Kendallville Bank Case Study

KENDALLVILLE BANK BOARD MEMBERS AND EMPLOYEES

BOARD OF DIRECTORS/AUDIT COMMITTEE MEMBERS

Sandra Renwood, *President, CEO, and Chairman*
Rob Singh, *Audit Committee Chair*

EXECUTIVE TEAM

Sandra Renwood, *President, CEO, and Chairman*
Tom Kmetko, *Chief Financial Officer*
Dan Davis, *Chief Lending Officer and Credit Quality Committee Head*

EXTERNAL AUDIT

Pat LaSalle, *Audit Engagement Partner*
Jennifer Watkins, *Engagement Team Manager*

OTHER EMPLOYEES

John Jones, *Senior Vice President External Reporting*
Janet Lee, *Head of Internal Audit*

About This Case Study

This case study was developed as a joint effort by the Center for Audit Quality, Financial Executives International, the National Association of Corporate Directors, and The Institute of Internal Auditors. These four organizations have formed the Anti-Fraud Collaboration to actively engage in efforts to mitigate the risks of financial reporting fraud. The Anti-Fraud Collaboration promotes the deterrence and detection of financial reporting fraud through the development of thought leadership, awareness programs, educational opportunities, and other resources targeted to the unique roles and responsibilities of the primary participants in the financial reporting supply chain. For more information about the Anti-Fraud Collaboration and its resources please visit www.antifraudcollaboration.org.

A Video Introduction to Kendallville Bank

The Anti-Fraud Collaboration has created a short video that provides a high-level introduction to the Kendallville Bank Case Study and brings it to life. Watch the video at www.youtube.com/thecaqorg.

Sandra Renwood—president, CEO, and chairman of Kendallville Bank—stood waiting to board a plane along with Tom Kmetko, the bank's CFO. The pair was on an early-morning flight for a quick trip to review a potential acquisition opportunity for Kendallville. Renwood stated, "This is the third bank we have looked at in the past six months, and while it is important that we make an offer only if this bank is a good fit for us, I am more convinced than ever that an acquisition is the right next step in our growth." Kmetko replied, "I agree. With the team we have at Kendallville, operations are running smoothly and efficiently; and with the overall market situation the way it is, organic growth opportunities are limited." Renwood then mentioned Dan Davis, Kendallville's chief lending officer (CLO). "Dan is a big reason we are out here pursuing acquisitions. The loan portfolio is doing great, and he helps us in so many ways." Kmetko replied, "Dan does seem to have his finger on the economic pulse of the region. He's been a big part of our success."

The plane began to board. Kmetko picked up his briefcase and then continued, "At some point, however, we need to sit down and make sure we are not missing anything with our existing operations and risk management. You remember I told you that Dan's Credit Quality Committee just combined two of our real estate loan categories. While I approved it, I sure wish I had more time to fully work through the implications of that change." As Renwood settled into her seat, she recalled Kmetko telling her about the change. At the time she had felt confident that it had been fully vetted, but now she wondered if her confidence was justified. And she understood Kmetko's desire for more time. As the plane accelerated down the runway, Renwood asked herself whether she should look into this further—one more thing to add to her to-do list.

KENDALLVILLE BANK

Kendallville was a community bank headquartered in northern Indiana that served mostly small and mid-sized towns in that state, plus parts of Michigan and Ohio. Its roots stretched back to a small-town bank founded in the early 1900s. Kendallville went through several mergers and acquisitions in the 1990s and expanded its product offerings along the way. Its most recent acquisition came 10 years ago, at which time the bank took its present form and became publicly traded.

Kendallville now had a 37-branch network offering consumer and commercial banking services. For consumers, Kendallville offered checking, savings, and money market accounts; CDs; personal loans; credit cards; mortgage and home equity loans; retirement saving accounts; and access to telephone, ATM, and online banking services. For commercial and small-business customers, Kendallville offered various checking and loan products, cash management services, payment processing, and other banking services. A significant part of Kendallville's commercial business was real estate lending for residential development, strip malls, and small office and professional buildings. In recent years, Kendallville had modestly outperformed its comparable competitors in the sector. In its most recent year, Kendallville had $770 million in deposits, $635 million in loans, $920 million in total assets, and net income of $7.8 million. Its market capitalization was $140 million.

Like all banks, Kendallville operated in an environment of expanding regulatory requirements, and new regulations increased the amount of time senior management spent focused on understanding and meeting the new requirements. Kendallville's board of directors was not only concerned about being compliant, but also about managing the costs associated with the heightened regulatory environment.

