



Accounting For Loan Losses at County National Bank

By Larry M. Prober, PhD, CPA

Bellows wants to avoid regulatory intervention. Most analysts are predicting a reduction in the discount rate. Is the current year loan loss provision justified?

Abstract

Jane Bellows, controller at County National Bank, is debating whether the current year's loan loss estimates are justified. Trying to meet her professional obligations and the bank's goals are not easy when accounting and regulatory objectives differ. Examine the facts presented for County National Bank and determine the course of action you believe she should follow.

Background

County National Bank is a large regional bank with 375 branch offices located mainly throughout the southeastern United States. Known for its strong customer service and innovative product offerings, the bank has in recent years taken on new strategic initiatives. These new goals--made possible through acquisitions--have included broader geographic diversification of its customer base and a wider range of products and services, including new types of brokerage accounts, investment fees from asset management and personal/business advisory services. Bank management is concerned that in the current environment banks are racing to acquire or be acquired, so it is careful in its assessment of the financial marketplace and in its considerations of potential product offerings/services, its own capacity to meet these needs and the competition in each banking segment.

To meet corporate goals for growth, County has targeted several groups of potential customers, such as high-earning individuals and small businesses, to provide new services and loans. The economic boom of the nineties made this strategy feasible and, along with merger economies of scale and technological additions that improved service levels and lowered transaction costs, provided a viable means to improve profitability. However, acceleration of the economy in the early part of the year 20X2 combined with Federal Reserve tight money policy and increased competition have made the year more difficult than expected. These events, coupled with a declining stock market, high personal bankruptcies and slowing growth during the last quarter have created profitability concerns among the bank's management. Some of its major concerns are the quality of the bank's loan portfolio and its ability to withstand negative economic circumstances. Although the bank views its lending policies as conservative and more than adequate for the risks involved, several key executives are not happy with loan procedures and related grading of loans. They believe that until recently stock market



gains made everyone feel better off than was justified, and that eventually market conditions will change, making it essential for institutions such as theirs to be in strong economic shape. They reason that after an extended period of high economic growth, the bank should be able to weather any type of storm. Consequently, as the bank completes its current year, they wonder how the accounting for loan losses and the provision for them reflect the underlying nature of these assets.

The Problem

While lending policies at County have changed little in the recent past, these newly raised concerns have created some anxiety for Jane Bellows, County's controller. She is responsible for preparing the financial statements and reports submitted to bank regulators. She knows from her own experiences that profitability and valuation issues have been raised before, but this year she has conflicting thoughts. Ms. Bellows has always sought to comply with generally accepted accounting principles as a first priority, particularly when she felt that loss estimates were high. Accordingly, she has in the past challenged some of the estimates for being on the high side, a position now endorsed by the Securities and Exchange Commission. On the other hand, she realizes that bank regulators look for loan provision adequacy and would rather the bank maintain healthy loan provisions. In accordance with Financial Accounting Standards Board Statements No. 114, *Accounting by Creditors for Impairment of a Loan—an amendment of FASB Statements No. 5 and 15*, and No. 5, *Accounting for Contingencies*, she is obligated to measure as well possible loan loss estimates based on circumstances through the balance sheet date. Although some of her previous training in economics tells her that a longer timeframe for economic events in the decision would be preferable, she understands the vital role of consistency in financial reporting and her obligation to the financial reporting model. She also understands that with adequate disclosures, those in the investment community should be able to assess the adequacy and appropriateness of the bank's estimates. Nevertheless, Ms. Bellows is uncomfortable with the apparent conflict between FASB rules and bank regulator objectives. She is also troubled that some at the bank see loan loss estimates as a means to an end when it comes to profit rationalizations.

At year-end Ms. Bellows and her staff are finalizing the estimates needed for the financial statements. She is aware that most analysts are predicting a Federal Reserve reduction in the discount rate. That change should help enhance value of the bank's fixed rate portfolio and lower the bank's cost of capital, which should stimulate demand and reduce delinquency rates for customer loans. Thus, her concerns are not as great as some at the bank who would rather see an increase in the loan loss provision.

This limited discussion describes some key points of County Bank's policies regarding loans and the provisions needed for financial reporting.

