Numb and Number: Bankers and Accountants

by Dev Strischek

This article evaluates the current climate of financial statement quality and offers some suggestions on how to manage the related risk.

Figuring Out What’s Going On

When the British historian Thomas Carlyle observed a century ago that you may prove anything by figures, little did he realize that so many people in today’s financial world would try to prove him right. Stock market analysts and chief financial officers count on the accounting profession to substantiate their observations while bankers and other creditors rely on the auditors to validate their borrowers’ financial statements.

Our industry has long relied on the accounting profession for accurate, consistent, and material information on which to evaluate repayment ability. Sound, prompt credit decisions require reliable, timely financial statements. Daily revelations of deceptive accounting practices, catastrophic failures of some of the nation’s largest corporations, and probing questions about the accounting profession’s role in these practices and failures require bankers to reassess their traditional reliance on accountants’ accounting.

Under these circumstances, what can we do to manage this informational and reputational risk? Is there a cost-benefit trade-off on financial statement quality? Are there other informational options to supplement or supplant financial statements?

What Do You Really Need?

Bankers have operated under some basic assumptions in their use of financial statements. First, the greater the risk, the more reliable the information should be. Therefore, the better the quality of the financial statements, the more reliable we bankers expect them to be. We generally prefer financials prepared by an objective third party to those done by the borrower. Further, the more involved the external preparer, the better, so we view audited statements as superior to unaudited numbers.

These generalizations date back to a time when few companies had accounting software, management information systems, and chief financial officers. Today’s standard financial reporting packages generate financial statements with the speed, accuracy, and detail that render many company-prepared financials today on a par with the unaudited product of outside accounting firms a generation ago.

Opinions and No Opinions

Nevertheless, the CPAs’ unqualified opinion remains the zenith of financial statement quality. Much rarer and much less desirable are qualified and...
adverse opinions. In off-color contrast to these darker shades of audited financials is the unaudited statement. If the term “unaudited” looks odd to you, it’s because you entered banking after 1979, when the accounting profession retired the unaudited financial statement and replaced it with two new unaudited products—the compilation and the review. The original intent of the name change was to entice clients to use an outside preparer and not turn them off with the negative-sounding “unaudited financial statement.” The profession hoped that clients would upgrade to full audits after their introduction to the cheaper compilation and review.

In fact, perusal of RMA’s Annual Statement Studies shows a steady decline in full audits as a percentage of the statements received by banks. The ongoing controversy over fraudulent accounting continues to occupy the business press, and although these revelations typically expose publicly held companies, the consequence of the adverse publicity is to diminish the reputation of the entire profession and reduce users’ trust in the quality of the full audit. Gresham’s Law that bad money drives out good provides an apt analogy for the downmarket impact of the bad news. More and more users are wondering just how much value is added by requiring audited financials. The value-added math has become more problematic as accountants find themselves more vulnerable to high-profile lawsuits and less inclined to take on the legal risk of full audits.

**Less Quality, More Risk?**

Less quality might be tolerable if users promptly received the financial information. However, the IRS has raised the sales limit for the use of cash basis accounting to $10 million for certain types of companies effective for tax years ending on or after December 31, 2001, and the change has made it feasible for another 500,000 companies to forgo accrual accounting in favor of cash-basis accounting. The change does not yet apply to companies in industries that rely heavily on inventory for income, such as retailers, wholesalers, manufacturers, mining, farming, and publishing. On the other hand, the services sector—the fastest-growing sector of the American economy—is an obvious beneficiary of the IRS action. If an outside accountant prepares the company’s tax returns, the accountant can get double duty out of them by labeling them a compilation or review and noting that the financials do not reflect generally accepted accounting principles (GAAP).

As more companies adopt cash-basis accounting, the trend away from full audits to the unaudited compilation and review is likely to accelerate. Since tax returns are typically some variant on cash or tax basis accounting, for which there is really no standard per se, not only will full audit quality continue its decline, but the specter of automatic extensions to October portends even slower delivery of unaudited numbers. The traditional busy season in bank credit analysis is likely to slide out of the second quarter well into the second half of the year. Even now, the distance between a borrower’s fiscal year end and its annual review or renewal has lengthened to six months or more. Timely credit analysis is fossilizing into epochal financial archeology.

So pull out your financial statement policy and ask yourself whether you are asking for the right level of financial validity relative to the credit risk. Must every borrower provide audited financial statements? A common approach is to gauge financial statement quality requirements to the level of credit exposure:

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<th>Level of credit exposure</th>
<th>Financial statement requirements</th>
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<td>&lt;$1,000,000</td>
<td>Company prepared</td>
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<td>$1MM &lt;$3MM</td>
<td>Unaudited</td>
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<tr>
<td>$3,000,000</td>
<td>(compilation or review)</td>
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<td>Unqualified audit</td>
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One variation on the scheme above is to treat unaudited financials as audited if the loan’s collateral is regularly audited by the bank. Other banks grant a little more exposure to reviews than to compilations.
Yet another layer of tolerance can be injected by policy exception administration. Banks may establish a financial statement policy exception that permits up to some percentage of loans to be made with inferior-quality financial statements. The catch is some effort at mitigating the policy exception with additional protection, such as more frequent company-prepared financial statements, bank physical audits of collateral, more guarantors, and so forth.

