To the Graduate Council:

I am submitting herewith a dissertation written by Jane Ellen Campbell entitled "An Empirical Investigation of the Impact on the Decision Processes of Loan Officers of Separate Accounting Standards for Smaller and/or Closely Held Companies." I recommend that it be accepted in partial fulfillment of the requirements for the degree of Doctor of Business Administration.

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AN EMPIRICAL INVESTIGATION OF THE IMPACT ON THE DECISION PROCESSES OF LOAN OFFICERS OF SEPARATE ACCOUNTING STANDARDS FOR SMALLER AND/OR CLOSELY HELD COMPANIES

A Dissertation
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To my family

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ABSTRACT

The accounting profession has repeatedly expressed its desire to provide useful information to the readers of financial statements. Although a significant number of studies have been undertaken in recent years to determine what information is useful, very few have directly investigated the decision processes of the users of accounting information. A protocol analysis methodology was used in this study in order to overcome that limitation of previous studies.

The issue under investigation was whether certain accounting and reporting requirements should be modified or abandoned for smaller and/or closely held businesses. Four areas were specifically examined: earnings per share, deferred income taxes, leases, and inflation adjusted information. The subjects, commercial bank loan officers, were presented with information about a hypothetical small, family-owned company requesting a line of credit and asked to make a decision. Verbal and nonverbal behaviors were recorded and analyzed.

The results indicated that earnings per share and deferred tax information were not useful to bankers in this decision situation. The leasing information was useful. A

conclusion about the usefulness of the inflation adjusted data was deferred because of the unfamiliarity of the subjects with the information. In general, therefore, there was evidence that differential accounting principles are feasible in certain areas. However, future research should attempt to reproduce these results in other decision contexts and with other users of the financial statements of small, closely held businesses prior to the implementation of any changes in accounting standards.

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THE IMPORTANCE OF STUDYING THE DECISION PROCESSES OF USERS OF FINANCIAL STATEMENTS

The utilitarian nature of the accounting function was mentioned in early writings by several prominent members of the profession. In 1924, Hatfield (1924, p. 1) stated that accounting arose in response to a social need. Later, Paton and Littleton (1940, p. 1) introduced their monograph on corporate accounting standards with the following statement:

> The purpose of accounting is to furnish financial data concerning a business enterprise, compiled and presented to meet the needs of management, investors, and the public.

This view was reiterated when Littleton and Zimmerman (1962, p. 250) attributed the evolution in accounting practices to changes in the perceived needs of users of financial statements.

In 1966, the American Accounting Association (AAA) issued a booklet, A Statement of Basic Accounting Theory, intended to provide a comprehensive framework for accounting theory. It was one of the first such works to emphasize the importance of determining the needs of financial statement users as a prerequisite to providing "appropriate" accounting information. Relevance was identified as a crucial characteristic of financial data and was shown to be related to usefulness and user needs:

<T>he information must bear upon or be usefully associated with actions it is designed to facilitate or results desired to be produced (p. 9).

Known or assumed informational needs of potential users are of paramount importance in applying this standard (p. 7).

A later chapter in the booklet identified areas for future research and highlighted the fact that users' needs are a function of their decision processes:

Major areas in which changes are occurring which will influence accounting in the future are perceived as including "<u>knowledge of decision processes</u>". This calls for added research in the following areas:
Information needs of individuals and organizations both in terms of what is and what should be. Such needs must be discovered and analyzed if the services rendered by information reporting are to be improved (p. 63). (Emphasis added.)

Following the precedent of the AAA, the Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA) included the concept of usefulness in the identification of the function and environment of accounting in its Statement No. 4: <u>Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises</u> (1970):

<Accounting's> function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be <u>useful</u> in making economic decisions (para. 1022.01).

<u>Needs</u> and expectations of users of financial statements are a part of the environment that determine the type of information required of financial accounting. A knowledge of important

> classes of users, of their common and special needs for information, and of their decision processes is helpful in improving financial accounting information (para. 1022.10). (Emphasis added.)

By the early 1970's, several "Big Eight" public accounting firms had made public statements advocating greater attention to this user orientation. Arthur Andersen and Company (1972) stated:

> Financial statements are strictly utilitarian. A fundamental consideration, therefore, in seeking to define the objectives of financial statements . . . is what is most useful on the broadest possible basis for users of financial statements. While some have argued that usefulness is obvious and not helpful as a criterion, it has nevertheless been too often ignored and too easily forgotten (p. 7).

One of the publications of Arthur Young and Company (1972, p. 7) recommended a specific course of action. It was argued that since the contents of financial statements should be a response to user needs, "an extensive survey of the information needs of users of financial statements" should be undertaken. An Ernst and Ernst (now Ernst and Whinney) publication (1972, p. 2) even went so far as to chastise the profession for taking a proprietary interest in financial statements rather than attempting to serve the users:

> For a long time, accountants have tended to consider financial statements to be something of a private matter falling completely under their own cognizance. The Ernst and Ernst view is that financial statements are also a matter of direct interest to many other participants in the business community. Only as the needs, rights, and

> expectations of those other interests, and their influence on financial statements are taken into account, can an appropriate statement of the objectives of financial statements be obtained.

The AICPA established an Accounting Objectives Study Group (the Trueblood Committee) in 1973 in another attempt to develop a conceptual basis for accounting theory and practice. An emphasis on usefulness was apparent in the fundamental objective of accounting set forth in their report:

> The basic objective of financial statements is to provide information useful for making economic decisions.
>
> This basic objective requires that every accounting objective, standard, principle, procedure, and practice should serve users' needs (p. 13).

The target population of users was defined as those users with "limited authority, ability, or resources to obtain (financial) information" (p. 17). In other words, their sophistication level was assumed to be rather low. At this point, although the accounting profession had admitted the utilitarian nature of accounting, there seemed to be a belief that the profession could decide what users needed without asking them or examining their decision processes. Stamp sharply criticized the profession for this attitude:

> An overriding problem, however, has been the traditional "producer oriented" attitude of the so called "independent" public accountant. . . . A layman might well be forgiven for assuming that a "user oriented" study of the objectives of financial statements would have been completed long ago. It

> is a sad commentary upon our profession that it has in fact so long neglected to give serious consideration to the users' point of view (1973, p. 15).

Because more effort had been expended on normative discussion about which methods should provide the most useful information, than on empirical investigations of the users' actual decision processes, the Trueblood Committee based the remainder of the objectives on axiomatic assumptions about user decision processes:

> Users' needs for information are not known with any degree of certainty. This study is therefore dependent upon certain assumptions about users' information needs and their decision processes:
>
> 1. Users of financial statements seek to predict, compare, and evaluate the cash consequences of their economic decisions.
>
> 2. Information about the cash consequences of decisions made by the enterprise is useful for predicting, comparing, and evaluating cash flows to users.
>
> 3. Financial statements are more useful if they include but distinguish information that is primarily factual, and therefore can be measured objectively, from information that is primarily interpretive (pp. 13-4).

These assumptions were consistent with economic theory, but were so general as to provide limited insight into which of a group of alternative methods might provide more useful information.