COMPANY STRATEGY

Kendallville focused on small market communities generally located away from major cities. And while Kendallville was a small bank when compared with industry leaders, it was a large bank in many of the communities it served. This enabled the bank to offer higher service levels and more products to its customers than many of its competitors. Kendallville, which promoted itself as "The local bank that does more," took advantage of its competitive position to heavily market itself to customers who thought they might need the services of a larger bank, but liked the idea of staying with a more local operation. It was especially visible to commercial customers, and many of Kendallville's executives and senior managers made an effort to personally connect with the successful mid-sized business owners in the bank's service areas.

Kendallville faced limited growth opportunities due to nearly saturated markets in its region. Modest growth could be obtained by outcompeting its rivals, while significant growth would only come through acquisitions or expansion into other geographic regions.

For much of her tenure at Kendallville, Renwood had pushed for steady, "smart" growth. Rather than trying to set the world on fire, which might lead to accepting inappropriate risk levels, she focused on running the current bank as effectively and efficiently as possible. To keep profits growing and shareholders satisfied, she pushed her team hard to compete for new business and to drive down costs wherever possible. Cost cutting had occurred primarily in back-office, non-customer facing departments so as to not undercut business and revenue generation. While the bank avoided layoffs for fear of hurting morale or sending signals the bank was not strong, Renwood strongly encouraged her team to not hire replacements for staff who left on their own.

About a year ago, Renwood came to believe that Kendallville's smart growth strategy was reaching its limits. The bank was doing well, but she felt it needed to grow faster. She initiated discussions among her executive team around whether it might be time to acquire another bank. Renwood expressed a belief that the Kendallville team could apply its skills of efficiently running a bank and squeezing out profits during difficult times to any bank it acquired. The team agreed and she and Kmetko took the lead on identifying potential acquisition candidates. Renwood reminded her team that to remain an attractive acquirer, to both its own shareholders and to the owners of potential targets, it was important that Kendallville maintain above-average performance.

EXECUTIVE TEAM

Renwood had joined Kendallville five years earlier as president and CEO. She had grown up in Indiana but attended an East Coast college where she majored in economics. After graduation, she went into banking and spent the first 20 years of her career just outside of New York City, earning an MBA along the way. Early in her career, Renwood had worked in bank operations and branch management before moving into the finance function. She became a CFO and had been active in a number of bank mergers. She had only limited experience in loans or managing loan portfolios. Renwood eventually became a senior executive at a mid-sized publicly traded bank. Looking to return home to Indiana, she kept her eyes open for new opportunities and jumped at the chance to join Kendallville. Her experience, along with a track record of success, made her a natural candidate to head Kendallville. Eighteen months after she joined, Renwood became chairman of the board as well.

CFO Kmetko had been hired by Renwood's predecessor 11 years earlier to help take Kendallville public. Kmetko held a finance undergraduate degree and an MBA. Prior to Kendallville, Kmetko had experience in bank mergers and acquisitions and had been involved in two IPOs. Kmetko was not a CPA and did not have a deep knowledge of U.S. GAAP, so Renwood and her team turned to John Jones, senior vice president of external reporting, for help in this area. Kmetko projected a serious, "all-business" demeanor that did not encourage casual conversations with his subordinates, but he was willing to answer questions and get involved when his expertise was required.

CLO Davis had been hired by Renwood shortly after she joined Kendallville. Davis held an undergraduate degree in mathematics and a master's degree in accounting. He became a CPA early in his career, and then moved into banking where for nearly 20 years he worked in lending, loan portfolio management, credit risk management, and other areas at several large, fast-growing, Midwestern banks. Renwood hired Davis because she wanted to add a strong outsider to the executive team which was otherwise heavy on long-tenured Kendallville executives.

Renwood thought Davis was one of the smartest people she had ever met. He was quick-minded, mathematically gifted, and knew his way around the financial statements as well as Renwood or Kmetko, maybe better. Davis also had enormous self-confidence and a positive outlook. It seemed he was always right about everything, but when he was not, he was the first one to correct himself. Finally, Davis was loud, friendly, and full of energy. And it was hard to tell which he enjoyed more: complimenting someone, or hearing compliments about himself. After Davis joined Kendallville, it was not long before other executives were seeking out Davis for his thoughts and opinions, as it became clear he had insights that they sometimes missed. Davis often had suggestions on ways the bank could adjust to market conditions that, when implemented, proved successful.