Who Do You Really Trust?

Next, think of the accounting firm as a potential subcontractor to whom you are considering the outsourcing of the validation task for financial statements. As part of your due diligence, you might want to employ a checklist of such questions as the following:

- **Familiarity with the industry.** Does the accounting firm have experience with the borrower’s line of business? For example, construction, real estate, and colleges and universities have unique accounting and their own specialized accounting principles, bulletins, and guides. These specialized industries require extra education and training, reinforced with the experience of accounting for them.

- **Other clients in the industry.** The more clients the accountant has in the borrower’s line of business, the deeper the accountant’s industry experience.

- **Mix of audits to non-audits.** The more audited financials the accountant has done, the better they are likely to be. Moreover, auditing is a skill and talent that not all accountants possess equally, just as not all attorneys are gifted trial lawyers.

- **Years in practice.** Experience tends to correlate positively with competence.

- **Credentials.** The accountant should have the appropriate accreditation and licenses to practice accounting in your legal jurisdiction. Not every bookkeeper is a CPA.

- **Quality of clients.** The accounting firm with bankrupt clients is likely to share some of the attributes of its fallen customers. A perusal of the accountant’s client list may yield obvious bankrupt firms’ names; alternatively, the banker could ask the accountant directly. More ominously, the accountant may have contributed to clients’ failures.

- **Accounting criss-cross directory.** Some banks maintain an accountant cross-file in which accounting firms and bank customers are listed alphabetically and cross-filed against one another. Bankers can see who and what kind of bank clients a given accounting firm serves. Problem borrowers seem to gravitate to problem professionals.

As you peruse these points, you may want to think about the attention your credit analysis function pays to the quality of the accountant as well as the quality of the accounting. Russian Premier Nikita Khruschev once boasted that in nuclear warfare, quantity has a quality all its own, but number mass may be no less devastating than nuclear mass. Poor accountants have the potential for dropping a quantity of poor quality financial bombs on unwary bankers.

What Do You Really Need to Know?

We users need to remember that as we give up audits and accept more unaudited financials, we assume a greater intellectual burden for the risk. Therefore, some strategies to consider for developing and maintaining these intellectual resources include the following:

- **Supplement financial analysis with behavioral indicators, such as commercial and personal credit reports.** The borrower may have a 2.0 current ratio because the receivables are uncollectible, the inventory is unsellable, and the payables are unrecorded. The lender doesn’t need financial statements to know the borrower is in trouble if the commercial credit reports show past-due trade debt; the personal credit bureau reports indicate delinquencies, judgments, and liens; the depository accounts are frequently overdrawn; and interest payments are often late.
Correct accounting and finance deficiencies with remedial training in accounting, auditing, and finance.

Recruit more individuals with degrees or previous work experience in accounting, auditing, and finance. This option offers a way to reduce remedial training in these subjects by simply hiring individuals with the appropriate education, training, and skills.

Maintain proficiencies in accounting, auditing, or finance by requiring some minimum number of hours of certified, professional education.

Conduct training in tax return analysis to accommodate the rising tide of tax-based financials.

Rotate lenders and credit approvers through asset-based lending (ABL) and floor plan auditing units.

Revise policies to encourage more ABL- and audit-supported lending by allowing more exposure and higher LTVs to borrowers if collateral is physically checked by the bank, funds are advanced under borrowing base certificates, monthly company financials and audited statements are required, quarterly covenant compliance certificates are mandatory, and so forth.

Upgrade loans where the collateral is monitored and audited.

Einstein postulated that matter cannot be created or destroyed. Risk also is indestructible; it can’t be eliminated, but it can be transferred. As we accept more of the audit risk inherent in unaudited and company-prepared financials, we must be willing to mitigate that risk by assuming competent execution of the audit function.

**Adding It Up**

Financial statements play a vital role in our credit decision making, and we need to maintain a flow of accurate, timely credit information. However, despite the wealth of information that detailed, audited financial statements can yield, management lecturer Robert Townsend has observed that the relationship between the sophistication of tools and the usefulness of the results is sometimes inverse. Therefore, we need to be realistic in our qualitative expectations for financial statements and the professionals who prepare them. At some lower level of exposure, we can probably accept lower-quality financial statements and manage the risk on an exception basis. As we tolerate more unaudited financial statements, we must understand that we are assuming more of the audit risk and so should acquire and maintain our own intellectual resources in accounting, finance, and audit training. Finally, we should encourage lending behavior that mitigates the accounting information risk through the implementation of appropriate policies and more reasoned tolerance of the risk within our respective credit cultures. Author Peter Bernstein says it well: “The capacity to manage risk, and with it the appetite to take risk and make forward-looking choices, are key elements of the energy that drives the economic system forward.”

*Strischek can be contacted by e-mail at dev.strischek@suntrust.com*

**References**