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SMALL BUSINESS LOANS

BANKERS’ REACTIONS TO THE NEW STANDARD REPORT AND CONSISTENCY REPORTING REQUIREMENTS

by Marshall A. Geiger

The auditor’s report is the primary source of information for a bank loan officer concerned with the integrity of a potential client’s financial statements. Recently, the auditing standards board of the American Institute of CPAs established new wording and reporting requirements in the standard report for companies that change accounting principles—among other changes in reporting on audited financial statements. The ASB modified the long-lived standard report wording to which the U.S. financial community had grown accustomed.

THE CHANGE

In order to communicate better to audit report readers the nature of an audit, the responsibilities assumed by auditors and management and the auditor’s resulting conclusions, the ASB adopted a new standard three-paragraph audit report in Statement on Auditing Standards no. 58, Reports on Audited Financial Statements. Representing a controversial change, SAS no. 58 eliminated from the opinion paragraph the long-standing reference to consistent application of generally accepted accounting principles. The new unqualified report does not refer to consistency in the normal case of no change in accounting principles. However, if there has been a change in accounting principles during the period, SAS no. 58 requires, following the opinion paragraph, an additional paragraph that directs the reader’s attention to the footnote in the financial statements discussing the change. In this fashion, SAS no. 58 eliminates the former “except for” qualification for consistency exceptions and replaces it with a required reference to inconsistency when there has been a change.

A CASE STUDY

One hundred and ninety-nine randomly selected bank loan officers from across the United States participated in a mail survey designed to assess the impact of the new report and consistency reporting requirements on commercial loan officers’ decisions. The survey was based on a loan application for a hypothetical medium-sized ($51 million in sales) regional retail grocery company, operating at or slightly below average for the industry. A marginal applicant was used to allow the audit report wording a chance to affect the banker’s decision. (With an extremely creditworthy or uncreditworthy applicant, the report wording would not affect the loan officers.) Financial statements and related footnotes, a description of the company and its key executives and a set of calculated financial statement ratios were sent to each participant.

The loan request was for $2.2 million, repayable in 10 equal annual installments. The proceeds were to be used to add additional inventory items...
to existing stores and open up several new stores in a surrounding area. Six different loan applications were used. The first four involved no change in the accounting principle. These four were identical except for the wording of the auditor’s report. One group received the old standard report, one received the new standard report, one group received the old report with the traditional reference to consistency removed and the fourth group received the new standard report altered to include a reference to consistency.

The two remaining loan applications were similar to the first four. However, they described a client that had changed its depreciation method, resulting in an 8% aftertax ($26,000) increase in net income. These are the “change” cases. One group of bankers received the old “except for” qualification while another received the new “modified” unqualified report with the additional paragraph. All other information, including descriptive footnotes of the change, was identical across both groups.

The bank loan officers were asked either to grant or deny the loan. Once the loan decision was made, they were asked to state the interest rate premium above prime they would assess the applicant or, if denying the loan, the premium another lending institution might charge.

RESULTS

• “No change” cases. An analysis of the responses of the four groups of loan officers receiving the “no change” cases revealed the audit report wording did not affect the bankers’ decisions to loan or the interest rate premiums they would have assessed the loan applicant. Thus, the reference or lack of reference to consistency in the auditor’s standard report (new or old) did not appear to affect the bankers’ decisions.

• “Change” cases. The two “change” groups had markedly different responses from the “no change” cases. The loan officers receiving the new modified report were far more likely to grant the loan than those receiving the same application with the former qualified report wording. Additionally, of the officers granting loans, the ones receiving the new report assessed the applicant an average interest premium of 1.22% over the prime rate, compared with 1.70% for those receiving the old report wording. This difference is significant because those applicants formerly using “except for” audit reports may have been penalized not for their financial integrity but for the wording of the audit report. A premium of almost one-half of one percentage point is a substantial price to pay because of audit report wording.

The results indicate the deletion of the former consistency reference in the standard report probably will not have much effect on loan officers’ decisions. However, the new report’s references to consistency exceptions (“modified” unqualified) generally will be viewed more favorably by loan officers than the former “except for” qualification. The new reporting requirements under SAS no. 58 will not force companies to carry the stigma of a qualified report during periods in which accounting principles have been changed. The new requirements alleviate the negative impression of a qualified report but still direct attention to the change in principle and its effect on the company and its financial statements.