Other members of the executive team that reported to Renwood included a chief operating officer, who was responsible for the bank branches, a commercial business head, and a consumer business head, who each focused on growing their parts of the business.

BOARD OF DIRECTORS

Kendallville's board had 11 total directors who were elected to staggered three-year terms. The board consisted primarily of current and former small to mid-sized business owners in the bank's service areas. As such, most of them had been, or still were, customers of the bank. No director other than Renwood had experience as a bank executive; however, two members also served as directors at other financial services firms, while a third director had been president of a leading insurance company in the region. Only one director, other than Renwood, had been a senior executive of a publicly traded company. What the board members lacked in banking experience, they made up for in knowledge of the local business market. They had a great sense of the local economy and deep understanding of the types of businesses that were Kendallville's key commercial customers.

The board met monthly throughout the year. Additional meetings could be scheduled if necessary, but such extra meetings had been rare. Renwood prepared an agenda for each meeting and distributed it about 10 days in advance. The agenda consisted of a presentation of what was happening at the bank, and then specific items for discussion and decision. Renwood typically recommended a decision for each agenda item and the board usually supported her position. While Renwood liked to work through the agenda items in an efficient manner, she allowed time for questions and debate, and she also ensured there was sufficient time at the end of each meeting in case a board member wanted to raise an issue.

As chairman, Renwood actually enjoyed the board meetings. There were often lively discussions around what was happening in the business community and insights into particular large customers or lines of business the bank could pursue. To her, each director seemed proud of his or her role at the bank. She felt a few directors were less prepared for meetings than she would like, and she had considered suggesting to them that they step down when their term expired, but so far she had taken no action.

Rob Singh had served as the chairman of the audit committee since Kendallville went public. Singh appeared well-qualified for his role. He was a CPA and had retired 10 years earlier from an independent public accounting firm, where he was an audit partner. Joining Singh on the audit committee were two other board members: the owner of a local construction firm, who was also a regular recipient of business loans from Kendallville, and the former president of an insurance company.

INTERNAL AUDIT

Janet Lee headed Kendallville's internal audit function. After conferring with Singh, CFO Kmetko had promoted Lee to her current position two months earlier, when her predecessor quit unexpectedly. Lee, a CPA, had been with Kendallville for six years and was highly regarded for her skills; however she had not held a managerial position at Kendallville before her new promotion. Renwood trusted Kmetko's judgment in selecting Lee, but she wondered whether Kmetko would have pursued a more senior external candidate had she not encouraged her team to avoid new hires.

Lee had two direct reports. Both were technically proficient accountants, but were not experienced or senior enough to challenge the status quo on their own when performing their audit and compliance work. The annual goals for internal audit—which focused on operational efficiency opportunities and identifying weaknesses in the loan underwriting department—had been developed by Kmetko and Lee's predecessor at the beginning of the fiscal year.

Internal audit at Kendallville historically reported administratively to the CFO. Lee knew that internal audit needed to interact more directly with the audit committee and that the annual audit plan needed to be more risk-based, but she struggled with how to best elevate the function accordingly. Lee was looking forward to a meeting with Renwood and Kmetko to discuss this, but was not sure that Kmetko was going to be very supportive.

Not long after taking over the function, Lee had a conversation with Kmetko. She explained to him that she was unfamiliar with several aspects of the job that had been handled by her former boss. This included testing the operating effectiveness of the controls related to the Allowance for Loan and Lease Losses (ALLL)—an estimate of loan losses. Kmetko indicated that there had been no issues from an internal audit perspective with ALLL in the past so that for now she should focus on getting up to speed managing the department and that once she got settled in he would find a time when the two of them could meet with Davis and they could discuss the ALLL together.

EXTERNAL AUDIT

Kendallville Bank had used PLN LLP (PLN) as its external auditor since the bank had gone public. PLN had 21 public company clients in its portfolio that consisted of a mix of small to mid-sized companies. PLN did not specialize in either banking or financial service firms, but had SEC expertise. Pat LaSalle had been the PLN partner in charge of the audit engagement team for Kendallville for four years. In addition to Kendallville, LaSalle oversaw engagement teams for four other PLN clients, all public companies in a variety of industries. Kendallville was a large client for PLN, and LaSalle had always paid close attention to its needs. While she maintained professional relationships with the bank's executives, she also counted a few executives among her personal friends.