The Trueblood Committee Report received mixed reviews, but it was generally believed that more work was necessary to satisfactorily describe the foundation underlying accounting practice. In 1974, Miller (pp. 19-20) advocated the empirical investigation of user needs, because he felt it was a prerequisite to the development of a cohesive conceptual framework for accounting theory:

> To ignore the users of accounting information would be a terrible mistake . . . . It would be unfortunate if lack of knowledge about the information desires were used as a reason (or excuse) for not reaching more precise positions about accounting objectives. There is a risk that accountants may have been giving too much weight to the lack of . . . knowledge about users' wants and needs.

The latest effort in the formulation of a conceptual framework for accounting theory was issued by the Financial Accounting Standards Board in 1978: Statement of Financial Accounting Concepts (SFAC) No. 1, Objectives of Financial Reporting and Elements of Financial Statements of Business Enterprises. The concept of usefulness and the importance of user needs again received significant emphasis:

> Accounting, financial reporting, and financial statements are not ends in themselves but are intended to provide useful information about specified entities. Thus the objectives set forth in this statement stem largely from the needs of those for whom the information is intended (para. 3).

A definition of the target population of users, which was different from and more precise than that in the Trueblood Committee report, included identification of some of the decision processes for which accounting information should be useful:

> Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence (para. 34).

The remainder of the statement was primarily an expanded discussion of the users and decisions of interest.

The literature and authoritative pronouncements reviewed above reveal the accounting profession's increasing concern with the needs and decision processes of financial statement users. Although considerable research into user decision processes has been performed in recent years, the current state of knowledge is still limited. Intuition and previous research suggest that there are significant differences in the way the same individual processes different information sets, as well as in the way different individuals process the same set of information. In addition, there is reason to believe that the same individual may process the same set differently on different occasions. The dynamic nature of information processing precludes the identification of one decision process which is appropriate for all individuals in all situations. The process which occurs will be a function of the decision maker, the environment, and the decision situation.

The implication of these findings is that research needs to be done on the decision processes of users of financial statements/accounting information in many different contexts, and that such research should be updated as changes in the environment occur. Arthur Andersen and Company realized that changes in circumstances might lead to changes in the decision processes and needs of financial statement users which, in turn, might affect the usefulness of various items of accounting information: "Usefulness is a dynamic consideration which must be examined continually by accountants (1972, p. 7)."

One environmental variable whose impact on financial statement users has been hotly debated recently is the proliferation of generally accepted accounting principles (GAAP). There has been disagreement as to whether all the information generated under GAAP is useful to the readers of financial statements of smaller and/or closely held (SCH) businesses. If not, according to the profession's user orientation, and assuming that these users qualify as part of the target population that is to be served, some changes should be made in the accounting and reporting requirements for these companies. This issue is identical to the one the accounting profession has been faced with all along, only it involves a subset of the total user population. The recommended action is the same also: empirical investigation of the decision processes and needs of the users of financial statements of SCH businesses, so that rational decisions about accounting requirements can be made.

CHAPTER 2

THE "BIG GAAP—LITTLE GAAP" ISSUE

In the past decade, the complexity of GAAP has increased dramatically. Coincident with this proliferation of accounting and reporting requirements a controversy has developed over the usefulness of some of the resulting information to the readers of financial statements of SCH businesses. The question of the propriety and necessity of differential accounting standards first received a significant amount of attention in the early seventies, and a satisfactory response has not yet been agreed upon.

Arguments for Differential Accounting and Disclosure Requirements

Literature of the Seventies

The proponents of differential GAAP have generally based their position on the assumption that the operating characteristics, and thus the resulting needs of financial statement readers, of SCH companies are significantly different from those of larger, publicly held (LPH) corporations. McGill (1974) provided an example:

> I would argue that the economic environment of a multinational conglomerate operating in the Middle and Far East, Europe and South America is not the same as that of a chain of dog-grooming parlors in San Diego (p. 79).

Block (1977) went further, making the connection between company characteristics and accounting requirements:

> Because the responsibility and public impact of the financial statements of public corporations and nonpublic companies (partnerships, corporations, and sole proprietorships) are vastly different, the uniform application of accounting standards to both groups, as well as certain other requirements, is unrealistic (p.11).

A typical argument states that differential user needs must exist since the primary readers of the financial statements are different for SCH versus LPH corporations.

> It is widely accepted that the principal users of public company financial statements are financial analysts and public stockholders, while financial statements of smaller and/ or closely held businesses are usually directed toward owner managers and bankers or other credit grantors (Chazen and Benson, 1978, p. 49).

> The information needs of the small group of readily identifiable users of financial statements of SCH business enterprises vary from those of the multifaceted, multidimensional groups of external users of financial statements of publicly held corporations (Benis, 1978, p. 37).

The fundamental objectives of the two external user groups vary:

> The basic role of commercial bank lending is to smooth the cash flow of the enterprise; it is not to provide permanent or long term capital <n>or is it to replace capital that has been drained from the business by operating losses (Benis, 1978, p. 35).

Beyond the differences in the purpose of financial statement analysis of investors and creditors, size and ownership characteristics of firms differentiate the users in another way:

> An additional and major distinction is that users of public company statements must usually depend on such statements for their sole source of financial information. However, owners and creditors of privately owned enterprises can often request and get additional information when they deem it relevant (Chazen and Benson, 1978, p. 49).

The accounting standard setting bodies have largely ignored these differences.

> There is apparently no awareness by the rule makers that small and closely held companies are in an economic environment completely different from that of large and publicly held companies (Chazen and Benson, 1978, p. 49).

Although espousing a desire to accomodate a wide range of financial statement users (see, for example, FASB, 1978b, para. 24):

> <N>early all the evolving standards have dealt with GAAP and auditing standards applicable to problems of financial reporting of larger business entities whose securities are publicly traded (Gregory, 1978, p.61).

The result, according to proponents of differential GAAP, has been the promulgation of several accounting principles which require the development and presentation of information which is irrelevant to the decisions made by the users of SCH companies' financial statements.

> The SEC and AICPA are justified in leaving no room for misunderstanding when it comes to the public at large, but the unlisted corporations and unincorporated businesses are more often than not confused by the very things that are supposed to enlighten the public (McGill, 1972, p. 83).

The desire to produce general purpose statements has, in the past, overwhelmingly outweighed the annoyance to financial statement readers from having to overlook items which are irrelevant for their particular purpose. However, it is becoming less tenable as GAAP multiply to argue that the users of financial statements of SCH companies can obtain the information they need from financial statements prepared under current GAAP and ignore any additional information that is irrelevant. There is already a great deal of concern about the occurrence of information overload from the relevant information, without considering the impact of having to sort through irrelevant information also.

Another disadvantage of having this category of companies subject to the same GAAP as LPH companies is that:

> <T>he cost factor of compliance with irrelevant standards may inhibit the inclusion of other analytic data which may be pertinent and valuable to the client or the statement user (Chazen and Benson, 1978, p. 50).

The costs associated with complying with GAAP hurt not only the financial statement readers, but also the companies themselves, and indirectly, society as a whole.

