

Financial Accounting Issues in Commercial Lending Institutions: A Cross-Cultural Study

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As the number and complexity of financial reporting standards (generally accepted accounting principles [GAAP]) continue to grow, non publicly-traded companies find it increasingly expensive to use the GAAP-basis of accounting. Likewise, small and medium-sized businesses often see no benefits in seeking the services of independent certified public accountants (CPAs) to audit or review their financial statements. Previous research reveals some evidence that small businesses are turning away from the GAAP-basis and find appeals in using other bases of accounting. This study investigates the significance of using alternative accounting basis as well as the extent of CPAs involvement with small or medium-sized firms for commercial banks' lending decisions.

Because banks represent a significant source of credit in most countries, particularly for small and medium-sized companies, bankers' perceptions of reliability of financial statements has been used as the basis for this investigation. The study uses a cross-cultural design in order to detect any significant differences between the lending practices of the American and Asian-Pacific bankers. The results indicate that while both American and Asian banks require balance sheets and income statements in considering all commercial loan applications, variations abound with respect to other financial reporting issues. However, no cross-cultural differences were found concerning the choice of the accounting basis or the required extent of financial statement verification.

Introduction

Decisions concerning whether or not loans should be granted pose the greatest risk to a bank's long-term survival. In the banking system, the manual of lending policies is the most important document that establishes the basis for the loan officers to make sure that decisions are made properly and are based on information that is relevant and reliable. As the incidences of bankruptcy, foreclosure, and uncollectible lines of credit continue, bankers and regulators realize the importance of using a solid and well-defined lending policy in deciding whether a loan might be worth making [Hollander, 1987, p. 14].

Historically, a great deal of information about prospective loan applicants was collected through personal acquaintances or the banker's informal networks of clients and informants operating in the community. However, as communities continued to grow in size and the number of business failures increased, the need for some proof of solvency other than personal acquaintances gained considerable importance. Today, no longer could loan considerations be made based solely on acquaintances or through referrals by those whose families had been known to the bank for generations [Mair, 1991].

In today's business environment, neither the clients nor the loan officers may remain with the same bank for a long period of time, forcing the banks to move away from using their past decision models to a more modern, impersonal, and GAAP-based analysis. In evaluating the ability to bear financial commitment, today's loan officers must rely heavily on the loan applicants' financial position and operating results, both on a historical and prospective basis. Decisions concerning clients' future earnings power, collateral, and the guarantees for loan

repayments are made more directly by using financial information provided by the loan applicants' accounting information system, instead of the use of indirect means such as informants, clients' reputations, and previous relationships [Hollander, 1987].

However, with this new approach, reliability of the information presented is a great concern to the banking community [O'Dell, 1991]. Reliability is a characteristic that is of utmost importance to external users of accounting information as many external users (e.g., bankers), have neither the authority nor the ability to evaluate whether the information presented is accurate or complete [FASB, 1980].

For the users of financial information two questions are central to the concept of reliability. First, what accounting framework (i.e., cash-basis, accrual-basis, or modified cash-basis) is used as the basis for recording accounting transactions? And second, whether the statements have been independently verified by a Certified Public Accountant. Thus, the purpose of this study is to investigate the bankers' perceptions of the importance of the above issues in the context of commercial loan decisions concerning small and medium-sized businesses.

Accounting Basis and Financial Information Verification

GAAP versus Non-GAAP Basis:

Financial statements are the basis for commercial loan considerations. To prepare financial statements, business entities may choose one of several accounting bases, including the accrual basis, the cash basis, or the modified cash basis. Among these alternatives, only the accrual method is supported by the generally accepted accounting principles (GAAP). GAAP provides a framework for the preparation of financial statements that is intended to enhance reliability and comparability of financial statements. However, only publicly held companies (or those permitted to access the U.S. capital markets) are required by law to report on the GAAP-basis. Others are only encouraged to voluntarily comply if they so desire (e.g., in loan covenants).

As the FASB continues its rule-making crusade by developing more and more accounting standards dealing with such accounting issues as leases, pensions, post-employment benefits, financial instruments, and comprehensive income, many small and closely held companies find it overly complex and expensive to apply GAAP on a consistent basis [O'Dell, 1991]. Instead, other accounting bases have gained popularity over the past few years.