A recent reorganization at PLN had left the engagement team with many new members unfamiliar with Kendallville. Jennifer Watkins, the engagement team senior manager who reported to LaSalle, had been with PLN for eight years, but with limited experience in the financial services industry. LaSalle impressed upon Watkins the importance of Kendallville to PLN when she was brought onto the engagement. LaSalle selected Watkins because she trusted her technical competence, and also because she felt Watkins had good people skills for working with an important client. LaSalle had hoped to provide significant hands-on mentoring to Watkins. Recently, however, LaSalle's time became limited after the audit committee of a major company she had pursued selected PLN and LaSalle as its external auditor.

KENDALLVILLE CULTURE

At Kendallville, Renwood set clear expectations that her executive team meet financial and business targets both on an individual and business unit level. While her targets were not overly aggressive, meeting them, she believed, would keep the bank on a solid footing. She regularly reviewed each executive team member using a structured performance review process that included metrics that fed into the incentive compensation plan for executives. Renwood encouraged debate and discussion among her direct reports, though she wished her team members would push or challenge each other a bit more than they did. Too often, she felt, when one of her executives presented at a meeting, the other executives tended to ask clarifying questions, but not probing or challenging questions. This was particularly true when Davis spoke.

Despite her expectations, and the fact that she kept her relations with her executives on a professional level, Renwood promoted a friendly work environment. While Renwood would give anyone at the bank a hello and a smile, she rarely had significant work-related conversations with anyone below her direct reports for fear of interfering with the chain of command.

ENTITY-LEVEL CONTROL ENVIRONMENT

As was common practice at public banks, Kendallville published a code of conduct. The bank required that all employees certify each year that they had read and followed this code. Kendallville also maintained a whistleblower hotline for employees to report any matter of concern—another requirement of public companies. Employee surveys, however, indicated that individuals were either unaware of the hotline or were reluctant to use it because they were skeptical that the calls remained confidential. In the past six months, the hotline had received no calls. Since the enactment of the Sarbanes-Oxley Act of 2002, Kendallville had reported effective internal control over financial reporting and unqualified integrated audit opinions. Kendallville had just completed undergoing its regulatory review, and there were no problems raised in the review.

RECENT EXTERNAL FACTORS

Several years earlier, the U.S. economy had suffered an economic recession that hit most sectors, but particularly impacted real estate values. Most banks suffered losses, but Kendallville, following Davis's advice, had avoided the worst effects. Davis had identified early on several real estate sectors that he felt would be hit hardest. This enabled Kendallville to cut back business in those sectors just as the economy slowed. Kendallville took some losses, but at a much lower level than its peers. As the economy improved, Kendallville was well-positioned to act quickly. It relaxed its loan underwriting standards to pre-recession levels and grew its business while competitors were still licking their wounds.

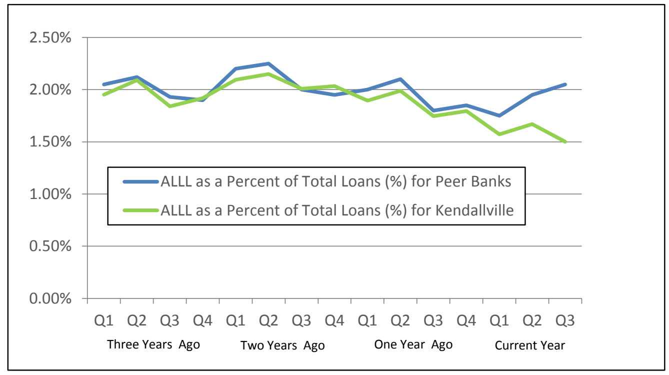
Over the past several quarters, however, there were signs that the real estate sector was again slowing. Prices had flattened, and in some cases declined while properties took longer to sell. The number of borrowers who were behind on their loans ticked upwards—as did the unemployment rate which had been declining. Many banks responded quickly over the last two quarters by tightening underwriting, reducing loans to customers with questionable credit, and by increasing their ALLLs.

LOAN ACCOUNTING: ALLL, PLLL, CHARGE-OFFS, AND RECOVERIES

Bank accounting rules under GAAP played a role in Kendallville's situation. Under these rules, any bank that originated loans presented the principal balance of the outstanding loans, net of deferred origination fees and costs, as an asset on its balance sheet. Bank managers knew from past experience, however, that some loans would not be repaid. To reflect this, a bank's balance sheet also included an Allowance for Loan and Lease Losses. The ALLL represented management's best estimate of the amount of its probable incurred loan losses at each balance sheet date that were expected to be confirmed and charged-off in future periods.

