically recreate ownership of the assets on the balance sheet of business on the basis of the amount that would be required to purchase each item on the open market. When the total value of the assets has been estimated, the liabilities are deducted to estimate the fair value of the equity. Appraisers call this approach the "cost" approach because it reflects the cost required to duplicate the assets of the enterprise. The approach works well if the assets are normally bought and sold actively on an open market. Difficulties creep into the valuation problem, however, when the market does not reflect the value of the assets in question because there is no active market for the item of property in question. In the valuation of a commercial banking enterprise,

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the difficulty with using the cost approach to value its assets might be in finding a ready market for a class of assets like the bank's term loans that are held to maturity. A bank does not usually sell its term loans, so there is no organized market for them. This type of loan is held by the bank while the borrower repays in installments, or a lump-sum is paid at the termination. By requiring a bank to reflect the fair value of its term loans by using the cost approach in restating its equity by revaluing its assets may introduce distortions into the valuation. Remember, substituting the value of assets into the balance sheet is not an application of the market approach, even though exceedingly thin or non-existent market data is sought to measure the value of the assets. Substituting the fair value of assets into the balance sheet is an application of the cost approach because it is an attempt to estimate the cost to duplicate the assets of the enterprise.

To reflect the best indication of value for the assets with non-existent or very thin markets, an appraiser might employ the income approach by discounting the unpaid balance of a term loan to present worth at a prevailing interest rate. It is doubtful, however, that this approach would yield a result that is any more "accurate" than merely reflecting the term loan at its face or book value. Even though the "income" approach is suggested in this approach, the overall technique of valuing the equity of the enterprise by restating the fair value of its assets is still called the "cost" approach.

An investor contemplating an investment in a financial enterprise or commercial bank will look to the securities market for an indication of the price of that enterprise's shares, especially if the contemplated investment is a minority interest. If a significant interest in the financial enterprise is being considered, or if the bank is closely held and does not have access to a public market, then analysis needs to be undertaken to measure the value of the equity of the enterprise. In addition to using the cost approach to restate the value of the bank's equity, it is usual valuation practice to estimate the income of the enterprise into the future and discount it to present worth (the "income" approach). Alternatively, a ratio analysis of earnings to market prices of equity securities may be undertaken of publicly traded banks that are comparable investment opportunities as the subject bank (the "market" approach). Consideration, of course, would have to be taken into account for the size of the block of stock in the equity of the bank being contemplated for investment.

A bank customer considering making a deposit in a federally insured institution would probably not go through the process of trying to measure the fair value of the equity of the business, whether by use of the cost, income or market approaches, although a review of the financial statements of the institution will probably be in order.

The result of all this theoretical discussion of valuation is relevant if an investor is contemplating an investment in a financial institution or commercial bank. If that is the purpose of the valuation exercise, then it is critical that the relevant data be disclosed in the footnotes of the bank's financial statements. If the purpose of the analysis is to ascertain whether or not the bank is likely to be solvent in the near term, then all the analysis outlined above by an investor is no

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doubt in direct proportion to the degree of risk being contemplated by the investment. Regulators will also need to examine all this relevant data. In no case, however, is it meaningful to any interested party to restate the value of the equity of the enterprise using only the cost approach. It is probably unnecessary, therefore, for the financial institution to state the fair value of its assets on its balance sheet in an attempt to employ the cost approach in a casual and off-hand manner for whoever may be interested in the results of the exercise. Therefore, the purpose of the valuation exercise needs to be disclosed in the financial statements and more than the cost approach (i.e., both the income and market approaches together with the cost approach) needs to be employed to draw a meaningful valuation conclusion.

Thank you for allowing me to express my opinions as to why restating the value of assets on the balance sheet of an enterprise may not enhance the knowledge of a potential investor, depositor, or borrower, without investigating indications of value from the other approaches to value, that is, the market and income approaches after acknowledging the purpose for the valuation.

Yours truly,

cc:  
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