A survey of 2,175 Certified Public Accountants (CPA) revealed that the majority of these practitioners (81%) have clients who use non-GAAP methods of accounting. In addition, over one-third of the respondents (36%) reported having some GAAP clients who could benefit changing to a non-GAAP basis [O'Dell, 1991].

The decision as to whether or not to use the GAAP-basis may entail both costs and benefits for the firm involved. On the one hand, there is some evidence indicating that the cost of compliance with the GAAP is greater than the benefits that small business owners will receive. In a survey of 70 small business bankers, 68 senior executives of privately-held companies, and 54 Certified Public Accountants, Nair and Rittenberg [1987] found strong consensus that the costs of compliance with the FASB pronouncements are disproportionately greater than the benefits received by management. On the other hand, the cost of noncompliance may also be worth considering. A study of 230 commercial loan officers across the country revealed that not only do loan officers consider the GAAP-basis reports more complete and useful for their loan considerations, but also lower interest rates are charged on GAAP-basis loans compared to those supported by the tax-basis statements [Baker, 1990].

Financial Information Verification:

Regardless of what basis of accounting is being used, the issue of dependability and verifiability of financial statements also play a significant role in decisions involving loan or credit issues. In evaluating loan applications, a loan officer may consider whether the financial statements provided by clients have been audited by independent CPAs. If unaudited statements are presented, the extent of the CPA's involvement with the preparation or review of the statements might be important in determining financial statements' reliability and if the loan should be authorized [Hollander, 1987].

Research evaluating the relative importance of independent accountants' involvement in the preparation or verification of financial statements tend to suggest that the greater the degree of this involvement, the more likely that the bankers will place more reliance on the financial statements. Nair and Rittenberg [1987] found that unaudited statements receive significantly lower ratings from bankers in their evaluation of loan applications.

Additional evidence suggests that bank interest rates fluctuate by an amount (risk premium) that is in part dependent on the level of independent auditors' involvement with the applicant. A study by Baker [1990] demonstrated that the average interest rates on loans supported by financial statements reviewed by a CPA were 11% higher than the rates on loans backed by audited statements. Indeed, the added risk premium is a reflection of the bankers' concerns about the reliability of unaudited financial statements and the greater probability of default associated with loans that are not supported by audited statements.

Thus, from an economic standpoint, as with the decision dealing with the choice between the use of the GAAP or some other basis of accounting, small and closely held companies also are faced with another decision; whether it is worth considering financial statements audited by an independent CPA.

The focus of the present study is to investigate the above issues trying to find answers to such questions as: (1) which general-purpose financial statements are widely required by banks for commercial loan considerations, (2) what basis of accounting is acceptable for the preparation of financial statements, (3) should financial statements be audited, reviewed, or compiled by a Certified Public Accountant, and (4) in what interim periods should financial statements be presented to the bank for the continual assessment of future collectibility of a loan.

Cross-Cultural Investigation

There is ample evidence suggesting that people of different national origins have different preferences for various organizational practices (i.g., Chow, Kato, and Shields, 1994; Chow, Shields, and Chan, 1991; Hofstede, 1980). In an era of rapid globalization coupled with increased emphasis on diversity in the United States, it is important to investigate whether cultural differences are in fact so significant to impact the bankers' lending decisions.

In an extensive study of culture in 53 nations, Hofstede [1980] discovered that despite the presence of a strong organizational culture among corporate managers participating in the study, cultural forces identified with the nationality of the subjects were found to be highly significant in explaining differences in values, assumptions, and goals. In his study, Hofstede [1980] identified four work-related values that differed systematically across nations, including (1) Uncertainty Avoidance, (2) Individualism versus Collectivism, (3) Masculinity versus Femininity, and (4) Power Distance. Among these four values, the present study investigates the effects of uncertainty avoidance on bankers' lending practices. It is this characteristic that

measures the extent to which members of different cultures react to uncertainty in their daily decision-making activities. Accordingly, in the banking environment, the bankers' attitude toward the GAAP-basis compared to other bases of accounting, or the difference in their required extent of verification of financial statements, can be viewed within the cultural differences associated with uncertainty avoidance.