> With the proliferation of additional accounting principles over the years, small business, in addition to the other difficulties inherent in competing in an economy dominated by big business, must bear excessive administrative and accounting costs to comply with irrelevant rules (Chazen and Benson, 1978, p. 46).

Eventually, it is the profession which will suffer.

> <S>uch enterprises do not have the technical expertise to implement many of these principles and standards. <T>he task of implementation, therefore, has often become that of the enterprises' outside accountants who have then been required to justify increased fees. In many cases, the increased fee has created tension and conflict between accountant and client, since the client believes the additional work of the accountant does not produce new or relevant information for the primary users of his financial statements--commercial bank lenders and trade creditors, or even the client himself (Benis, 1978, p. 33).

Various authors have suggested that ignoring the existence of differential economic circumstances and user needs could lead to the use of "paraprofessionals", increasing noncompliance with GAAP, and ultimately, an undermining of the authority of the profession's rulemaking bodies, which might induce a governmental takeover of the promulgation of accounting standards.

> It is suggested here that, unless our profession finds suitable alternatives, the small businessmen will look elsewhere for solutions to their reporting problems (McGill, 1972, p. 83).

> If such matters are not given due weight, the degree of compliance with APB and other AICPA pronouncements will diminish and lead to undermining the authority of the APB and other AICPA rule making bodies (Arnstein, 1972, p. 84).

The recommendation generally made by these authors was to exempt SCH businesses from some of the requirements of GAAP.

> <T>he accounting standards should not have been made mandatory to public and private companies without

exception. In some instances . . . they should have been made optional to private companies (Block, 1974, p. 30).

> The tolerance margin of the profession's accounting standards for public and private corporations cannot and need not be identical. The remedy is to modify the universally mandatory aspect of the standards so that in specific instances their application to private corporations is optional instead of mandatory (Block, 1974, p. 34).

> The partners of our firm believe that one way to alleviate the problem is to exempt the financial statements of certain closely held companies from conformance with those sections of APB Opinions requiring the development and presentation of information which is helpful only to the readers of the financial statements of publicly held companies. Such exemptions would be stated in the Opinion itself, except that a new Opinion would be required to cover exemptions applicable to existing Opinions (Arnstein, 1972, p. 84).

> To bring about improvements in current practice we recommend nonessential disclosures for small or closely held businesses be identified by the FASB and be segmented in authoritative accounting pronouncements . . . . (Ingram, 1977, p. 86).

Some members of the profession have taken the moderate position of supporting differential disclosure but uniform measurement principles:

> All of us who are concerned with financial reporting and disclosure are taking a hard look at the burdens on smaller and privately held companies. I'm very heartened to see the concept of differential disclosure being thoroughly discussed and considered. This is certainly a healthy development. But we're also starting to hear arguments for differential measurement as well as differential disclosure. Differential measurement could, of course, give rise to all sorts of problems from different reports for entities of different sizes to different classes of CPA's to prepare them. The resultant confusion can only diminish the

credibility of financial statements of both large and small companies and could lead to an increase in disclosure requirements and greater burdens than now exist. I'd much rather see us recognize reality than leap to vast change (MacKay, 1981, p. 135).

Specific Changes Recommended

The most obvious target for elimination from the financial statements of SCH companies was the earnings per share figure.

<T>he determination of EPS, which can be complex and uncertain for closely held corporations when options and warrants are outstanding and there is no market in the stock, seldom interests management, stockholders, or creditors of such corporations (Arnstein, 1972, p. 83).

This requirement, in the case of closely held corporations, has almost a comic aspect. Many of these companies have 1 or 2 stockholders and a nominal number of shares outstanding. To the principals, and to whomever they may furnish statements, the EPS data are meaningless. The exceptions cited in paragraph 6 of APBO 15 do not include closed corporations. Thus, we have here a clearly unrealistic standard (Block, 1974, p. 32).

Benis (1978) agreed that EPS calculations provide little or no useful information to the major users of these companies' financial statements:

The requirement for reporting EPS has been challenged for years by accountants for nonpublic corporations. Certainly this information does not improve the predictability of cash flows and short term liquidity. This is clearly a standard designed for publicly held corporations; it has no relevance to the information communicated to the user of financial statements of small/closely held business enterprises (p. 36).

> EPS, capitalized leases, imputed interest, and other esoteric accounting measurements are of little import to <the users of these statements> (p. 35).

His arguments against lease capitalization are based on creditor objectives for engaging in financial statement analysis; creditors are concerned primarily with the cash flows available to repay loans.

> <F>or both the lessee and the lessor, whether or not the lease is capitalized, the cash effect is not changed. In view of the above, the logic and benefits of lease capitalization for smaller, closely held business enterprises must be challenged (p. 36).

Arnstein (1972) believed the process of interperiod tax allocation was another accounting procedure which produced information generally irrelevant to the readers of financial statements of nonpublic companies:

> In some cases, the computation of tax allocation effects for closely held corporations is complicated for such reasons as capital gains combined with operating losses, the relatively larger effect of the difference between the rate of the corporate normal tax and surtax on corporations with lower income, changing from filing separate returns to a consolidated return, etc. These clients are principally interested in pretax income and minimizing tax liabilities. They are not interested in the production of a technically correct tax allocation determination which they may not understand and which may require the expenditure of hundreds of dollars worth of professional time (p. 83).

Other accounting requirements which have been mentioned by various authors as generally irrelevant to the users of financial statements of SCH businesses include the equity method of accounting for intercorporate investments, capitalization of interest costs (Gissen, 1981, p. 149), and even the statement of changes in financial position.

Arguments against Differential Accounting and Disclosure Requirements

An article appearing in the January, 1974 issue of The Journal of Accountancy by James H. Naus summarized many of the arguments of those accountants who have opposed the creation of "Little GAAP". While he did not actually state that there were no differences in the needs of readers of financial statements of the two types of companies, he did argue that anything that improved the statements of companies in one group should also improve the statements of companies in the other.

> If official pronouncements from the APB or the FASB improve accounting treatment and disclosure, then those pronouncements should apply to all financial statements (p. 78).
>
> It seems logical that procedures, policies, principles, and disclosures which make financial statements more meaningful or more comparable should be employed by all businesses whether publicly held or closely held (pp. 78-9).

He contended that all domestic companies exist in the same economic environment, and since the objective of accounting is the description of economic activity, all should follow the same accounting rules.

<E>ach business operates in an economic environment that extends far beyond its own activities. It does not make sense that in this one economic sphere there should be two classes of financial statements, two levels of standards for financial reporting, two sets of criteria for determining financial position, results of operations, and changes in financial position (p. 78).

In his opinion, the "recording and reporting of economic events transcend the number of owners or the relationship of those owners to each other" (p. 78).

