

Bankers' Perceptions of Accounting Principles: Some Implications for the Small Business

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Abstract

This study examines perceptions of bankers regarding the usefulness of generally accepted accounting principles for small businesses' financial statements. Perceptions were obtained regarding four accounting standards that have been criticized as being unnecessarily costly for smaller businesses. Although results were somewhat mixed, support was given to prior research that has suggested bankers would accept financial information prepared from a less costly non-GAAP basis for some small businesses.

Introduction

Each day bankers use financial statements, prepared using generally accepted accounting principles (GAAP), to make loan decisions for small businesses. The accounting profession is very concerned about the usefulness of the financial information provided by accountants in the loan decision process. Usefulness provides a "litmus test" for determining which accounting information should be measured and reported. The importance of this qualitative characteristic is noted in *Statement of Financial Accounting Concepts No. 1*,¹ which states that the major objective of financial reporting is to "...provide information that is useful to present and potential investors and creditors..." for decision making.

The purpose of this paper is to report results of a study on the perception of bankers concerning the usefulness of GAAP-based financial reports provided by small businesses for loan decisions. These results have implications regarding the type of financial information required by bankers, and the cost incurred by small company borrowers and accounting practitioners that serve them.

Prior Research

Studies by the American Institute of Certified Public Accountants (AICPA) and Financial Accounting Standards Board_1 (FASB) have shown consistent results concerning bankers and GAAP in a small business context: 1) bankers are the primary external users of financial statements of small businesses and are interested in financial information to ascertain the collateralization of their loans; 2) bankers generally perceive their information needs and

decision processes as essentially the same regardless of a company's size or ownership structure (public or private); and 3) of the various groups examined, bankers tend to have the highest satisfaction level with GAAP, followed by managers of small businesses and then CPAs. The high satisfaction levels imply that bankers believe GAAP-based accounting information is useful to them for loan decisions in a small business context.

Data were collected for the above studies primarily using questionnaire surveys and/or interviews. However, more recent studies, where subjects were involved in a simulation of a loan decision, reveal that GAAP financial statements are not as necessary to bankers as the AICPA and FASB studies indicated. Campbell (1984) found that loan officers would make loan decisions for a closely held company without complete GAAP information. Similarly, Hildebeitel (1985) concluded that compliance with certain accounting standards was of limited value to bank lending officers.

Methodology

This study measures perceptions of usefulness of GAAP-based accounting information in a small business context. Usefulness, however, is a qualitative characteristic not easily measured. As a practical matter, the benefits of accounting information are difficult to determine. Usefulness is a feeling, a subjective evaluation of accounting information's value to a decision process. Therefore, any qualitative characteristic of accounting information is usually restricted to a measure of respondents' perceptions

of that characteristic.

To measure perceived usefulness of selected accounting standards, this study employed a decision simulation utilizing twenty-seven financial analysts from within banks. Banks were selected judgmentally from yellow pages throughout the United States. Each participant was given a description of a hypothetical small manufacturing company and a discussion of four accounting standards that affected that company. Those standards dealt with accounting for leased equipment, deferred taxes, interest on construction loans, and compensated absences. This information was followed by sixteen narrative descriptions on how the company could present the four accounting areas. Each of the four accounting standards had two alternative methods of reporting: 1) per GAAP (accrual); and 2) a non-GAAP (cash basis) alternative. Each subject made judgments concerning usefulness by their perceptions of "relevance"² and "cost effectiveness"³ for each of the sixteen narrative financial statement presentations on a one-to-seven scale.⁴

The appendix shows a portion of the instrument given to each subject. Only two of the sixteen cases evaluated are provided. The first case in the appendix shows the GAAP alternative for each accounting issue. The second case shows the non-GAAP alternative for each accounting issue. Each of the fourteen other cases given to respondents was an intermingling of the four accounting issues so that every possible combination of GAAP and non-GAAP reporting of the four issues was evaluated.