Supported by the Hofstede's [1980] theoretical framework, previous studies have found significant differences between the attitudes of Asian-Pacific businessmen and their American counterparts toward situations affecting the work environment. For example, Lincoln and Kalleberg [1990] discovered distinct differences between Japanese and Americans in their evaluation of work values. While Japanese favor close relations with supervisors and working with groups, Americans prefer independence in performing their duties. In another study, Dubinsky, Jolson, Kotabe, and Lim [1991] compared ethical perceptions of industrial employees working in the U.S., Japan, and South Korea. Significant differences were observed between American subjects, Japanese, and Koreans in evaluating ethical conflicts described in the study. The authors attributed these differences to cultural characters of each nation. In a third study, auditors' perceptions of uncertainty contained in financial information were examined among a group of Australian auditors (labeled as Whites) and a group of auditors from Hong Kong (labeled as Chinese) [Gul and Tsui, 1993]. The subjects were presented with a set of hypothetical financial statements and were asked to indicate the likelihood of rendering a qualified audit opinion. The results showed that Chinese auditors are more likely to issue a qualified opinion than their Australian counterparts. The authors attributed these differences to the presence of a weak form of uncertainty avoidance among the Chinese compared to a strong type found among Whites.

On the basis of Hofstede's [1980] and Gul and Tsui's [1993] findings, this study is designed to determine whether differences between the nations with respect to uncertainty avoidance retain their significance when individuals cross their national boundaries and choose to live and operate in another country. Is the measure of uncertainty avoidance more a function of rules and regulations established by the country we reside or those of a nationality we belong?

To investigate this, a systematic random sample of American bankers was selected along with a matching group of their Asian-Pacific counterparts operating in the United States. The following hypotheses are designed to test cultural differences between the two groups:

- HA1: There are significant differences between the American and Asian-Pacific bankers with respect to their choice of the accounting basis.
- HA2: There are significant differences between the American and Asian-Pacific bankers with respect to their perceived reliability of independent accountants' verification of financial statements.

In the United States, the audit report is believed to be an important document accompanying a company's financial statements. In this report, the independent accountant (auditor) provides an assurance that the financial statements are faithful representations of the firm's actual economic activities. Thus, it is safe to assume that individuals with a strong type of uncertainty avoidance would require that the financial statements be audited or reviewed by an independent CPA.

The Study Design

Data Collection:

The data required for this research were collected via a questionnaire containing four general sections. The first section was comprised of demographic information about the banks including their nationality or the country of origin, whether they were private or public, total years of experience in commercial lending, and their primary service areas. The second section solicited certain financial information including the banks total assets, total loans, and total deposits. These questions were intended to determine the size of the participating banks. The third section contained specific questions pertaining to what financial statements the banks need for considering a loan application, what basis of accounting is required, how much CPA involvement is needed, and how frequently financial statements are issued. The fourth and final section of the instrument included questions designed on a Likert scale, to evaluate the relative importance of certain financial reporting issues.¹

The Sample:

A total of 40 banks were identified representing the Asian-Pacific countries including Japan, Korea, China, and The Philippines. A matching sample of the American banks was also selected at random.

The questionnaire was mailed to each subject. The first mailing along with the follow-up telephone calls resulted in 27 responses. The second and third mailing attempts contributed additional 21 returns, bringing the total number of responses to 48, for a 60 percent overall response rate.²

The Results

The results presented here are derived from the following analyses. (1) General analysis: performed to summarize the respondents' answers to the research questions, (2) evaluating reliability of financial statements: performed to identify the factors used by bankers to determine if the financial statements are reliable, and (3) cross-cultural analysis: performed to test the research hypotheses.

General Analysis:

The response rates ranged from 53% for the Chinese banks to 100% for the Filipinos. The majority of the American banks (82%) were publicly owned compared to only 33% of the Japanese, 22% of the Chinese, and 13% of the Koreans. Banks' primary service areas were local communities, with the exception of the Japanese banks with 67% statewide service area.

¹The survey instrument was pre-tested by inviting three bankers to serve as a pilot group, by reviewing the instrument and providing their comments for improving the quality of the study. The input received from the group resulted in minor modifications with regard to both the content and clarity of certain questions. Upon inclusion of their comments, a revised copy was sent back to the participants in the pilot study, soliciting further comments. All participants returned their completed questionnaire with no additional comments.

²Statistical t-tests were conducted to measure any significant differences between the early and late responses. At a $p = 0.05$ no noticeable differences were found between the first, second, and third group of responses. Thus, it was concluded, with a reasonable degree of assurance, that the chance of non-response bias was not a major concern in this study.

Also, most of the banks surveyed indicated having more than five years of lending experience, with the exception of 37% of the Koreans and 10% of the Chinese that had fewer than five years of experience.