Naus also argued that differential accounting standards could actually be detrimental to SCH businesses. Even though a company is small or closely held, it continues to interact with members of the "publicly held environment". For instance, trade associations and other groups collect data for industry ratios. If different accounting standards are followed, the numbers cannot be combined without jeopardizing the validity of the results. The owner of a SCH company would be unable to compare his company's performance with that of competitors who were publicly held. Even more important according to Naus, is the tremendous potential for change in the ownership characteristics of a small company. "Corporations which are at one time planning no change in structure may consider merger, sale, or public issue" (p. 79). In his opinion, the proper response to the issue of standards being developed primarily with LPH companies in mind would be for members of the profession (particularly those working with SCH businesses) to make a greater effort to participate in and contribute to the standard setting process (p. 79):

> Rather than attempting to divide, segment or exempt businesses and their reporting standards by type or extent of ownership, CPAs dealing with nonpublic businesses should participate and influence development of opinions and pronouncements which are relevant to all reporting needs. We should make the FASB aware of complications to nonpublic corporations which may result from pronouncements.

Other arguments against differential GAAP have focused on the potential harm to the profession. Some authors have argued that the existence of two sets of GAAP will confuse users and reduce accountant and auditor credibility. Others have expressed a fear that the government will take over the standard setting process for the LPH companies, which are already subject to the rules of the Securities and Exchange Commission (SEC).

Reaction of the Profession

As early as 1952, an AICPA (formerly the American Institute of Accountants) study group was contemplating the logic of establishing separate accounting standards for SCH companies. The following comments were contained in its report, <u>Changing Concepts of Business Income</u>:

> There is no public interest which calls for applying to the hundreds of thousands of small corporations, whose management and ownership are closely combined, requirements deemed appropriate for the guidance of

> investors in the few thousand large corporations whose securities are widely distributed. Nor should the requirements exacted from the listed corporations be measured by the needs of the owners or the competence of the bookkeepers of small private ventures (p. 71).

The members of the group acknowledged that a difference in size and ownership characteristics can influence the relative importance of accounting requirements.

> The owners of these small ventures will have ready at hand the information necessary to implement any concept of income that may be significant to them for a particular purpose; this is not true of the small investor in the larger corporation. The service which accounting renders to this type of enterprise, though important, is of a character different from that rendered to the large company whose ownership is widely distributed (p. 71).

<u>Committee on Generally Accepted Accounting Principles for Smaller and/or Closely Held Businesses</u>

In July, 1974, the AICPA appointed a committee to study the question of differential accounting and reporting requirements. The committee distributed more than 20,000 copies of a discussion paper requesting public comment on four questions:

1. Are any differences in the application of GAAP appropriate?

2. If there were differences in the application of GAAP, on what basis should different application be determined?

3. If there were differences in the application of GAAP, what differences would be appropriate?

4. If there were differences in the application of GAAP, what impact would this have on the independent CPA? (Chazen and Benson, 1978, p. 47)

In September, 1976, the <u>Report of the Committee on Generally Accepted Accounting Principles for Smaller and/or Closely Held Businesses</u> was issued. The committee reached three major conclusions (AICPA, 1976, p. 116):

1. The same measurement principles should be applied in the general purpose financial statements of all entities, because the measurement process should be independent of the nature of users and their interest in the resulting measurements.

2. The nature of the information disclosed and the extent of detail necessary for any particular disclosure may vary depending upon the needs of users.

3. There should be a distinction between disclosures required by GAAP and additional or analytical disclosures in the financial statements of all entities.

The moderate position of differential disclosure requirements but uniform measurement principles was, therefore, supported by this committee. Three recommendations were also included in the report (pp. 116-7):

1. The FASB should develop criteria to distinguish disclosures that should be required by GAAP, from disclosures that merely provide additional or analytical data. The criteria should then be used in a formal review of disclosures presently considered to be required by GAAP and should also be considered by the Board in any new pronouncements.

2. The AICPA Auditing Standards Division should reconsider pronouncements concerning a CPA's report on a) unaudited financial statements, including those accompanied by an "internal use only" disclaimer, b) financial information presented on prescribed forms, and c) interim financial statements of smaller and/or closely held businesses.

3. The FASB should amend APB Opinion No. 15 to require only publicly traded companies to disclose earnings per share data.

Specific Changes Implemented

Compilation and Review. The second recommendation made in the report of the committee on GAAP for SCH businesses addressed the hardships which SCH companies endure in the preparation of financial information for purposes other than annual reports:

> Enterprises large enough to employ internal accounting staffs are able to prepare abbreviated financial information (such as unaudited quarterly reports) and submit such information to third parties without restrictions imposed on the independent CPA when associated with similar reports. Smaller businesses, however, frequently look to the independent CPA for such services. In this situation the independent CPA must comply with promulgated standards, including all required disclosures, or must explain in his report that the financial data is not in accordance with GAAP, thus giving a negative cast to reliable data (Chazen and Benson, 1978, p. 50).

In 1975, the Auditing Standards Executive Committee (AudSEC) established a subcommittee, the Accounting and Review Services Committee (ARSC), to study the question of the

CPA's involvement with the unaudited financial statements of nonpublic entities. Its first Statement on Standards for Accounting and Review Services (SSARS), _Compilation and Review of Financial Statements_, which was issued in December of 1978, delineated two possible levels of CPA association with financial statements other than an audit. This has been a tremendous aid to SCH companies, allowing them to use the services of a CPA without incurring the cost of an audit or receiving a qualified opinion for omitting some disclosures.

SFAS No. 21. The FASB received recommendations regarding the "Big GAAP--Little GAAP" issue from several sources other than the AICPA committee. Members of both the Financial Standards Advisory Council and the FASB Screening Committee on Emerging Problems advised the FASB to develop criteria for distinguishing between accounting requirements that are applicable to all firms and those that are required only of LPH corporations. In February of 1978 the FASB placed a project on its agenda which called for consideration of whether guidelines are needed for:

a) distinguishing between information that should be disclosed in financial statements and information that should be disclosed in financial reporting otherwise, and

b) distinguishing between information that all enterprises should be required to disclose and information that only designated types of

> enterprises should be required to disclose (FASB, 1978a, p. 2).

A few months later, the FASB issued _SFAS No. 21_, in which it suspended the requirements for reporting EPS and segment disclosures for nonpublic companies.

> For purposes of this Statement, a nonpublic enterprise is an enterprise other than one (a) whose debt or equity securities trade in a public market on a foreign or domestic stock exchange or in the over-the-counter market (including securities quoted only locally or regionally) or (b) that is required to file financial statements with the Securities and Exchange Commission (p. 6).

There was some criticism of this definition of nonpublic companies since it encompassed some companies for which there was considerable public interest. However, the definition was adopted, and the statement became effective April 30, 1978, with retroactive application permissible for fiscal years beginning after December 15, 1976.

AICPA Special Committee on Small and Medium Sized Firms

The AICPA's most recent comments on the subject are included in the _Report of the Special Committee on Small and Medium Sized Firms_ which was issued in October of 1980. This report is the work of a committee which was appointed in October, 1978 to "study the future viability and prospects of smaller and medium sized accounting firms" (p. 6). Because the majority of the clients of small or medium sized accounting firms are SCH businesses, the committee became involved with the "Big GAAP--Little GAAP" issue.

> We considered how regulations, some of which primarily serve the public securities markets, affect smaller, privately held companies and the CPA firms representing them (p. 11).