1. The allowance for loan losses is developed to absorb probable losses to the portfolio as of the balance sheet date. While a number of tools are employed to measure losses, no group of tools can replace seasoned judgment. Losses for retail products, such as credit cards, residential mortgages and consumer installment loans, are developed based on net losses expected over a 12-month period consistent with bank loss models. Commercial portfolio losses are estimated on



- the basis of the bank's loss migration model relying on eight quarters of data and historical loss experience for loans of similar quality and with similar ratings.
2. The loss factors resulting from the above procedures are tempered by known changes in economic trends from the time periods used in the analysis. Loss estimates developed from the analysis are applied to each segment of the portfolio and ultimately added to specific reserves established for impaired loans.
 3. A loan is considered impaired when it is not expected that amounts for both principal and interest will be collected in accordance with the terms of the lending agreement. Some smaller-balance consumer loans are collectively evaluated for impairment in a separate assessment.
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Financial Information

The following is the condensed income statement for years 20X2, 20X1 and 20X0 based on pre-audited numbers: (\$000,000s)

	20X2	20X1	20X0
Net interest income	1,386	1,293	1,192
Provision for credit losses	<u>212</u>	<u>161</u>	<u>158</u>
Net interest income after provision for credit losses	1,174	1,132	1,034
Noninterest income:			
Service charges on deposits	206	182	165
Fees for trust services	174	109	96
Credit card income	145	94	88
Investment fees	131	33	29
Capital markets income	94	71	27
Electronic banking	48	40	35
Mortgage fees	18	24	13
Other operating income	<u>134</u>	<u>116</u>	<u>103</u>
Total other income	950	669	556
Other expenses:			
Salaries and benefits	561	491	408
Occupancy	83	76	64
Equipment	109	84	76
Merger and restructuring charges	10	57	101
Other	<u>364</u>	<u>310</u>	<u>284</u>
Total other expenses	1127	1018	933
Income before income taxes	997	783	657
Income taxes	<u>299</u>	<u>227</u>	<u>199</u>
Net Income	698	556	458



The following schedule presents certain details pertaining to County's loans and loan loss reserves.

Loans at December 31 are summarized as follows: (\$000,000s)

	<u>20X0</u>	<u>20X1</u>
Commercial	9,752	8,415
Retail	5,613	6,007
Real estate	9,801	9,087
Lease financing	1,428	1,033
Foreign	<u>693</u>	<u>601</u>
Total	<u>27,287</u>	<u>25,143</u>

The following schedule summarizes impaired loans and related allowance information at December 31

	<u>20X2</u>	<u>20X1</u>
Impaired loans with related allowance	76.4	15.1
Impaired loans with no related allowance	<u>5.2</u>	<u>16.1</u>
Total impaired loans	81.6	31.2
Allowance on impaired loans	<u>23.6</u>	<u>3.9</u>

Changes in the allowance for loan losses for the three years ended December 31 were as follows:

	<u>20X2</u>	<u>20X1</u>	<u>20X0</u>
Balance at beginning of year	301.4	299.6	285.6
Additions from acquisitions	0.2	1.5	16.6
Provision for loan losses	212	161	158
Recoveries on loans previously charged off	32.9	32.6	31.6
Loans charged off	<u>-193.1</u>	<u>-197</u>	<u>-176.9</u>
Balance at end of year	<u>353.4</u>	<u>297.7</u>	<u>314.9</u>

The Dilemma

Jane has examined some of the underlying documentation behind in the above loan loss estimates. Her review included discussions with loan officers and other members of the loan committee. While she believes that substantial data are provided to support the allowances recognized, she is not totally convinced this year's increase is justified. Even though the economy has declined in a general sense she reasons that much of the negatives were already considered during the previous year and that the expected changes in Federal Reserve policy will benefit County's customers in the future. She also believes that the bank's loan policies are conservative and therefore provide a cushion from any economic downturn. Accordingly, she sees no reason to increase the provision from the previous year. Her discussions with members of the finance committee have not convinced her that any change is justified. Thus, she is debating her next course of action. Should she pursue the matter further or just rationalize that the increase will provide an even more favorable rating when the bank regulators examine the data?



How should Jane Bellows handle the current situation? Are any changes from the original estimates necessary? What criteria or considerations should be used in making this determination?

Comments on “Accounting for Loan Losses at County National Bank”

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‘There appears to be tension between incentives to increase the provision to ensure a smooth income stream and to lower the provision to more accurately convey the economics of the business.’