Results

Analysis of variance (ANOVA) was used to analyze bankers' perceptions of relevance and cost effectiveness. The objective was to determine if any of the four GAAP accounting standards significantly affected the perceptions of relevance and cost effectiveness. If a given GAAP accounting standard is statically significant, the GAAP alternative was perceived as being more relevant (or cost effective) than the non-GAAP alternative. If the difference is not significant, the implication is that the bankers are indifferent between the GAAP standard and its non-GAAP alternative.

From the ANOVA procedure an omega-square statistic was calculated for each accounting principle. The omega-squared statistic is useful in ascertaining the relative importance of each factor in explaining response variation. The higher the percentage of variation caused by an accounting standard, the more importance placed on it by the bankers. This measure allows a ranking, by order of importance, of the GAAP accounting standards.

Tables 1 and 2 show the GAAP accounting standards that were significantly different (at the .05 level) from their respective non-GAAP alternative and the percentage of

variation caused by each standard. These amounts are shown for both relevance (Table 1) and cost effectiveness (Table 2).

**Table 1
Results of Subject Responses
on Relevance**

FACTORS	BANKERS
Leases	* 5.18%
Interest	0.24
Taxes	* 4.14
Absences	* 4.65
Totals	14.21%

*Factor was significant at 5% level

**Table 2
Results of Subject Responses
on Cost Effectiveness**

FACTORS	BANKERS
Leases	* 5.50%
Interest	0.00
Taxes	0.45
Absences	0.55
Totals	6.50%

*Factor was significant at 5% level

Bankers' Perceptions of Relevance

Table 1 reveals that bankers, as a group, perceive that three of the four GAAP accounting standards investigated are significantly more relevant than their respective non-GAAP alternatives. However, the total variation in relevance judgments of 14.21% seems low when compared with similar studies.⁵ In comparing between standards, GAAP accounting for interest on construction loans seems to be the least relevant accounting standard (of the four examined) in that it was not significant and had very little variation.

Bankers' Perception of Cost Effectiveness

Table 2 reveals that bankers, as a group, perceive one of the four GAAP accounting standards was significantly more cost effective than its respective non-GAAP alternative. Only GAAP accounting for leases was perceived as significant, and the total variation was 6.50%.

Implications

Although not overwhelming, the results of this study give some support to the findings of Campbell and Hiltelbeitel, implying that for some smaller businesses compliance with certain accounting standards may be of limited value to bank lending officers. Although three of the four accounting standards investigated were perceived as relevant by bankers, the overall relevance variation of 14.21% was small when using other groups (accountants

in CPA firms) as a benchmark. This finding coupled with the weak cost effectiveness perceptions of GAAP accounting standards add support to the notion that bankers might be persuaded to use financial statements prepared using an alternative to GAAP for some small business borrowers. This is particularly important for smaller businesses and their accountants that seem to be the most severely burdened by some costly GAAP accounting standards.

The AICPA's Special Committee on Accounting Standards Overload examined several approaches to allow smaller businesses relief from burdensome accounting standards. One was to provide an alternative to GAAP as a basis for financial accounting. A suggested alternative therefore might be the income tax basis of accounting.⁶ The accounting information generated by the income tax basis of accounting is readily available, conservative in its measure of income, auditable, and is easily understood. Small business managers and their accountants could put forth these arguments in requesting a "change in basis" from lenders. While the change might not always be feasible, there would likely be many situations where bankers would allow an alternative basis to be used.

For most small companies using a tax basis of accounting would allow the accounting system to provide financial information for both tax reporting and financial reporting without duplication or the need for reconciliation of book and tax differences. Also, by reducing the borrowing-related costs of financial statement preparation, businesses could operate more efficiently and their ability to make debt payments would be enhanced.