The calculated ALLL balance was comprised of quantitative and qualitative components. To calculate the quantitative component, management separated the loan portfolio into categories that had similar risk characteristics, determined the historical loss (charge-off) rates for each of the categories, and then applied those historical loss rates to the outstanding loan values for each category of loans at the balance sheet date. The qualitative component represented an adjustment to the quantitative component that was recorded because current economic conditions differed from the historical conditions; the objective was to reflect changes in the collectability of each loan category that would not be captured in the historical loss data. Management determined the qualitative component by studying factors impacting current collectability—such as housing prices, vacancy rates, unemployment rates, and changes in lending policies and procedures—and then comparing those factors to the factors and trends for the periods over which the quantitative loss rates were determined. **(Chart 1 shows ALLL as a percentage of total loans for Kendallville and its peers.)**

Chart 1



Consistent with all financial institutions, activity in Kendallville's ALLL included charge-offs and recoveries. Whenever management determined that all or a portion of a loan would not be repaid (collected), they "charged-off," or reduced the carrying amount of the loan, the amount they did not expect to collect. A recovery occurred when the bank collected payments on a loan previously charged-off. Charge-offs were recognized by reducing the carrying amount of the loan and reducing the ALLL; recoveries were recognized by restoring (increasing) the ALLL when cash was received. This all happened in accordance with GAAP.

At each balance sheet date, bank management estimated the ALLL needed based on the loan portfolio at that date. Management then made an adjusting journal entry to increase or decrease the ALLL account to the needed balance; the offsetting entry was recognized through an account called the Provision for Loan and Lease Losses (PLLL) that appeared as an expense on the bank's income statement. **(Data regarding Kendallville's loan portfolio and financial statements appear in the appendix.)**

THE CREDIT QUALITY COMMITTEE

The Credit Quality Committee (CQC) was responsible for making several estimates necessary for Kendallville's financial reporting. One of the most important of these was measuring the ALLL. The CQC was headed by Davis, and also included the corporate controller, the loan review officer, and John Jones, the senior vice president in charge of external reporting. Jones, who had served in his position for a few years, reported to Kmetko. Representatives from internal audit and external audit frequently attended CQC meetings to assess the design and test the effectiveness of controls, but these representatives did not participate in CQC activities. The CQC met several times during the last week of each quarter.

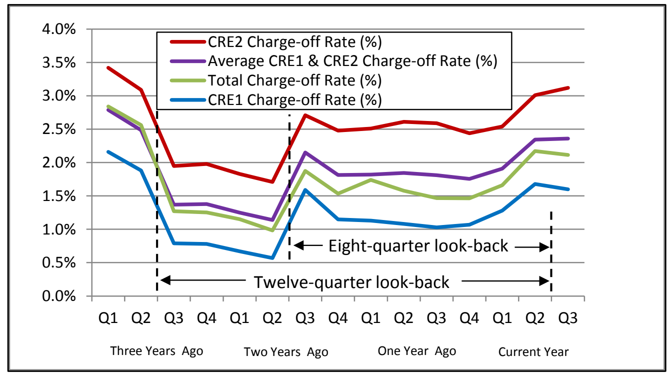
Davis played the key role in measuring the ALLL. He had built the ALLL calculation methodology, and he periodically modified or added to it when he uncovered new factors or trends to consider. This included evaluation of factors impacting the quantitative component, including how loans were segmented and the look-back periods to use for historical loss rates. On the qualitative component, his intelligence and interest in understanding the local economy and current environment, and his insight into factors or trends that should matter more, or less, going forward than they had in the past meant that his opinion generally carried the most weight.

During the CQC meetings, Davis typically presented his assessment of the performance of Kendallville's loan portfolio and current economic, political, and other environmental factors. Throughout his presentation, Davis encouraged questions from and discussion with the members of the CQC. This back and forth between Davis and the CQC members frequently seemed more about educating the members on Davis's thinking than about including the members' thoughts into the results. Davis wrapped up his presentation with several recommendations, one of which was a specific number for the ALLL. Since most of the discussion had already occurred, the CQC members typically agreed by consensus to the ALLL proposed by Davis. Only rarely did the CQC make adjustments to what Davis proposed. This was partly due to the design and format of the meeting and partly due to members' respect for Davis, his track record, and his sterling reputation at Kendallville. After the meeting, Davis wrote up a summarized memorandum covering what the CQC had decided, had the loan review officer review it, then presented it to Kmetko for his approval.