This case deals with the choice of loan loss provisions by a commercial bank's managers. The loan loss provision is an important accrual for commercial banks (averaging about 20% of income before taxes and provision). In general, the loan loss provision should adjust the allowance for loan losses to an amount that reflects expected loan losses (or default risk). However, because the size of the provision is a matter of judgment, managers have a potential tool for managing earnings. Furthermore, because the loan loss allowance is considered part of regulatory capital, managers can also use their discretion over loan loss provisions to ensure that they comply with regulatory capital requirements.¹

In this case there appears to be a tension between incentives to increase loan loss provision (to enable managers to ensure a smooth income stream) and to lower loan loss provisions to more accurately convey the changes in the underlying economics of the business. Ms. Bellows believes that the proposed provision is too high, while others think this provision is appropriate to appear strong from a regulatory capital perspective and to *save for a rainy day* (essentially to ensure a smooth income stream in the future). Therefore, the key issue is: What is the appropriate size of the provision (or the loan loss allowance)?

We can address this question in two steps. First, we can estimate the required loan loss allowance under the assumption that the riskiness of the loan portfolio has not changed. Second, we can adjust this amount for justifiable changes in riskiness.

¹ For a brief discussion of regulatory capital requirements see Ahmed, Takeda and Thomas, 1999, Bank loan loss provisions: a reexamination of capital management, earnings management and signaling effects, *Journal of Accounting & Economics* Vol. 28, No. 1, 1-26.



If the loan portfolio is as risky as last year and last year's allowance properly reflects default risk, the only adjustment to the loan loss allowance would be a scale adjustment. In this case, the required allowance would be computed as follows:

$$\begin{aligned} & \{\text{Last year's allowance} \div \text{last year's loans balance}\} \times \text{This year's loans balance} \\ & = 0.0118 \quad \times \quad 27,287 \\ & = \$322\text{m} \end{aligned}$$

Under this scenario, the proposed provision is overstated by \$30m.

Next, we can adjust the required allowance amount for changes in underlying default risks. There are two factors that *qualitatively* suggest a reduction in default risks:

1. The expected decline in rates is likely to reduce delinquency rates for customer loans.
2. The bank has a more diversified loan portfolio.

There is one factor that would suggest an increase in default risk of the retail loans: The expected increase in personal bankruptcies. But note that the retail loans have declined as a percentage of the overall loan portfolio whereas commercial and real estate loans have increased. Overall, this would suggest a further reduction in provisions.

Another factor related to default risk is the increase in the allowance for impaired loans. Compared to an allowance of 12.5% last year, this year's allowance for impaired loans is 29.9%. This may represent specific impaired loans that were perhaps acquired from other banks. If so, this would justify a \$20m increase in allowance.

Finally, two additional pieces of data would help in assessing the accuracy of the loan loss provision:

1. How large are non-performing loans (as a percentage of loan loss allowance)?
2. Has there been an increase or decrease in non-performing loans?

In general, we expect changes in non-performing loans to be positively correlated with changes in default risk. One could use an option-based valuation technique to estimate the implied standard deviation of the bank's assets.² Again an increase in this implied standard deviation would suggest an increase in the allowance.

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² See Ronn and Verma, 1986, Pricing risk-adjusted deposit insurance: An options-based model, *Journal of Finance*, Vol. 41, 871-895.



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Executive Summary

Jane Bellows, the controller at County National Bank, faces a conflict between supporting the proposed level of loan loss reserves—including a \$51 million increase—and keeping the provision at the same level as the previous year. She knows that the bank's loan committee has recommended the increase, but Bellows is not sure that economic conditions justify the change. Also, she believes that the bank's loan policies are conservative and therefore will cushion any economic downturn should it occur. Bellows knows that bank regulators prefer "healthy loan provisions," so if she pursues cutting back on the increase it may raise regulatory concerns. Moreover, she is aware of the importance of the financial statements in providing adequate information for the investment community about the bank's loan portfolio.

Stakeholders and Interests

The investment community is a major stakeholder since it relies on the accuracy of the bank's financial statements for investment decisions. If the loan loss reserve is kept at the same level as the previous year, and the bank subsequently experiences loan losses beyond that amount, then decisions will be made based on inaccurate information.

The bank regulators are important stakeholders because they are responsible for the soundness of the banking system. Bellows has a responsibility as the controller to provide accurate and reliable information to the regulators.

County National Bank is a stakeholder since the level of loan loss reserves will affect the bank's profitability. Bellows understands the danger in using the reserve to manage earnings because she is "troubled that some at the bank see loan loss estimates as a means to an end when it comes to profit rationalizations." However, the loan committee has recommended an increase in the reserve, and one at a level Bellows believes may be too high. She faces a conflict between not wanting to use the provision to manage earnings and keeping it at the level recommended by her own loan committee.