The opinions expressed by participants at public hearings and member forums sponsored by the committee provided evidence of the existence of differential user needs.

> <T>he environment in which smaller, privately held companies operate is different from that of larger publicly held companies. Smaller businesses generally engage in less complex transactions, and are frequently owner-managed. Further, the needs of users of their financial statements--both owners and lenders--are different because of their more intimate knowledge of the business (p. 12).

The committee accepted the premise that the accounting rulemaking bodies have focused on the needs of the public securities markets when developing financial reporting requirements. The narrowness of this perspective is then pointed out:

> Because certain information is useful, even essential, to those who evaluate publicly traded securities does not necessarily mean that the same information is useful (or economically justified) for privately held companies. The profession should be responsive to the needs of the public market without imposing unreasonable burdens on private companies (p. 11).

While giving the FASB credit for deciding to exempt nonpublic corporations from earnings per share, segment, and (more recently) inflation disclosures, the committee criticized the lack of progress on the "Big GAAP--Little GAAP" topic since 1976.

Although measurement principles as well as disclosure requirements were attacked in presentations before this committee, their report strongly supported the conclusion of the 1976 committee that "the measurement principles used by entities reporting under GAAP should be the same regardless of the size or character of the company" (p. 13). The development of other comprehensive bases of accounting was suggested as a possible compromise. A recommendation was made that the AICPA appoint another special committee to continue to examine the "Big GAAP--Little GAAP" question. The proposed charge to the committee was "to study alternative means of providing further relief for small, closely held businesses from accounting standards which are not cost effective for these businesses" (p. 13), with particular attention to the option of new comprehensive bases of accounting. For immediate implementation, the committee recommended some changes in the exposure draft system to encourage the smaller accounting firms to participate more actively in the standard setting process.

AICPA Private Companies Practice Section

Almost half of the October 1980 issue of the PCPS Reporter was devoted to the "Big GAAP--Little GAAP" question. After a brief description of the current status of the controversy, the comments of a number of prominent

CPAs were reproduced (see Appendix A). The editor of the article believed that significant changes in the accounting requirements for SCH businesses may be approved in the 1980's.

Activities in Progress

One of the topics currently being studied by the FASB is entitled "Financial Statements and Other Means of Financial Reporting." It is directed toward the question, raised by the 1976 AICPA committee, of what information should be required in financial statements versus what information should be considered supplementary. The "Big GAAP--Little GAAP" issue in particular is of interest:

> This project also considers whether all business enterprises should be required to present the same types of information. A primary focus is on the characteristics of small and closely held business enterprises and how their financial reporting needs may differ from those of other business enterprises (FASB, 1981, pp. 4-5).

A research project on user decision processes is underway, and a discussion memorandum is scheduled for release in the third quarter of 1981.

Following the recommendation of its special committee on small and medium size firms, the AICPA announced in its May 11, 1981 newsletter that a committee has been appointed to investigate the problem of "accounting standards overload," particularly as it relates to SCH businesses.

There are eight committee members, and the agenda includes the following:

1. Discuss the progress of the FASB project, "Financial Statements and Other Means of Financial Reporting--Small Business," with FASB representatives.

2. Consider the Report of the Committee on Generally Accepted Accounting Principles for Smaller and/or Closely Held Businesses issued in 1976.

3. Consider existing means for obtaining relief from GAAP requirements--the availability and usefulness of "other comprehensive bases of accounting" (SAS No. 14) and of a special compilation report for financial statements that omit substantially all of the disclosures required by GAAP (SSARS No. 1).

4. Solicit views from users of financial statements of small and closely held businesses and expose the committee recommendations for public comment before its report is submitted by the board of directors.

Empirical Research

Only one empirical study to date has focused specifically on the needs of users of financial statements of SCH companies. Falk, Gobdel, and Naus (1976) sent a questionnaire to a sample of commercial bank lending officers to get their opinions on the importance of various financial statement items for closely held businesses. The ratings were requested for two situations: audited and unaudited statements. The relative importance of items did not change when considered in terms of audited versus unaudited statements, but the same item was generally evaluated as more important when it was audited. In terms of the relative weightings of different data items, lease information was rated as very important, and the information in the statement of changes in financial position was ranked as important. In contrast, EPS and inflation accounting information were viewed as relatively unimportant. These results provided support for the possibility of differential accounting requirements for some items but not for others.

A comparison between the results of this study and the findings in studies of user needs in general (i.e., not related to closely held companies) revealed several differences in importance ratings. Typically, balance sheet data were rated higher than other financial information by the bankers, whereas in the other studies income statement items were more important. These differences supported the contention that there are fundamental differences in the needs of readers of financial statements of SCH versus LPH companies, but further evidence should be accumulated before any major changes in accounting standards are made.

Research Problem

This chapter has provided a summary of the controversy surrounding the possibility and/or necessity of differential accounting and disclosure requirements based on size or ownership characteristics of firms. Positions have been taken and changes have been recommended and opposed (some of which have already been implemented), in spite of the fact that very little formal research has been done in the area. Research on user needs began relatively recently, and the "Big GAAP--Little GAAP" issue has been empirically studied only once (Falk, et.al., 1976).

The research project described in this document was designed to gather some evidence on the impact of modifying accounting requirements for SCH businesses. Four items in particular have been examined: earnings per share, deferred taxes, leases, and inflation adjusted information. The decision processes of commercial bank loan officers, as primary users of the financial statements of SCH companies, were examined to see whether some proposed and some already implemented differences in GAAP have any effect.

The earnings per share requirement has already been eliminated for SCH companies, and since there has been little or no negative feedback, it was anticipated that the bankers would not be affected by its omission. However, the decision to exempt SCH enterprises from this accounting rule was made prior to any formal research about its impact. This project has collected empirical data about reaction to the implementation of this change. The usefulness of deferred taxes and lease capitalization has been debated by several authors, again with little formal, empirical evidence as a basis. The impact of eliminating these two requirements was also investigated.

The last accounting and disclosure standard of interest in this study was inflation adjusted information. As with EPS, SCH businesses are currently not required to present inflation adjusted information. However, the introduction to SFAS No. 33 contains a recommendation that smaller companies provide the information voluntarily. The statement is specifically described as experimental; the FASB intends to reevaluate it in five years, if not sooner, to see what modifications should be made. The accounting profession has been concerned with accounting for inflation for many years, and since inflation is a significant problem for all companies, no matter what the size or ownership characteristics, it is quite possible that future modifications to SFAS No. 33 might include expanding its applicability to cover SCH businesses.

CHAPTER 3

ALTERNATIVE RESEARCH METHODOLOGIES

The first part of this chapter contains a review of two methodologies involving human subjects which are available and have been used frequently by accounting researchers for the study of financial decision making: surveys and Brunswick lens approaches. Previous research using these techniques will be identified and an evaluation of each of the methodologies will be made.

The last part of the chapter is devoted to a methodology which is relatively new in accounting: protocol analysis. A general discussion and evaluation of the methodology and a review of financial research employing it is provided. Since protocol analysis was utilized in this research project, a detailed description of the analysis procedures is contained in a later chapter.