THE SECOND-QUARTER CQC MEETING

During the second-quarter CQC meeting, Davis explained that he had seen a few troubling signs that the economy was slowing, but he considered them to be minor negative points in an overall ongoing recovery. During his presentation, Davis also recommended increasing the look-back period used to calculate the ALLL from eight quarters to 12 quarters. The look-back period described how much historical data was used in the quantitative component of the ALLL. Many banks used a 12-quarter look-back period. Kendallville for most of its history had also used a 12-quarter look-back, but it had changed to an eight-quarter look-back during the economic downturn because the conditions were changing so rapidly that Davis decided that shortening the look-back would place greater weight on recent events when measuring the ALLL. Now that the overall economy had recovered and wide fluctuations seemed a thing of the past, Davis argued that it was time to return to its 12-quarter look-back. The CQC members had questions regarding this change, but they did not specifically question how much impact this change would have on the ending ALLL or how a change in the look-back period might impact the qualitative component of the ALLL. **(Chart 2 shows the change in look-back period.)**

Chart 2



Following the CQC meeting, Davis wrote up his typical memorandum; it provided the numbers and a high-level explanation recommending their approval. In the memo itself he made no mention of the shift to the 12-quarter look-back period, but he did include that information in the exhibits which he attached to the memo. The loan review officer read through the memo and had no changes. Davis sent it to Kmetko the next day. Kmetko approved it and sent it to Renwood and Jones. At the end of the quarter, Kendallville reported a slight increase in profits over the same quarter the previous year.

THE THIRD-QUARTER CQC MEETING

During the third-quarter CQC meeting, Davis again noted some economic concerns, but stated that he was not overly alarmed. He explained, "There are positive economic indicators and also some negative indicators, but my gut tells me that the negative signs are weaker and likely more temporary than the positive signs. Overall the economy is still improving." Davis then moved on to the ALLL calculation. He explained that he felt it was time to "drop" the separate Commercial Real Estate 2 (CRE2) loan category loans by combining them with the Commercial Real Estate 1 (CRE1) loan category for purposes of the ALLL calculation, and utilizing the default rates from the CRE1 loan category for the new combined portfolio.

CRE2 was a type of loan product that Kendallville began offering prior to the economic downturn. It involved loans to its regular commercial customers, but for uses outside the customer's historical business model. For example, Kendallville had traditionally made loans to commercial retail developers operating in its rural and small town markets. These loans fell into Kendallville's CRE1 category. Occasionally, these customers got involved in commercial development in larger cities. For most of its history, Kendallville had turned away these customers for these larger city loans. Then, about 10 years ago, it decided to make these loans—first for existing commercial customers, and then eventually to any primarily small-market customer venturing into a city so long as they met certain underwriting requirements. Kendallville created a new category, CRE2, for these loans, and this business grew rapidly.

During the economic downturn, however, Kendallville increasingly felt the brunt of riskiness in the CRE2 loans, which were experiencing higher default rates and thus higher than expected loss rates and charge-offs. Kendallville managers came to feel uncomfortable with CRE2 loans and, several years ago, decided to stop originating these loans. While it still carried CRE2 loans in its portfolio, these balances were being paid off so the CRE2 portfolio was decreasing in size. Because of this, Davis explained, dropping this separate loan category would be consistent with management's decision to close out this line of business. **(Charts 2, 3, and 4 provide additional data on Kendallville's CRE1 and CRE2 charge-off rates, loan balance, and charge-off volume.)**

Chart 3

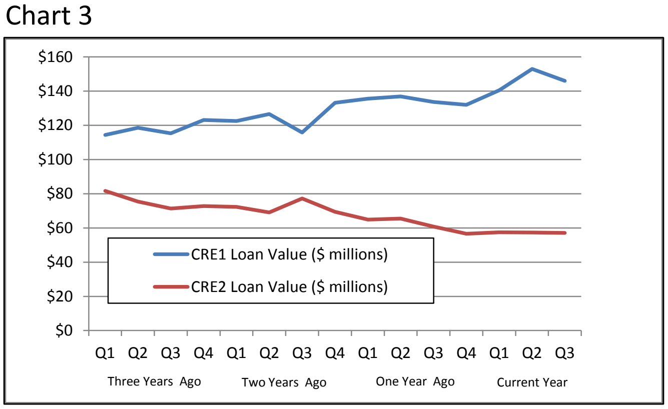
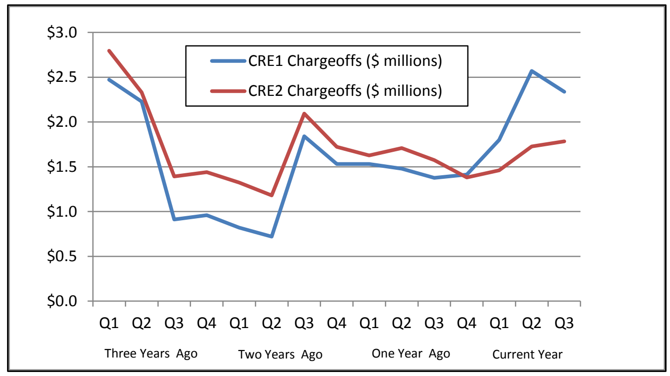