With respect to the first research question, the results showed that the balance sheet and income statement are the two primary statements that are required for all commercial loans, regardless of the loan size. Other financial statements, such as the Statement of Cash Flows and the Statement of Owners' Equity were not rated overly important for considering small loans. In addition, projected financial statements did not appear to be among the documents requested for considering small and medium-sized loans. Exceptions were found with respect to the Korean bankers, who seemed to require projected income statement along with the historical financial data.

The analysis demonstrated that bankers' strongly prefer the GAAP-based financial statements. This was a predominant response with both groups of bankers, the Asians and Americans. Other bases of accounting, such as the cash-basis or the tax-basis, did not seem to be acceptable by the banks.

When asked about the third question, the extent of independent verification required, bankers generally did not seem necessarily interested in having audited financial statements for considering small loans. Perhaps most banks prefer to perform their own investigation of these clients and do not rely on the client's evidence of independent verification. Furthermore, contrary to Baker's [1990] findings, no evidence was found linking the extent of independent verification (audit, review, or compilation) of financial statements to differences in loan interest rates.

Finally, on the question of the frequency of interim reporting, the predominant response was annual basis with the exception of the Filipinos, who seemingly prefer semi-annual reporting (possibly because of their business is primarily in issuing short-term loans).

Evaluating Reliability of Financial Statements

To investigate the perceived reliability of financial statements among the bankers, the mean ratings of each question in the fourth section of the questionnaire was compared across the sampled groups. Tables 1, 2, and 3 contain the results of these investigations for small, medium, and large loans, respectively. Note that the higher the mean ratings, the greater the importance placed on that particular issue. On the whole, as the size of commercial loans increases so does the expected reliability of financial statements.

As shown in Tables 1 and 2, American bankers consider the accounting basis used by a client as the most significant criterion considered in decisions concerning small or medium-sized loans. The next most important factor is the CPA opinion. On the other hand, for larger loans, the extent of assurance provided in a CPA report received the highest rating, followed by the accounting basis. Thus, regardless of loan size, the accounting basis used and the extent of independent verification of financial statements form the two most significant lending criteria used by this group.

In the Asian group differences were found with respect to both the loan size and nationality. In considering small loans, Chinese bankers favor the audit opinion as the most reliable piece of information. However, the most important factor for larger loans is the accounting basis used by the applicant. This contrasts with the Filipinos, who seem to place their greatest emphasis on the independent accountant's opinion, regardless of the loan size. It also contrasts with the attitudes of Japanese whose attitudes are similar to the Americans

in that they view the accounting basis used as the most important issue for considering medium-sized loans, and the audit opinion as the most important criterion for approving larger loans. However, unlike Americans, Japanese bankers do not rate the independent verification of financial statements overly important for reviewing small loans.

Finally, among all bankers, Koreans seem to be the ones who are least interested about the independent verification of financial statements in reviewing small and medium-sized loans.

Cross-Cultural Analysis

The results of nonparametric analysis of variance are also presented in Tables 1, 2, and 3. Comparisons of responses indicated significant cross-cultural differences among the bankers of different nationalities in evaluating the reliability of various financial reporting issues. However, such differences were not consistent across different loan sizes. For example, while significant differences were found among bankers with respect to small loans when considering reliability of the accounting basis and the auditor's reputation, the same was not observed with respect to larger loans. Likewise, the bankers' views differed considerably about the importance of the size of CPA firms and the desired extent of their involvement with clients.

The first hypothesis (H1) suggests that individuals from a strong uncertainty avoidance society (e.g., U.S.) place greater reliance on financial statements that are based on GAAP than individuals from societies with a low type of uncertainty avoidance (e.g., the Asian-Pacific countries). Short of supporting this proposition, the overall empirical results were inconclusive. While for small loans the ratings provided by the Japanese bankers were consistent with the hypothesis, other bankers' responses were not supportive. Also, for larger loans only the Filipinos' responses were consistent with the proposition.

The results were also mixed with respect to the second hypothesis (H2). Albeit a comparison of the Korean and American bankers' responses showed support for the hypothesis that American bankers are more in favor of audited financial statements than their Asian counterparts, other bankers' opinions were inconsistent with the proposition.

A possible explanation for these results is the influence of the host country's culture, social expectations, and regulations on these bankers. That is, because the Asian banks are operating in the United States, it is likely that they have gradually adapted to the American culture and became accustomed to the U.S. organizational culture. This may include accepting the U.S. GAAP-basis of accounting in lieu of the cash-basis that is more customary in Asia and relying on the role of CPAs in the financial markets.