Survey Research

Direct solicitation of the views of financial statement users has, for many years, been regarded as an apparently simple, straightforward, and logical method for determining what items of accounting information are useful for decision making. As a result, many accounting researchers investigating the area have used survey methodologies to gather data for analysis. In some cases, a questionnaire containing a list of financial statement items was mailed to subjects who were asked to indicate the importance or usefulness of each item for decision making. A five point rating scale was usually employed. In other studies (Backer, 1970), the financial statement users were personally interviewed.

In 1974, Chandra sent a questionnaire to a random sample of chartered financial analysts and CPAs to investigate the importance of various financial statement data for equity investment decisions. He compared the differences in the value of information items between the two groups. Fifty eight items were presented, and on more than half there were significant differences in mean ratings. Benjamin and Stanga (1977) collected information from two major financial statement user groups using questionnaires: financial analysts and commercial bank loan officers. Each subject was required to evaluate 79 information items on a five point scale of importance. Significant differences in mean ratings were found for 65% of the items investigated. The results of these studies supported the contention that differential information needs exist.

Baker and Haslem (1973) collected data on information importance via questionnaires and concluded that there may be different needs even within the same general class of financial statement readers: investors. They collected data from individual investors and found their needs to differ from those of professional analysts. They suggested that annual reports should include information to satisfy several levels of investor/reader sophistication, from brief summaries to detailed breakdowns of data.

Like Baker and Haslem, Buzby (1974) gathered data from only one user group, investors, in his study of the importance of different types of information for equity investment decisions. However, he did use professional financial analysts. After collecting importance ratings on 38 items, he then examined the annual reports of 88 small and medium sized companies to determine the extent of disclosure of the 38 items. He concluded that there were many items which were evaluated as relatively important by the financial analysts which were not being adequately disclosed and that:

> <A>n opportunity exists for an expansion of the extent of disclosure in the annual reports of small and medium size companies (p. 433).

The study indicated that, at least in 1974, even the public investors, which the accounting profession focused on when establishing accounting standards, were not being served very well.

Evaluation

Several deficiencies in survey methodologies have been identified. The first is the question of subject candor. The information that a subject says is important or useful for decision making is not necessarily the information he actually employs to make decisions. He may identify some items as important because of social or professional pressure to give the "correct" answer. Jensen (1977) provided a persuasive contemporary example of this potential weakness:

> The self explicative approach tends to leave us with proverbial doubts (e.g., what really happened?) typified by a studying of facts of the Watergate scandals juxtaposed against conflicting participant accounts of how decisions were reached (p. 154).

Alternatively, the subject may attempt to answer the questions as truthfully as possible and yet the information provided may not be particularly meaningful. Many researchers have argued that people cannot accurately describe their decision processes no matter how painstaking their efforts. Nisbett and Wilson (1977) reviewed the results of several studies which they felt supported the following conclusions (p. 247):

1. People cannot describe their mental processes very well.

2. When descriptions are accurate, they are not the result of the subject's introspective analysis but rather occur when the influential stimuli for a certain decision are "a) available, and b) plausible causes of the decision, and when few or no plausible but noninfluential factors are available (p. 253)."

3. Subjects often cannot identify the stimuli relevant to their behavior even when the stimuli are readily apparent.

4. Subjects often cannot correctly describe the effect of the stimuli on their behavior.

They hypothesized that the major cause of the inaccuracies of self reports was the "separation in time between the report and the actual occurrence of the process (p. 251)." The methodological implication of the evidence presented was that:

> It may be quite misleading for social scientists to ask their subjects about the influences on their evaluations, choices, or behavior. The relevant research indicates that such reports, as well as predictions, may have little value except for whatever utility they may have in the study of verbal explanations per se (p. 247).

Criticizing survey research for inaccurate results is a step too late according to Tunnell (1977). He opposed the use of survey techniques on the grounds that they typically do not measure the correct behaviors. In his opinion, the issues of whether subjects could or would answer survey questions accurately were moot. He identified three dimensions of "naturalness" which researchers can incorporate into their experimental designs, in order to improve the validity of their results: natural behavior, natural setting, and natural treatment. A natural behavior is defined as:

> <o>ne that is not established or maintained for the sole or primary purpose of conducting research (p. 426).

Tunnell specifically evaluated the naturalness of survey research:

> Self reports should not be considered natural behaviors unless they are made by the person in real life. Experimentally induced self reports are unnatural, since persons in real life rarely respond to adjective checklists or questionnaires, even if the instrument is designed to assess some natural behavior in the person's past (p. 427).

Survey techniques measure opinions or perceptions about behaviors rather than the behaviors themselves, except when "question answering behavior" is the focus of the research.

Accounting researchers are not interested in "question answering behavior", even if the questions have to do with the usefulness of financial statement information. Opinions about and perceptions of the usefulness of various items of accounting information are interesting phenomena, but they are subject to the deception and inaccuracies mentioned above. As a result, surveys may not be the best available methodology for gathering evidence about the use of accounting data in decision processes. The AAA Committee on External Measurement and Reporting was apparently aware of some of the limitations of survey research when it released its 1973 report:

> Users and user needs are an area that needs considerable empirical research . . . "who are users?", "can users be ranked?", and "assuming users can be identified, how can their needs be determined?" Attempts to resolve these questions by interview or questionnaire do not appear to be the ultimate answer, but these devices can be used until other means are developed (p. 244).

In general, subjective recollections are "difficult to obtain, to verify as to candor and accuracy, and to evaluate out of context" (Jensen, 1977, p. 156). A methodology which directly examines financial statement users' decisions and the data that are evaluated in coming to those decisions would overcome many of the deficiencies of survey techniques.

Brunswick Lens Approaches

Description

The seminal work in the area of modelling the decision processes of individuals was performed by Egon Brunswick. He designed a model (see Appendix B) to represent the probabilistic interrelationships between a) cues in the environment, b) variables in the environment which individuals wish to estimate, and c) individuals' judgments of those variables. This model has become one of the most common frameworks for the conceptualization of the decision making process.

The model has two parts: the left side of the "lens" represents the environment while the right side is the judgmental system of the individual. Dividing the model in half are cues in the environment available to the individual. The relationship between these cues and a criterion value (the element of the environment which the individual wishes to estimate) is described by the left side of the model. The right side represents the relationship between the cues and the individual's judgment of the criterion value.

The AAA Committee on Accounting Valuation Bases (1972, p. 549) identified three general areas of research based on Brunswick's model: 1) a descriptive model of the individual's cue weighting scheme, 2) a descriptive model of the actual predictive ability of the cues in the environment, and 3) the judgmental accuracy of the individual. Most of the research on financial decision making has been performed in the first area. The models were developed by analyzing the cues and decisions/judgments with statistical tools such as regression analysis. Quite often the researchers also collected information from the subjects about which cues they perceived to be the most important for their decision processes in an attempt to evaluate their self-insight.

Linear regression was the first statistical tool employed. In cases where the required judgment was dichotomous, discriminant analysis was sometimes used. Both of these procedures produce a linear model of the decision process, which implies that the decision maker combined the cues in an additive manner (AAA, 1972, p. 550).