Ethical Issues

The facts of the case do not indicate whether Bellows is a CPA or CMA. Nevertheless, she has an obligation as the controller to be neutral in deciding on how best to reflect the level of reserve. Bellows appears to be making a good faith effort to meet that obligation. However, she does not provide convincing reasons to depart from the recommendation of the bank's loan committee.

The investment community and bank regulators have a right to expect the bank's financial statements, including the provision for loan losses, to be objectively determined. They rely on this information for their decision-making needs. If Bellows uses the loan loss reserve to manage earnings, then these stakeholders will be harmed. The benefits to the bank, if any, will be short-lived since the true reserve level will become more apparent in the future and the bank may have to absorb larger losses at that time.

Alternatives

Bellows identifies two alternatives in the last paragraph of the case. She can allow the recommended increase to be recorded, which will provide a better rating when the bank regulators examine the data. Alternatively, Bellows can open up discussions with the loan committee and attempt to reduce or eliminate the increase in the reserve for the current year. As the controller, Bellows has an obligation to the loan committee, the bank and the regulators to open the lines of communication before deciding to forego the increase in reserves. The ethical principle of objectivity requires that she act fairly toward all the stakeholders. Perhaps an open discussion of the issues would clarify the bank's responsibility to its stakeholders to maintain the quality of its earnings and not manage them by ignoring justified increases in the provision for loan losses.

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Jane Bellows’ dilemma is very real. Many commercial banks--both national and regional--face conflicting messages from their principal federal regulators, the Securities and Exchange Commission and the banking regulators. While the SEC has been insisting that reserves be kept reasonably low, bank regulators prefer that federally insured institutions maintain reserves adequate to withstand potential economic downturns. That big picture tension, however, is only the beginning of Ms. Bellows’ problem. Her real concern is that, were she to ignore pressures from within her bank to increase the loan loss reserves (which appears contrary to her natural inclination), she might be subject to criticism from inside and outside the bank.



In a situation like this, where reasonable minds could likely differ, the first step is to establish a process that will withstand post hoc review, whatever Ms. Bellows decides. Ms. Bellows should therefore:

- Personally review the bank's financial results, including any supporting documentation for initial estimates of the loan loss reserve.
- Consult with the bank's accounting staff regarding current and historical financial results and trends.
- Confer with the bank's loan officers and loan committee concerning apparent trends in loan repayment and new loan generation.
- Seek guidance from the bank's economists regarding their fair estimates of future economic trends and their likely effect on the bank's loan portfolio.
- Discuss expected economic trends with outside resources, such as government economists and colleagues at peer institutions.
- Make preliminary inquiries of the bank's outside auditor regarding its opinion of the bank's current loan loss estimate and any modifications that it might consider positive.
- Have initial discussions with the chief financial officer, chief operating officer and/or chief executive officer concerning their sense of the bank's historical reserves, its current position and its future prospects.

Ms. Bellows is the ultimate decision maker in this circumstance, and she will be accountable for whatever estimate the bank ultimately adopts. Notwithstanding how reasonable she believes her decision is, she should document the steps that she took to reach it. Then, even if she's ultimately wrong about the long-term effect of the Federal Reserve's reduction in the discount rate or about whether last year's estimate anticipated this year's economic downturn, she will be able to point to a rational and reasonable process that led to her ultimate decision.

Just as Ms. Bellows' documentation will insulate her from fallout, the bank should consider how to make a management's discussion and analysis disclosure that is sufficiently clear so the market will understand the basis for its reserve. Even when disclosure does not appear in the bank's short-term interest, it will assist the bank in the long run because it will limit the risk of future litigation and enhance the bank's reputation among market participants.

Ms. Bellows seems to be on the way there. She has reviewed the bank's results and the basis for the current estimates, and she has discussed the estimate with the loan officers and the loan committee. She has not, however, used all of the resources at hand, and it is not clear whether she has adequately documented her review.

At a time when the bank is facing potential pressure from an economic downturn, Ms. Bellows should be particularly on her guard not only to make the decision that she believes is right but also to assemble and retain documentation supporting the reasonableness of her decision. She is not being held to a standard of perfection; rather,



she is being asked to work with others at the bank to make a reasoned judgment, in a condition of uncertainty with myriad competing pressures.

In making her decision (and any decision here sounds reasonable), Ms. Bellows should ensure that she follows a reasoned process, that she uses all available resources and that she collects the data necessary to justify whatever conclusion she draws.