

Banks and the “Twilight Zone”: Curious accounting tactics at Wells Fargo

Rod Serling wasn’t a banker, but he was a brilliant storyteller of all things bizarre. His creative genius brought us gems of TV fiction in such classics as *Outer Limits*, *Twilight Zone* and *Night Gallery*. As imaginations go, Serling was one of the best.

Bank executives (and their boards) also appear to have a flair for creativity, especially when presenting rosy Q1 earnings reports. However, in spite of seemingly “joyous” news, it cannot hide a darker secret most banker’s hold: “*we screwed up and everybody else is gonna pay for it*”.

At issue here is the oft-peculiar world of financial accounting. Over the years, we have seen plenty of imaginative bookkeeping in numerous industries, but never so debased as what’s being seen on bank financial statements lately. TARP, TALP and PPIP are confusing enough, what investors really need is HELP!

Banks, insurers, etc. are capitalized much differently than non-financial companies. Lenders, also rely heavily on assumptions to determine present and future values of assets and liabilities. As we know, “assumptions” have been liberally expressed in recent years which invariably have made asses out of you, me...and everybody else.

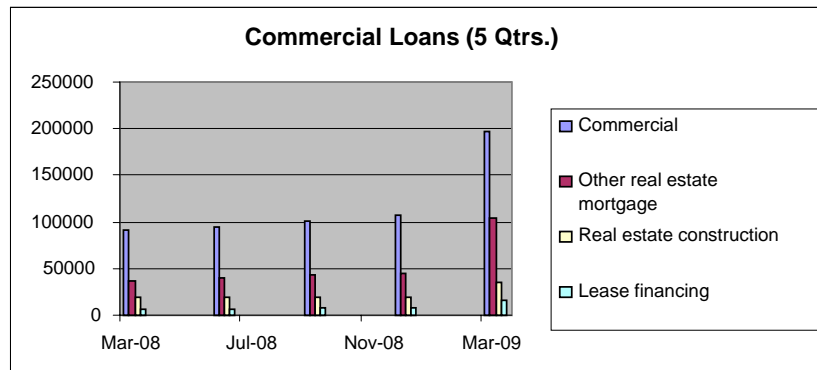
When analyzing a bank’s financial statements, we focus (mostly) on the balance sheet to divine future earnings quality. The income & cash flow statements are important too, but the information they provide is limited and finite to the period of time reported.

The Wells Fargo anomaly: We were rather surprised when Wells Fargo offered a glowing outlook for Q1 in their “pre-announcement” April 9th (last trading day going into a long holiday weekend) and several weeks before the scheduled earnings release date.

In an interview with CNBC that same day (April 9th), Wells CFO Atkins was asked if his bank had plans to issue stock. Atkins adroitly avoided any direct answer by replying he’d rather boost capital via earnings. Not surprisingly, Wells issued \$7.5B in new shares on Friday May 8.

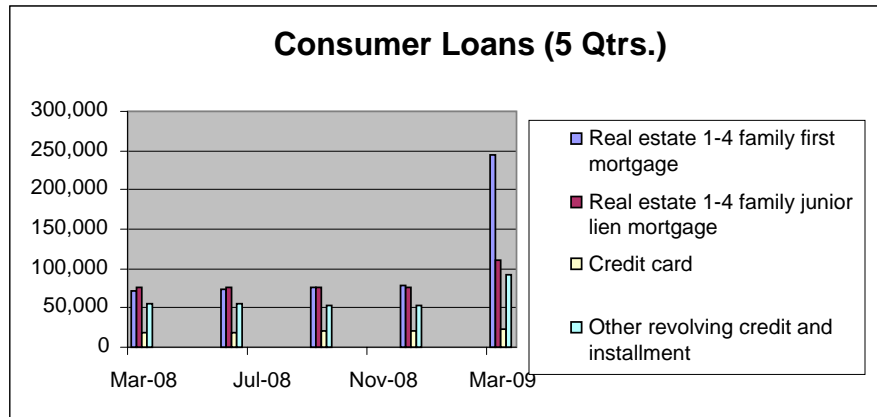
Timing is everything these days, but how pray-tell, does a bread-and-butter outfit like Wells with little exposure to the capital markets, suddenly declare they expect to report record net income? This we’d have to see with our own eyes in the 8k filing.

Once we had the financial statements in our grubby paws, we started by comparing the changes in loans over all categories. The spike in commercial and non-residential real estate lending caught our eye.

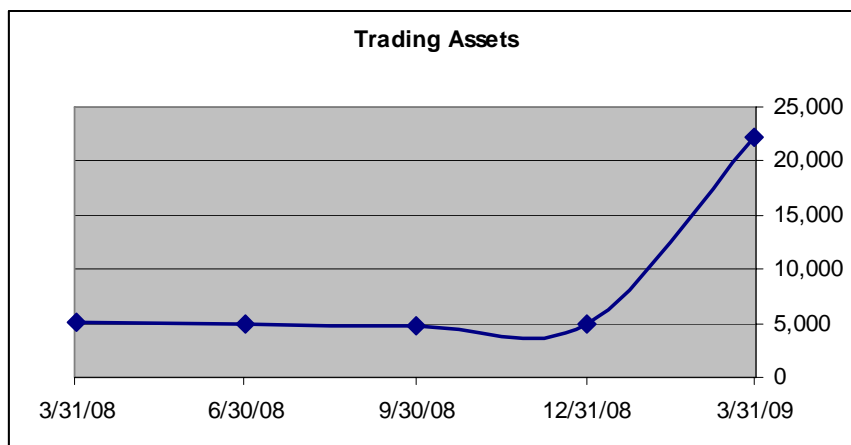


If it is true that commercial lending lags the residential markets by a few years, then aren't we near show-time when these bigger shoes start to fall?