> When factors have an additive effect, a change in one factor has the same effect on the judgments, regardless of whether the other factor is present or absent; that is, the effects of the factors are independent of one another (Slovic, Fleissner, and Bauman, 1972, p. 289).

When asked to describe their decision processes, most individuals (including those using financial information) attempt to describe their evaluations of complex combinations of cues. That is, they apparently believe that they combine cues in a nonlinear manner. Configural decision models compose the major subset of nonlinear models.

> Configurality means that the analyst's interpretation of an item of information varies, depending upon the nature of other available information (Slovic, 1972, p. 786).

Modelling this type of decision process requires consideration of the interactions of the variables since the effect of one cue is contingent upon the levels of the other cues. Several accounting researchers have used the analysis of variance (ANOVA) technique to try to model nonlinear decision processes and evaluate the probability of their existence. ANOVA has been the preferred method of analysis because it allows the separate identification of the linear and configural portions of a process.

> When judgments are analyzed in terms of an ANOVA model, a significant main effect for cue X(i) implies that the judge's responses varied systematically with X(i), as the levels of the other cues were held constant. Similarly, a significant interaction between cues X(i) and X(j) implies that the . . . effect of variation of cue X(i) upon judgment differed as a function of the corresponding level taken by cue X(j) (Slovic and Lichtenstein, 1971, p. 660).

<u>Accounting Research Using Brunswick Lens Methodologies</u>

In 1977, Savich used regression analysis in a Brunswick lens study of the stock buy/sell decisions of twenty six senior accounting majors. He used a 1/4 fractional replication design to present information about 64 hypothetical companies. Eight dichotomous independent variables were manipulated (see Table 1, Appendix C). He concluded that the decisions were based primarily on five of these items (numbers 1,2,6,7,8) and that the students had fairly good insight into their decision processes, based on a comparison of the objective regression weights and subjectively determined weights.

Libby (1975) also assumed that a linear model would sufficiently describe the decision process he was investigating when he employed discriminant analysis. He asked 43 professional lending officers to decide whether each of 60 hypothetical firms (plus 10 repeat cases) would fail within the next three years based on five accounting ratios (see Table 2, Appendix C). Each subject was also asked to indicate his degree of confidence (not very confident, confident, very confident) in his evaluation. The results indicated that the discriminant models were highly predictive.

Studies using ANOVA have been the most prevalent, indicating a special interest on the part of accounting researchers in the possibility of nonlinear processing in financial decisions. One of the earliest lens type studies employing ANOVA was performed by Slovic (1969), who examined the stock purchase recommendations made by two stockbrokers. Eleven dichotomous variables which are commonly included in Standard and Poor's reference reports were provided (see Table 3, Appendix C). A 1/16 fractional replication design was used, requiring each broker to evaluate 128 companies on a nine point scale. The results showed that only 7% and 5% of the variation in the judgments was explained by cue interactions (configural processing) while 72% and 80% was explained by the main effects of the cues (linear processing). However, Slovic was optimistic that even these slight indications of configurality were important:

> The present results are important in <that> they provide experimental evidence to support the commonly believed notion that judges use information configurally. The results of previous studies, most of which used less direct methods to infer the importance of configural processes, have led a number of workers to assert that humans are predominantly linear information processors. It is now clear that substantial configural processing of information does occur and can be readily detected by the ANOVA technique (pp. 262-263).

By 1972, Slovic had reevaluated the importance of configural processing. He participated in the performance of another study using ANOVA in which the results indicated that the capital appreciation judgments made by 13 stockbrokers and 5 MBA students were highly linear. In this study eight of the eleven cues from his 1969 study were used, in a 1/4 fractional replication design, and the subjects were asked to estimate the potential for capital appreciation of 64 stocks on a nine point scale. An additional conclusion was that the subjects' self insight was rather low.

Ashton (1974b) asked 63 practicing auditors to rate the strength of the internal controls for the payroll system of a hypothetical manufacturing company. Each auditor judged thirty two cases on a five point scale. Six dichotomous (yes/no) cues were provided for each case (see Table 4, Appendix C). After analyzing the data with ANOVA techniques, he concluded that configural effects were generally not significant.

> On the average, the _least important_ main effect accounted for six times as much variance in judgment as did the _most important_ interaction (p. 440).

However, he did admit that the design of his study may not have been conducive to the use of configural processing.

Joyce (1976) extended Ashton's work by examining the judgment process which occurs between preliminary data collection and the actual planning of the audit program rather than the intermediate step of evaluating the internal controls. He focused on the accounts receivable subsystem instead of the payroll subsystem and changed the nature of the hypothetical firm to a tire wholesaler. Thirty five practicing auditors were presented with five cues (see Table 5, Appendix C). Based on the cues, the subjects were asked to indicate which of five audit procedures (accounts receivable confirmation, review of write offs, review of collections subsequent to balance sheet date, determination of adequacy of allowance for doubtful accounts, and review of year-end sales cutoff) would be performed (any number and combination was allowed) and to estimate how many hours of audit work would be planned for each procedure. Both ANOVA and MANOVA (multivariate ANOVA) techniques were applied to the data gathered. Joyce concluded that the decision processes of his subjects were predominantly linear.

Several other studies using a lens type design have been performed (see Hofstedt and Hughes, 1977; Boatsman and Robertson, 1974; and Wright, 1977). Ashton (1974a) summarized the consensus opinion regarding financial decision models arising from this line of research:

> The overwhelming result has been that nonlinear models generally provide little, if any, increase in descriptive power over that provided by a simple linear model--even in judgment situations selected for their (supposed) inherent nonlinear relationships (p. 726).

He continued the discussion by saying that even if configural processing occurs, linear models approximate the relationships (between cues and decisions) quite well. Other researchers often expanded their conclusions to state that the decision processes of financial information users were in fact linear.

<u>Evaluation</u>

A major limitation of Brunswick lens research is that it is a "decision only" methodology (Stephens, 1980, p. 1). The models which are derived are a function of the inputs (cues) and outputs (decisions) of the decision process and the mathematical manipulations which constitute the analytical method employed.

> Multivariate data analysis is used to uncover hidden or obscure relationships (usually as parsimoniously as possible) without necessarily attempting to uncover or explain a causal link between stimuli and decisions or the actual mental processes of the decision maker (Jensen, 1977, p. 158).

Hoffman (1960) coined the term "paramorphic" to describe a weakness of the models resulting from this type of study.

> <T>here are bound to be several subsets of terms which will lead to essentially the same degree of predictive accuracy if included in the <model>. Even though the inclusion of a particular term . . . may enhance the accuracy of the estimate of the judgments, thereby providing what must in some sense be termed a "better fitting model", it does not necessarily follow that the judge was, in fact, using that particular term at all, much less in the way stipulated by the model (Hoffman, et al., 1968, p. 347).

Accurate prediction of a subject's decisions is a necessary but not sufficient condition for a model to qualify as a description of the cognitive processes underlying the decisions.