Conclusions

The overall analytical review of the lending practices revealed that in general the balance sheet and the income statement are universally required of all commercial loan applications. In addition, consistent with Baker's [1990] findings, this study found that regardless of loan size, bankers are nearly unanimous in their preference for the GAAP-basis of accounting. These results somewhat contradict the research findings presented by O'Dell [1991] suggesting that more and more small businesses find it useful to move to a non-GAAP basis of accounting. The bankers surveyed, regardless of nationality, indicated their strong preference for the GAAP-basis of accounting for extending credit to their commercial borrowers. However, contrary to Baker's [1990] conclusions, no evidence was found to indicate that the bank's interest rates on loans not supported with audited statements are significantly higher than those charged on loans with audited statements.

The results of this study failed to support the general theory that suggests significant behavioral and attitudinal differences among individuals with different nationalities [Hofstede, 1980]. The empirical findings did not support Hofstede's theory of cultural dimension, uncertainty avoidance.

As for the limitations, the present research surveyed only a small sample of American and Asian banks operating in the U.S. Future studies should investigate the issues raised herein by using larger samples, different nationalities, and other cultural issues to improve generalization of the findings. In addition, longitudinal investigations are useful to identify gradual effects of the host county's culture on organizational behavior of multinational corporations. It is only through these efforts that a comprehensive framework for an understanding of cultural issues affecting transnational business expansions can be developed.

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TABLE 1
 Analysis of Variance of Reliability Ratings
 of Financial Statements-related Issues by Nationality
 (Small Loans)

1 = Extremely Unimportant, 7 = Extremely Important

Reliability Issues	Mean Ratings					F	P
	American	Chinese	Filipino	Japanese	Korean		
Type of Assurance	3.24	3.80	4.00	2.50	3.25	1.97	0.148
Reputation of the CPA	3.38	3.90	7.00	3.33	3.75	3.57	0.027
The Accounting Basis	4.48	3.80	7.00	3.83	3.25	3.29	0.035
CPA Opinion	4.29	4.60	7.00	3.50	2.88	2.00	0.111
CPA Professional Association	2.71	3.60	4.00	1.50	2.63	4.43	0.053
CPA Peer Review	2.95	3.30	1.00	2.17	3.38	2.32	0.178
Size of the CPA Firm	2.24	3.00	1.50	2.00	2.88	2.45	0.083

TABLE 2
 Analysis of Variance of Reliability Ratings
 of Financial Statements-related Issues by Nationality
 (Medium Loans)

1 = Extremely Unimportant, 7 = Extremely Important

Reliability Issues	Mean Ratings					F	P
	American	Chinese	Filipino	Japanese	Korean		
Type of Assurance	3.86	5.20	2.50	4.67	3.63	3.33	0.034
Reputation of the CPA	3.71	5.30	4.00	4.33	3.63	1.26	0.376
The Accounting Basis	4.81	4.60	4.00	5.33	2.75	2.55	0.075
CPA Opinion	4.29	5.10	4.00	4.83	2.75	2.85	0.080
CPA Professional Association	2.71	4.20	2.50	2.17	2.50	1.94	0.121
CPA Peer Review	3.00	3.90	3.00	3.50	3.13	2.18	0.115
Size of the CPA Firm	2.29	3.80	2.50	3.67	3.13	3.66	0.025

TABLE 3
 Analysis of Variance of Reliability Ratings
 of Financial Statements-related Issues by Nationality
 (Large Loans)

1 = Extremely Unimportant, 7 = Extremely Important

Reliability Issues	Mean Ratings					F	P
	American	Chinese	Filipino	Japanese	Korean		
Type of Assurance	5.45	6.00	4.00	6.50	5.13	9.08	0.011
Reputation of the CPA	4.95	5.70	4.00	5.17	4.88	1.41	0.307
The Accounting Basis	5.18	5.00	4.00	5.83	3.63	2.23	0.108
CPA Opinion	5.04	5.70	4.00	6.67	4.00	22.31	0.001
CPA Professional Association	3.05	4.90	3.50	2.50	3.13	2.10	0.097
CPA Peer Review	3.24	4.60	3.00	4.00	3.63	1.84	0.149
Size of the CPA Firm	2.71	4.90	3.50	4.50	4.13	2.67	0.045