Wells' consumer loans didn't leave us warm and fuzzy either. The jump in first and second-lien residential loans, are tough to swallow, but the spike in "other" revolving credit obligations are significant.



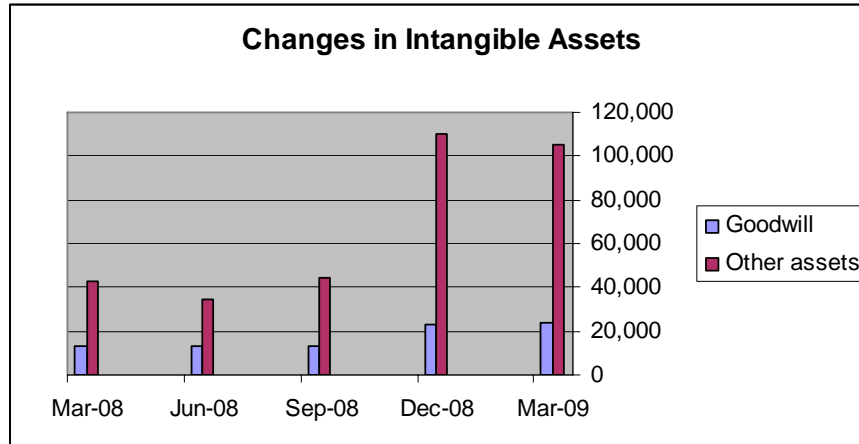
Then we looked at changes in "trading assets". We would expect to see declines in these "assets" because it would show the bank was comfortable with market risk by committing capital to supposedly less volatile markets and businesses. Instead, Wells' trading assets grew seven-fold. It looks like Wells is hoarding capital, not lending it.



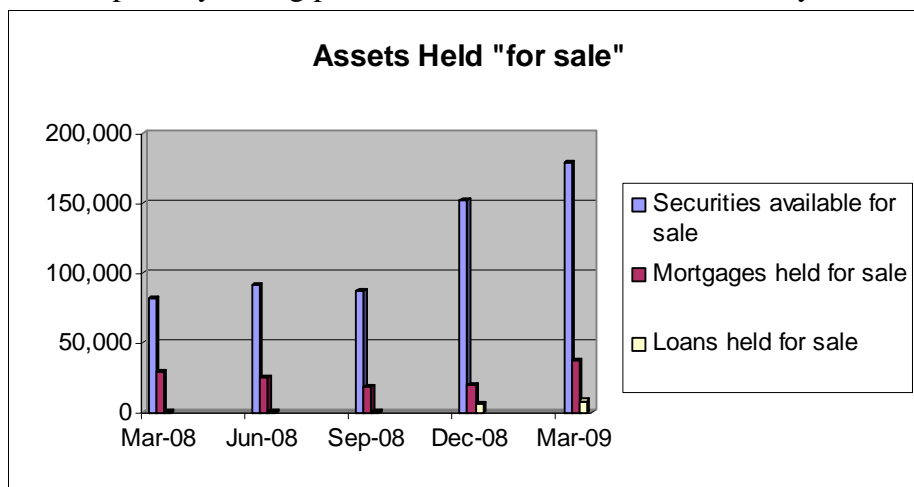
Goodwill and "Other assets" were also suspicious. Regardless of the slack banks are getting with loosened "mark-to-market" valuations, an increase in Goodwill indicates Wells paid more than fair value for a particular set of assets. In the old days, goodwill (an intangible asset) was amortized (to expense) in the income statement over a period of time. Since FASB's SFAS 142 and 141 rules came into effect in 2001, historical cost does not matter.

Problem is, Wachovia was a very complex consolidation. Whether or not related transactions between parent and subsidiary have been totally eliminated, or sufficiently written down for impairment, assets, liabilities, revenues, and expenses of the combined entity would in-fact likely be overstated.

Other assets can vary widely, but usually these are assets which will likely not be turned into cash anytime soon. This category could include anything from debt issuance costs to land or property held for resale. Think of other assets as a storage closet for non-cash assets which (usually) do not produce income or cash-flow.



As for assets or investments “held for sale”, we would prefer to see reductions in these balances, especially during periods of difficult access to secondary market liquidity.



However, given the huge secondary offering Wells just pulled off (it was over subscribed), keep an eye on future changes to these figures and the related disclosures. If for example these assets get moved into “portfolio”, then it’s hard to move them back

Wells Fargo shares have been on a tear since last month and investor sentiment towards financials is almost giddy. Sensational moves really! However, in the end, earnings quality does matter. While the balance sheet won’t tell you everything about Wells Fargo’s future profitability, it will provide good clues to the direction of earnings going forward.

WFC shares could keep rising, but the balance sheet is not jibing with management’s perky outlook. Loan quality looks suspect and earnings quality appears to be declining not improving. Disclosure: Author does not own WFC, but is long the SKF.