Conclusion

Further research is needed to explore bankers' financial accounting needs (as noted, this study was based only on a sample of 27 subjects). However, results of this and prior studies raise questions as to the necessity of GAAP-based financial information for lending decisions in a small businesses context. CPAs might consider asking bankers to allow an alternative to GAAP, such as the income tax basis of accounting, for some small clients. The tax basis of accounting should provide useful financial information for commercial lenders, yet information that would be less costly to prepare and audit. In addition, financial statements would likely be available on a more timely basis since small businesses could supply their financial statements based upon tax records.

Appendix

CASE 1

Leases: The leased items are shown as an asset on the balance sheet with the future lease payments being shown as a liability.

Interest: Interest on the funds used to finance construction of plant facilities is included on the balance sheet as part of the cost of the plant facilities.

Taxes: A tax liability is included on the balance sheet for the amount of additional tax that would have to be paid if taxable income was as large as book income.

Absences: A liability is included on the balance sheet and an expense on the income statement for the amount of salaries that will be paid in the future for vacation time earned this year.

How well would the presentation above provide relevant information for making economic decisions with regard to the company? The information is: (circle one)

Totally Irrelevant 1 2 3 4 5 6 7 Very Relevant

What is your perception of the above financial presentation with regard to its cost effectiveness? The information is: (circle one)

Totally Cost Ineffective 1 2 3 4 5 6 7 Very Cost Effective

CASE 2

Leases: The lease payments occurring during the year are expensed in this period. No liability or asset is shown concerning the lease.

Interest: Interest on funds used to finance the construction of plant facilities is expressed as an expense in this period.

Taxes: Nothing is shown on the balance sheet concerning the difference in book and tax incomes for the year.

Absences: Nothing is shown on the balance sheet concerning the effects of vacation time earned and not yet taken.

How well would the presentation above provide relevant information for making economic decisions for the company? The information is: (circle one)

Totally Irrelevant 1 2 3 4 5 6 7 Very Relevant

What is your perception of the above financial presentation with regard to its cost effectiveness? The information is: (circle one)

Totally Cost Ineffective 1 2 3 4 5 6 7 Very Cost Effective

Endnotes

1. These studies have dealt with the issue of accounting standards overload--the perception that the general purpose financial statements for small/privately owned companies, prepared in conformity with GAAP, are often unnecessarily costly to produce and provide irrelevant information to users.
2. Relevance was defined as "the capacity of information to make a difference in a decision..." as per FASB Concepts Statement No. 2, "Qualitative Characteristics of Accounting Information," (FASB, 1980).
3. Cost effectiveness was defined as a situation where the benefits of financial information to the user are greater than the cost of producing that information. This definition was based upon the FASB's Concepts Statement No. 2, "Qualitative Characteristics of Accounting Information," (FASB, 1980).
4. Relevance and cost effectiveness are used as surrogate measures of usefulness. Statement of Accounting Concepts No. 2, "Qualitative Characteristics of Accounting Information," states that useful information will possess both of these characteristics.
5. Similar studies conducted by the authors of respondents from accounting firms found a total variance of 36.43% for CPAs from local and regional firms and 51.45% for CPAs from international firms.
6. The tax basis of accounting is suggested, even though the non-GAAP alternatives used in the study were cash basis, because tax basis methods are required by the Internal Revenue Service regardless of what is used for financial reporting. Since the small business must design a system to comply with tax reporting, adapting a financial reporting system to a tax basis seems to provide a potential efficient and effective basis.

References

1. American Institute of Certified Public Accountants (AICPA), *Report of the Special Committee on Accounting Standards Overload*, AICPA, New York, 1983.
2. Campbell, Jane E., "An Application of Protocol Analysis to the 'Big GAAP' 'Little GAAP' Controversy," *Accounting Organizations and Society*, Vol. 9, No. 3/4, pp. 329-342, 1984.
3. Hildebeitel, K. M., *The Accounting Standards Overload Issue: An Empirical Test of the Effect of Four Selected Accounting Standards on the Lending Decisions of Bankers*, Unpublished Ph.D. dissertation, Drexel University, 1985.