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# The effect of SME reporting framework and credit risk on lenders' judgments and decisions

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ABSTRACT

Small and medium-sized entities have a number of reporting framework alternatives when preparing financial statements for users, including a new AICPA reporting framework designed specifically for such businesses as a cost-effective alternative to traditional GAAP. However, little is known about whether reporting framework choice affects users' assessments of reporting quality and subsequent business decisions. This study evaluates the effects of financial reporting framework type and credit risk on lenders' judgments and decisions. Specifically, we evaluate 157 lenders' assessments of the likelihood of loan approval and financial reporting quality for a prospective borrower in an experiment that manipulates reporting framework choice (FASB-based GAAP, AICPA's Financial Reporting Framework for Small and Medium-Sized Entities, or tax-basis) and borrower credit risk level (high or low) randomly between subjects. The results indicate a significant interaction between applicant reporting framework and credit risk level. Specifically, we find that lenders evaluating GAAP-based financial statements report a higher likelihood of loan approval and a lower interest rate than lenders considering statements prepared using the other reporting frameworks, particularly when the applicant's credit risk level is high. Mediation analysis provides evidence that the perceived quality of GAAP-based reporting explains the framework-approval results. However, the results also suggest that the AICPA reporting framework provides a viable alternative to GAAP when the applicant's credit risk level is low. We consider the study's implications for policy, practice, and research.



## 1. Introduction

Small and medium-sized entities (SMEs) make financial reporting framework choices that can affect the quality and ultimately usefulness of information and related business decisions. However, SMEs face important cost/benefit tradeoffs when making framework decisions because they have relatively limited resources to keep up with changing standards (Tysiac, 2012; Blue Ribbon Panel, 2011). Concerns about the costs and benefits of preparing high quality financial information have

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led to increased use of alternative non-GAAP approaches known as "special-purpose frameworks" (Sharp and Webre, 2015; Rosenfield and Gill, 1991).[1] In fact, among general questions about how to improve financial reporting (e.g., Sunder, 2016), the literature (e.g., AICPA, 2013; Blue Ribbon Panel, 2011) includes specific questions about whether traditional GAAP-based reporting by smaller entities provides enough additional information to justify the high financial statement preparation and assurance costs.

In response to concerns about financial reporting costs, benefits, and quality for smaller companies, the AICPA developed the "Financial Reporting Framework for Small and Medium-Sized Entities" (AICPA, 2013). The AICPA designed the new principles-based framework to be a simpler, cheaper, and more consistent alternative to GAAP and a more robust alternative to other special purpose (non-GAAP) frameworks available to SMEs such as cash, modified cash, and tax-basis financial statements (AICPA, 2013). For example, the AICPA FRF for SMEs does not provide for assessment of impairment for long-lived assets and goodwill, while GAAP provides for trigger-based impairment testing. Further, unlike GAAP, the FRF for SMEs does not include the concept of comprehensive income.[2] When compared to tax-basis reporting, the FRF for SMEs allows businesses to provide an allowance for doubtful receivables while tax-basis allows only specific write-offs for bad debts.

The objective of this study is to evaluate the effects of financial reporting framework type on lenders' assessments of SME financial reporting quality and likelihood of loan approval. The extant literature lacks comparative testing of competing reporting frameworks and empirical evidence about the impact of framework type on users' perceptions of reporting quality and the business decisions that follow. We focus on a lending scenario in this initial study given the challenges SMEs face in obtaining external financing (Altman and Sabato, 2007; Beck and Demirguc-Kunt, 2006; Strahan, 1999) and the relative flexibility they have in selecting a reporting framework (AICPA, 2013). One hundred fifty-seven lending professionals participated in a between-subjects experiment that manipulated financial reporting framework type (i.e., FASB-based GAAP, AICPA FRF for SMEs, or tax-basis) and credit risk level (i.e., low or high) for an SME applying for credit. The participants assessed the overall quality of the applicant's financial information before providing loan approval and interest rate judgments.

The credit risk manipulation in the study is motivated by literature suggesting that assessments of borrower reporting quality and subsequent lending decisions are affected by credit risk (Srinivasan and Kim, 1987). The Basel Committee on Banking Supervision (2000) defines credit risk as "the potential a bank borrower will fail to meet its obligations in accordance with agreed terms" (p. 1). Assessing credit risk for SMEs is more difficult because information asymmetry is more prevalent in smaller entities than larger entities (Berger and Udell, 1995). Accordingly, we evaluate the impact of credit risk level on lenders' assessments of reporting quality and likelihood of loan approval across financial reporting framework type.

The results indicate that an SME's financial reporting framework choice and credit risk level affect lenders' loan approval, interest rate, and reporting quality judgments and decisions. For example, the loan approval results suggest that lenders' prefer GAAP-based reporting when SME credit risk is high. This preference reflects higher perceived reporting quality under GAAP than under other special-purpose frameworks. However, when credit risk is low, the AICPA FRF for SMEs provides a viable alternative to GAAP reporting. We also find that an application with tax-basis reporting is less likely to be approved and subject to a higher interest rate when credit risk is low. Mediation test results reveal that perceived reporting quality mediates the relationship between financial reporting framework and loan approval.

The study has a number of policy, practice, and research implications. From practice and policy perspectives, the study provides evidence that financial reporting framework choice impacts lenders' credit decisions and interest rate assessments. Thus, both policymakers and managers should consider how their financial reporting framework choices ultimately impact future financing ability and costs. Specifically, although our study indicates that lenders perceive GAAP-based reporting is best for SMEs, the results also indicate that the relatively new AICPA FRF for SMEs provides a reasonable financial reporting alternative for SMEs, particularly when compared to tax-basis reporting. From a research perspective, this study extends the extant literature indicating that lenders care about the quality of applicant financial information (e.g., DeZoort et al., 2012; Holder-Webb and Sharma, 2010). For example, the study complements and extends research on how financial information quality impacts lending decisions in smaller private companies (Chen et al., 2011; Berger and Udell, 2006).

The remainder of the paper is organized as follows. The next section contains background on the financial reporting frameworks for SMEs and develops the study's hypotheses. The third section describes the study's method, including the experimental design, participants, and research instrument used. The fourth section provides the study's results. Finally, the paper concludes with a discussion of the study's implications and limitations.

## 2. Background and hypotheses

### *2.1. Financial reporting frameworks for SMEs*

For years, accounting policymakers (e.g., AICPA, 1972, 1980; BRP, 2011) have called for financial reporting standards to take into consideration the unique needs of SMEs. For such companies to prepare financial information for external users,

[1] Sharp and Webre (2015) indicate that the term "special-purpose frameworks" replaces the traditional term "other comprehensive bases of accounting" (OCBOA).

[2] The AICPA (2014) provides a detailed comparison of the FRF for SMEs with GAAP and tax-basis accounting in a wide variety of areas (e.g., fair value, impairment, revenue recognition, leases, stock-based compensation, derivatives, etc.).

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