International Review of Business Research Papers
Vol 4 No. 4 Aug – Sept 2008 Pp.199-207

Financial Statements and Loan Decision in Community Banks

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The loan decision model of community banks is known to differ from loan decision model of large banks. This study focuses on community banks and examines whether financial statements are important consideration in loan decision and whether level of attestation affects loan officers' perception of the importance of those financial statements. Results indicate that while financial statements are perceived as important information in loan decision of community banks, loan officers may not adequately consider the credibility of the financial statements when evaluating loans.

Field of Research: Accounting and Banking

1. Introduction

Bankers are known to be major users of financial information. Large banks rely on hard financial information, computer models and centralized decision making, as a basis of loan decision. Community banks, however, rely more on non-financial information collected by personal contact, community ties and close lender–borrower relationships. These banks depend more on non-financial information principally because: (1) Reliable financial data of small business loan applicants are not available, and (2) Community banks have better understanding of local business and economic conditions through informal meetings and conversations with business owners (Feldman, 1997). Cole, Goldberg, and White (2004) found evidence that the lending decisions of large banks are more likely to be a function of financial variables, whereas the lending decisions of small banks are more likely to be a function of variables indicating pre-existing relationships between the bank and loan applicants. Many other studies confirm our understanding that non-financial information is important in lending decision of community banks. (Cowen and Page, 1982; Whiteman, 1998; Cole, 1998; Berger and Udell, 1995; Berger and Udell, 2002; Cole, Elyasiani and Goldberg, 2004; Ebben, 2004). It is also well known that community banks require financial information, including business and personal financial statements, in a loan application package. Nevertheless, it is not clear whether these financial statements are actually an important consideration in

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lending decision by community banks or whether community banks require them simply because government regulatory agencies require banks to obtain such documentation in loan processing. The primary purpose of this study is to investigate whether financial statements are an important consideration in lending decisions of community banks. The secondary purpose of this study is to examine whether the level of different types of attestation of financial statements influences the perception of the importance of financial statements in lending decisions. This study also investigates whether that perception differs among different groups of loan officers like more experienced vs. less experienced, and those with undergraduate business (or accounting) degrees vs. those with non-business degrees.

2. Literature Review and Hypotheses

Though many prior studies stress the importance of non-financial data in lending decision of community banks, Barret (1990) found that the approval procedures of small business bank loans were becoming more formal and the relationship with loan officers less personal. My initial interview with senior officers of four community banks revealed that financial statements are one of many variables considered important in the lending decision. Examination of loan evaluation working papers of two community banks revealed that information from financial statements is included in the data evaluated by loan officers. The preceding findings lead to the first hypothesis:

H1: Financial statements are important consideration in the lending decision of community banks.

When loan officers consider financial statements in lending decision, they should find that audited financial statements are more credible than reviewed financial statements and, in turn, reviewed financial statements are more credible than financial statements compiled by a certified public accountant (CPA) or prepared by management. Three prior studies considered different levels of auditor attestation associated with financial statements. Bandyopadhyay and Francis (1995) presented loan officers with a commercial loan application that included financial information. Three different case versions included compilations, reviews, and audit reports. Using loan officers as subjects, they found that both the decision to lend and the interest rate to be charged were related to the level of attestation. The results were in the direction expected. However, two prior studies reported conflicting findings. Johnson, Pany and White (1983) asked loan officers to evaluate financial statement information, approve a loan, and select an interest rate. Four levels of attestation were provided: no attestation at all, compilation, review, and audit. The level of attestation made no difference to the loan decision. Wright and Davidson (2000) examined the effect of auditor attestation on commercial lending. Results of their study indicate that auditor attestation had no effect on risk assessment, and, in turn, on the decision to recommend the loan. Initial interviews with senior officers of community banks also revealed that audited financial statements are rarely required for a loan application in community banks. Some bank officers mentioned the high cost involved in auditing, and other officers stated that compilation by a CPA is good enough for loan evaluation. Thus, a second research hypothesis is proposed.

H2: The level of attestation has no significant difference in the perception of the importance of financial statements in lending decision at community banks.

Based on the research finding, Wright and Davidson (2000b) proposed training and education to teach loan officers the difference among audits, reviews, compilations and information that is prepared by management. If we assume that training and education is an effective method of teaching loan officers the difference among various financial statements with different level of attestation, loan officers who have longer bank experience and those with a business degree may show different survey results from loan officers with less experience and those with non-business degrees. It is because loan officers with longer bank experience might have more chance to get training and loan officers with business instruction during college might have taken accounting courses, thereby learning the different levels of attestation of financial statements. Thus, a final research hypothesis is proposed.

H3: There are significant differences in the perception of the importance of different levels of attestation based on bank experience and business coursework in college.

3. Methodology

The sample for this study consisted of loan officers of six community banks in the Southern California area. Author contacted either the president or vice president of operations at each bank and asked for their cooperation on data collection. A total of 105 survey forms with self-addressed envelopes were delivered to them to distribute to loan officers, and 57 surveys were collected. Members of each bank’s board-level loan committee were allowed to participate in the survey as well. After eliminating surveys with missing responses, the usable sample consisted of 55 responses. The survey included several demographic questions such as bank experience and college major (or minor). Table 1 presents demographic characteristics of the respondents.

