

First National Bank Corporation Class Preparation and Homework Questions

Question 1 is a class prep question and should not be turned in as part of problem set 6. Question 2 should be turned in at the beginning of class on Thursday 13 November 2002 as part of problem set 6. Only one set of answers *per group* needs to be turned in. Make sure that your name appears on the copy handed in, otherwise you will not receive credit. Also, each member of the group should keep a copy for themselves as you will need to refer to it during the discussion of the case.

1. The accounting decision (setting the loan loss allowance) is influenced by many factors and numerous users' decisions can be affected by this accounting judgment. In determining the allowance for bad debts, the measurement objective is to set the allowance equal to the expected future write-offs. The accounting for credit losses on loans is similar to other companies' accounting for bad debt expense. The bank must estimate the amount of outstanding loans will not be repaid; it calls this amount the Allowance for Credit Losses (or Loan Loss Allowance). Think of this allowance as being analogous to the Allowance for Doubtful Accounts that applies to Accounts Receivable.

The amounts added to the Loan Loss Allowance in a particular year represent that period's Provision for Credit Losses (much like Bad Debt Expense on A/R). When specific loans are deemed uncollectible, the bank writes them off (called Credit losses: See Exhibit 1-C). The write-off of uncollectible loans reduces the balance of the Loan Loss Allowance and the balance of Loans Due (just as writing off A/R reduces both the A/R account and the related Allowance account). Previously written off loans that are subsequently repaid are called Recoveries.

- a. Management will have private information about the related economic activity that will influence these accounting decisions. What business decision(s) require FNB's management to estimate future loan write-offs? Are these business decisions made before, after, or concurrent with the accounting decisions? Who is likely to be involved in these decisions and what are their roles? Suppose you were asked to estimate the allowances for returns and bad debts (as an FNB employee); what types of information would you collect and from whom?
- b. Management's accounting decisions can be influenced by users' conflicting demands for information. Suppose FNB discloses the same financial information to its regulators, customers, shareholders, potential future shareholders, and competitors. For what decisions would each of these stakeholders like to know management's private information about their estimates of future write-offs? Explain why one or more of these stakeholders might oppose disclosing this information; that is explain why there could be conflicting demands for this information.
- c. Management must anticipate the consequences of users' decisions when making accounting decisions. Suppose FNB discloses the same financial information to

its regulators, customers, shareholders, potential future shareholders, and competitors. For what decisions would each of these stakeholders like to know management's private information about their estimates of future write-offs? Why might one or more of these stakeholders oppose disclosing this information? What are the potential consequences of these users' decisions? How did the likelihood of these consequences occurring change in New England in the late 1980s?

- d. Management's personal incentives can affect accounting decisions. What are the personal incentives (regarding the way the allowance is set) of Gina Marcoccio, Paul Shea, Adele Kalimian, and Peter Royston? What are the incentives of the board of directors?
- e. Reporting regulations and accepted practice affect accounting decisions. Implicit industry guidelines have a particularly strong influence on returns and bad debt allowances. Still, for financial and regulatory accounting, management has considerable latitude within these implicit boundaries. If you were on the external audit team (Sally Jenkins or David Wright), what information would you collect to determine "reasonable boundaries" for FNB's allowance for bad debts?
- f. Suppose you were a bank regulator who was deciding whether to impose operating restrictions on FNB (or perhaps even close the bank). Assume that like an external auditor, you have access to the bank's internal records but that it is costly for you to process this data. What types of information would you request? What types of information would you suspect that management knows but won't disclose to you? Suppose you have the power to significantly influence the way management sets the allowance. What are the costs and benefits of exerting this power?
- g. Suppose you were an investor deciding whether to purchase FNB shares? You have access to considerably less information than regulators, auditors, and management. Using FNB's financials, ratios discussed in the case, and your own creatively designed ratios, estimate a "reasonable range" for the allowance for bad debts. What are the limitations of using this type of ratio analysis to compute an estimate of the provision? (be sure to discuss the limitation as it relates to each ratio you choose above) What other information would you likely use to conduct your analysis?

Question 2 appears on the next page.

Question 2 (part of homework 6)

- a. Complete the 1990 column of Exhibit 1-C and the 4th quarter and year columns of Exhibit 1-F based on FNB's original expectations for the year (hint: see comment by Board member Alice Jones in the middle of p. 6). Recompute the missing figures for these two exhibits under (i) the minimally prudent charge being proposed by the CFO and (ii) the most conservative alternative being suggested. Explain briefly how you identified scenarios (i) and (ii) above.
- b. The historical levels of several ratios might be useful in analyzing the potential loan loss situation for 1990 at FNB, including: Allowance/Loans, Net credit loss/Provision, and Allowance/Nonperforming Loans. Pick two of these ratios, analyze their historic values for FNB, and briefly discuss their advantages and disadvantages for determining the allowance and provision that FNB should recognize for 1990.
- c. Another issue we have studied - marking securities to market value - can also have a significant impact on banks' capital ratios. If Tier I Capital equals Total Equity, does it matter whether a bank classifies securities as Trading or Available-for-Sale? Explain briefly.
- d. Choose two of the following five parties (Company Chairman Royston; CFO Shea; Controller Marcoccio; outside Board member Jones or Drummer; audit partner Jenkins) and briefly discuss their incentives and potential economic consequences with respect to the loan loss accounting decision.