Chart 4



Davis received more questions than usual as he presented his reasoning for dropping the CRE2 category. Jones did not understand how you could simply drop a category that still contained outstanding loan balances. Davis explained the outstanding balances would not completely disappear, but rather would be combined with the CRE1 category. Davis briefly explained how dropping the CRE2 as a separate category would impact the historical loss rates of the loan portfolio. In the end, the CQC approved the ALLL changes as recommended by Davis.

Following the CQC meeting, Davis wrote up his typical memorandum: it provided the numbers and a high-level explanation recommending their approval of the change. The memo itself did not include details regarding the combination of the CRE loan categories for purposes of the ALLL calculation, or changes to the quantitative components of the ALLL model that would be necessary to support that change, but such details could be found in the extensive exhibits that Davis attached to the memo. After having the loan review officer look over the memorandum, Davis sent it to Kmetko the next day.

Jones had a previously scheduled meeting with his boss Kmetko immediately after the CQC meeting. As an aside, Jones brought up the just-ended CQC meeting. He stated, "I think we covered everything we needed. By the way, Davis recommended we drop the CRE2 category from the ALLL process. I never anticipated that we would stop tracking them separately; I thought that portion of the ALLL would just get smaller and smaller until the remaining loans were paid off." Jones added, "But Davis had his reasons for doing what he wants to do. Anyway, I would be curious to hear your thoughts when you see his memo." Kmetko replied, "Waiting for the loan payoffs would make sense to me too, but I will look at it."

When Kmetko received the memo, he was in the midst of a very busy time, considering the bank's potential acquisitions. Kmetko remembered what Jones had said about the CRE2 loan category and he wanted to look into it, but he also knew that Jones needed his approval to move ahead with completing the financial reports. The memo looked good to him and rather than delay, he approved it and sent it to Renwood with a copy to Jones. Jones, busy himself, never followed up with Kmetko, but he generally had confidence in Kmetko so he didn't worry about it any further.

EXTERNAL AUDIT'S RESPONSE

At the end of the quarter, Watkins, PLN's external audit engagement team senior manager, gathered the material her team would need to complete the quarterly review, and requested from Kmetko the ALLL memorandum and all the supporting material relating to it. Watkins knew that for banks the ALLL was an important accounting estimate and she planned to spend sufficient time reviewing Kendallville's ALLL. Kmetko sent Watkins the memo, but told her to ask Davis for the supporting material. Davis said he would send her what she needed. Watkins moved on with other work and it was nearly two weeks before she realized she did not have the ALLL supporting material. She placed a follow-up call to Davis as a reminder, but had to leave a voicemail. She found herself wondering why she was having to track this down; Kendallville should be working on this internally, she felt. Knowing how busy Davis was, and having several other sections to review herself, she did not press him too hard to deliver the details. When she finally received the documentation, she saw it was more complicated than she had anticipated. She called Davis for an overview to get her started and found Davis was travelling and would be unavailable until the following week. Running out of time before the filing deadline, she pushed ahead with her review of the ALLL. She found nothing concerning, but because she was unfamiliar with the changing conditions in the industry, she was not sure she fully understood the judgments and assumptions Davis made in the model. She completed her work with the plan to spend more time on Kendallville's ALLL during the upcoming quarter.

THE THIRD-QUARTER BOARD MEETING

A part of each quarter-end board meeting included a review of the quarterly financials before they were filed. Kmetko led the presentation. He talked about the slowing economic conditions appearing in the news, but noted that it was management's view that the situation was not so bad. He further noted that Kendallville's steady growth strategy was going well and enabling the bank to outperform its competitors. Several board members questioned Kmetko regarding his interpretation of the economy and Kmetko replied that his position was based on the sound judgment of Davis who had a very strong track record on such matters. Janet Lee gave a brief presentation on internal audit's review pointing out that nothing unusual had been found. Because she and Kmetko had yet to sit down with Davis, she provided no details on the ALLL, and board members did not question her about it. By the end of the meeting, the board decided to file Kendallville's financial statements.