In order to measure the loan officer’s perception of importance of financial statements in lending decision, an opinion survey questionnaire was developed. It included 19 variables that may be considered in lending decisions. Sixteen variables were selected from results of initial interviews with senior bank officers and from loan evaluation worksheets of two community banks. Three variables—client education, legal structure of business and client personal net worth—were selected from the study by Page, Trombetta and Werner (1977). Respondents recorded their opinion on the importance of loan decision variables on a seven-point scale ranging from “not at all important” to “extremely important.” Respondents were assured of complete anonymity and were requested to disregard whether such data is required by regulatory agencies

Table 1
Demographic Characteristics of Loan Officers
(N = 55)

Bank Experience		N
More experience	(>or= 3 years)	26
Less experience	(< 3 years)	29
Major (Minor) in College		
Business administration or accounting		30
Non-business		25

4. Findings

To test the importance of financial statements in lending decision, the overall means for considerations in lending decision was calculated. The results are presented in the Table 2. Three non-financial variables—loan purpose, collateral and years in current business—were first three top-ranked considerations in the lending decision. Financial statements with the involvement or input by a CPA—whether audited, reviewed or compiled—were also perceived as important considerations by loan officers. The mean scores of the first three non-financial variables and second three financial statements variables are not statistically different. Other information like nature of business, tax return, credit scores and physical observation of business are perceived as important information in loan decision in community banks. Client education, client race/nationality and client gender are not considered as important in loan decision. Therefore, H1 is supported.

The difference of mean scores of the three different financial statements involving a CPA is not significant even though audited financial statements are perceived as more important than reviewed financial statements and, in turn, reviewed financial statements are more important than compiled financial statements. However, financial statements prepared by the client were not considered as important as financial statements involving a CPA. In perceived importance, only financial statements prepared by the client are significantly different from other financial statements involving a CPA. The t-value of means between financial statements prepared by clients and those complied by a CPA was 5.69 ($p<.01$). Based on the results, H2 is supported partially. As long as a CPA is involved, the level of attestation does not matter much in the perception of importance. However, financial statements prepared by clients are not perceived as important information, compared to those financial statements with CPA involvement.

Table 2
Mean Scores of Consideration in Lending (Overall)

Consideration	Mean
Loan purpose	6.20
Collateral	6.18
Years in current business	6.07
F/S audited by CPA	6.01
F/S reviewed by CPA	5.98
F/S compiled by CPA	5.94
Nature of business	5.94
Tax return	5.90
Client credit score	5.89
Physical observation of business	5.81
Client personal net assets	5.63
Guarantor	5.56
Other business experience	5.49
Reputation of client	5.12
F/S prepared by client	5.00
Legal structure of business	4.70
Client education	3.74
Client race/nationality	1.98
Client gender	1.72

Scale 1 Not at all important
4 Neutral
7 Extremely important

Table 3 shows mean scores of considerations by different groups. It is interesting that financial statements compiled by a CPA are perceived as most important among three kinds of financial statements involving CPA in both less experienced group and non-business major group. T-test results (Table 4) shows that between more experienced group and less experienced group, there is statistically significant difference in mean scores of financial statements compiled by a CPA (t-value=2.06) and financial statements prepared by clients (t-value=2.02). More experienced loan officers recognized that the credibility of the compiled financial statements and financial statements prepared by clients is less than the other two financial statements with some forms of attestation. The other two variables that have significant difference between more experienced and less experienced group are client personal net worth and guarantor. The more experienced group put more emphasis on these two variables than the less experienced group. There is no statistically significant difference ($p<.05$) in any one of 19 variables for college major background. Therefore, H3 can be supported on the basis of banking experience only.

Table 3
Mean Scores of Consideration in Lending Decision by Group

Consideration	More Experience	Less Experience	Business	Non Business
Loan purpose	6.23	6.17	6.20	6.20
Collateral	6.23	6.13	6.23	6.12
Years in current business	6.23	5.93	6.16	5.96
F/S audited by CPA	6.03	6.00	6.10	5.92
F/S reviewed by CPA	6.00	5.96	6.03	5.92
F/S compiled by CPA	5.69	6.17	5.83	6.08
Nature of business	5.96	5.93	5.96	5.92
Tax return	5.96	5.86	5.83	6.00
Client credit score	5.96	5.82	5.80	6.00
Physical observation of business	5.80	5.82	5.83	5.80
Client personal net assets	5.88	5.41	5.66	5.60
Guarantor	6.00	5.17	5.73	5.36
Other business experience	5.61	5.37	5.43	5.56
Reputation of client	5.26	5.00	4.96	5.32
F/S prepared by client	4.69	5.27	4.86	5.16
Legal structure of business	4.65	4.75	4.73	4.68
Client education	3.69	3.79	3.73	3.76
Client race/nationality	1.98	1.75	2.00	1.52
Client gender	1.80	1.65	1.83	1.60

Scale 1 Not at all important
4 Neutral
7 Extremely important

5. Conclusion

The results of this study provide evidence that financial statements information is perceived as important information used in the loan decision of community banks when those statements have CPA involvement. The finding of previous studies that community banks heavily rely on non-financial information is also confirmed in this study. The findings suggest that loan officers of community banks do not realize the significant difference in credibility among financial statements of different levels of attestation. The implications for practice are that community bank loan officers may not adequately consider the credibility of financial information when evaluating commercial loans. Loan officers with a business degree should have taken some accounting classes in college and were expected to recognize the difference in credibility among different levels of attestation. But results of this study indicate that their perception of importance of attestation is not significantly different from that those loan officers with a non-business degree. Introductory accounting courses that are taught in college should be designed to cover the differences among audits, reviews, compilations and information that is prepared by client. Results of this study also indicate that loan officers might have learned, through bank experience, that the credibility of client-complied and client-prepared information is much lower than that of independent reviews and audits. Training new loan officers may also be warranted to teach the differences of credibility among financial statements with different levels of attestation as early as possible.

Table 4
Results of t-tests (Difference in Experience)

Consideration	**t-value**
F/S prepared by client	2.02*
F/S compiled by CPA	2.06*
Client personal net worth	2.19*
Guarantor	4.42**

* p<.05, two tailed test
** p<.01, two tailed test

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