SANDRA RENWOOD'S SECOND THOUGHTS

After a busy day visiting the potential acquisition target, Renwood reflected again on Kendallville. She found herself returning to Kmetko's concerns about "not missing anything with our existing operations." She was especially hesitant about the bank's decision to combine the two CRE loan categories. Based on the economic conditions and financials she had seen in the potential target, she started to worry about Davis's judgment. She had always considered him a great asset to her executive team, but she wondered whether she and others at the bank had come to rely on him too much. Was it possible that others felt the same way? Was this a problem? If so, what should she do about it?

Kendallville Loan Portfolio Data ($ millions)

		Home Mortgages		Consumer Loans		Credit Cards		Commercial RE1		Commercial RE2		Business Loans		All Loans	
	Quarter	Loan Value*	Charge-Off Rate (%)	Loan Value*	Charge-Off Rate (%)	Loan Value*	Charge-Off Rate (%)	Loan Value*	Charge-Off Rate (%)	Loan Value*	Charge-Off Rate (%)	Loan Value*	Charge-Off Rate (%)	Loan Value*	Charge-Off Rate (%)
Three Years Ago	1	$147	1.05	$65	2.43	$71	8.23	$114	2.16	$82	3.42	$65	1.91	$545	2.84
	2	$151	0.90	$70	2.34	$70	7.64	$119	1.88	$75	3.09	$54	1.68	$539	2.56
	3	$170	0.58	$77	1.26	$60	3.74	$115	0.79	$71	1.95	$55	0.83	$549	1.27
	4	$179	0.56	$84	1.21	$62	3.72	$123	0.78	$73	1.98	$39	0.71	$560	1.25
Two Years Ago	1	$184	0.55	$78	1.18	$56	3.66	$122	0.67	$72	1.83	$45	0.67	$557	1.15
	2	$190	0.48	$75	1.03	$58	3.20	$127	0.57	$69	1.71	$58	0.41	$575	0.98
	3	$154	0.82	$83	1.91	$66	4.32	$116	1.59	$77	2.71	$55	1.27	$552	1.87
	4	$185	0.78	$69	1.68	$52	4.21	$133	1.15	$69	2.48	$69	1.19	$579	1.54
One Year Ago	1	$189	0.76	$71	1.65	$65	5.83	$136	1.13	$65	2.51	$65	1.12	$590	1.74
	2	$185	0.74	$65	1.41	$60	5.02	$137	1.08	$65	2.61	$83	1.11	$595	1.58
	3	$188	0.63	$67	1.35	$67	4.35	$134	1.03	$61	2.59	$91	1.07	$608	1.47
	4	$189	0.64	$75	1.38	$69	4.43	$132	1.07	$57	2.44	$107	1.03	$628	1.46
Current Year	1	$192	0.71	$77	1.42	$77	4.88	$141	1.28	$57	2.54	$96	1.21	$639	1.66
	2	$178	0.86	$76	2.17	$70	6.73	$153	1.68	$57	3.01	$102	1.61	$637	2.17
	3	$178	0.88	$89	2.10	$64	6.98	$146	1.60	$57	3.12	$102	1.43	$635	2.12
	4														

* Loan Value represents the average loan total for the period.

Kendallville Financial Statement Data ($ millions)

	Three Years Ago				Two Years Ago				One Year Ago				Current Year			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Income Statement Data																
Income	$9.62	$11.29	$10.87	$10.04	$10.49	$12.31	$11.85	$10.94	$10.69	$12.55	$12.09	$11.16	$10.88	$12.77	$12.30	
PLLL	$0.94	$1.10	$1.06	$0.98	$0.91	$1.07	$1.03	$0.95	$0.87	$1.02	$0.98	$0.91	$0.67	$0.79	$0.76	
Other Expenses	$7.26	$8.53	$8.21	$7.58	$7.85	$9.22	$8.87	$8.19	$8.04	$9.44	$9.09	$8.39	$8.40	$9.86	$9.50	
Net Income	$1.42	$1.66	$1.60	$1.48	$1.72	$2.02	$1.95	$1.80	$1.78	$2.09	$2.01	$1.86	$1.80	$2.12	$2.04	
Balance Sheet Data																
ALLL	$10.63	$11.27	$10.10	$10.74	$11.67	$12.36	$11.08	$11.78	$11.17	$11.84	$10.61	$11.28	$10.04	$10.64	$9.54	

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