As mentioned above, several researchers attempted to assess the validity of the mathematical models derived by including a "self insight analysis" phase in their experimental designs. They asked the subjects to allocate points to the cues based on their importance to the decision process, and compared these subjective weights to the regression or ANOVA weights. Ashton (1974a) summarized the general conclusion of these researchers:

> Research has indicated that individuals (even experts) have poor insight into their own judgment processes as described via mathematical models. Generally, individuals overestimate the extent to which they utilize the less important cues and underestimate the extent to which they utilize the more important cues (p. 728).

Suggested explanations have been that people like to believe themselves to be more complicated than they really are (Hoffman, 1960, p. 130) or that experts' decision processes have become so automatic that they cannot describe them well and develop elaborate rationales for their decisions (Slovic, et al., 1972, p. 300). It is contradictory to admit that several mathematical models could fit the experimental results equally well and then imply that the subjects are ignorant of their own decision processes because their subjective weights do not match one set of mathematically determined weights.

Other methodological issues also challenge the validity of concluding that the linear models derived in Brunswick lens studies accurately describe the decision processes which actually occurred. First, these studies typically involved the presentation of a very limited number of cues, each of which could only assume two nominal or ordinal values (see Appendix C). This was a significant abstraction from reality where, at a minimum, complete financial statements are available to the decision makers. It seems reasonable to argue that requiring an "expert" to make a familiar decision on the basis of a drastically different set of information from that which is normally used could result in a modified decision process. A decision process which is configural when it takes place in a natural environment with a large, complex information set may well collapse to a linear model when only a handful of cues is available.

Secondly, the statistical analyses performed in previous studies are often described as "robust" by researchers who use them in spite of violating some of the underlying assumptions. It is possible that the very robustness which is so "useful" in some cases is covering up configural effects in this type of experiment. As Hoffman, et al., (1968) explained:

> While the validities of the individual cues are a sufficient condition for the finding of linear effects, strong interaction or configural effects will be found only when the implication of a particular cue is radically different when associated with one pattern of other cues, rather than with another (p. 347).

They suggested that the general environmental conditions for financial decisions result in patterns which attenuate the importance of particular cues rather than causing a dramatic change in the interpretation.

Finally, the requirement of ANOVA that the cues be orthogonal is a direct contradiction of reality where correlated cues abound. The presentation of a few uncorrelated cues might naturally lead to linear processing. That seems to be a questionable basis for generalizing linear processing to real world situations. Other technical problems with the analysis used in Brunswick lens studies are discussed by Schepanski (1978, pp. 74-81).

As with survey research, there is the question of whether the Brunswick lens approaches are the most desirable methodologies in a theoretical sense for examining the decision processes of financial statement users. As mentioned above, this technique is a "decision only" methodology in which the resulting model of the decision maker is based only on the inputs and outputs of a decision process. Data about the processes underlying the decisions are not collected and there is no means by which knowledge of such processes can be incorporated into the model which is derived. The appropriateness of this methodology is contingent upon the objective of the research. If prediction of a user's decisions is the concern, this methodology is quite appropriate and accurate. However, if accounting researchers are interested in learning about user processing of financial statement information, it would seem preferable to utilize a methodology which includes the collection of data about the processes involved in making financial decisions.

Protocol Analysis

Protocol analysis falls into the general category of process tracing techniques. As its name implies, rather than focusing on inputs and outputs of a decision process as in the Brunswick lens methodology, process tracing involves gathering detailed information about how the decision maker proceeds from the inputs to the outputs. The study of eye movements is a process tracing technique which has been used frequently in marketing research.

Newell and Simon (1972) developed a theory of human thinking and problem solving which has served as the basis for much of the process tracing research. Their theory "postulates that the human operates as an information processing system" (p. 19). They identified two types of knowledge which can be acquired by using a process tracing approach for the study of decision processes:

> 1. To the extent that the behavior is precisely what is called for by the situation, it will give us information about the task environment.
>
> 2. To the extent that the behavior departs from perfect rationality, we gain information about the psychology of the subject, about the nature of internal mechanisms that are limiting his performance (p. 55).

Newell and Simon spent most of their time examining subjects' problem solving processes when they were engaged in relatively unspecialized tasks, such as cryptarithmetic and chess. Bhaskar and Simon (1977) distinguished these from professional problem solving tasks which occur in what they term "semantically rich domains".

> <A semantically rich domain> is a task domain in which successful performance calls for specific knowledge as well as general problem solving skill (Simon, 1979, p. 369).

> <Semantically rich cues> have meaning for directing information processing . . . which can only be learned from training or experience. <They> are utilized to determine which information will be collected, how this information should be processed, and how to interpret results obtained . . . (Stephens, 1980, p. 71).

The collection of data for protocol analysis involves having the subject "think aloud" during the decision making process, identifying which items of information are being examined/compared/evaluated and any intermediate decisions made (e.g., the elimination of an alternative from further consideration). The verbalization is tape recorded and an observer makes notes of nonverbal behaviors exhibited by the subject (e.g., written calculations). The transcript of the actions and verbalizations is called a protocol.

To prepare the data for analysis, the protocol is broken down into a series of short phrases "based on a naive assessment of what constitutes a single task assertion or reference" (Newell and Simon, 1972, p. 166). The primary purpose of this step is to facilitate reference to sections of the protocol during the analysis phase. Although the procedure is subjective, researchers have found that variations in the phrasing of protocols do not significantly affect the analysis.

The general objective of the analysis is the development of a description of the subject's problem solving behavior based on the contents of the protocol. Newell and Simon identified two components of problem solving behavior: "knowledge states" and "operators". Operators are processes used to move from one knowledge state to another. The operators hypothesized depend, to a large extent, on the type of task being studied. Basic problem solving tasks such as cryptarithmetic are generally analyzed in terms of fundamental mathematical and reasoning operators. For example, Newell and Simon postulated operators like "assign a value to a variable", "test a variable", and "process a column" (pp. 171-172).

The choice of the level of detail for analyzing the protocol is a critical decision. Inappropriate levels of aggregation of behavior will diminish the usefulness of the results.

> If too aggregated, the <description> would be superficial or epiphenomenal; if too disaggregated, it would fail to reveal the larger units of organization (Newell and Simon, 1972, p.187).

In a semantically rich domain, the concern is not so much with basic mathematical procedures as with which specific items are selected for processing out of the available data and the general way in which those data are evaluated. For example, rather than "assign a value to a variable" or "process a column", the operators used in a loan officer's lending decision process might be "calculate a ratio" or "compare with industry average".

In addition to providing data about the specific information items evaluated and the processes used to evaluate them, protocol analysis may provide information about the general information processing strategy of the decision maker. The general strategy will be determined to a large extent by the task environment. Psychological research consistently indicates:

> . . . that human problem solvers utilize heuristics to reduce complexity of information processing. In addition, many actions are dominated or at least influenced by standard operating procedures and information processing behavior in professional problem solving tasks seems dominated by task requirements, perhaps formulated as professional rules, rather than personality characteristics of individual decision makers (Stephens, 1980, p. 69).

The study of the decision processes of financial statement users should allow the identification of heuristics and standard operating procedures used in the processing of accounting data and provide information about the tasks requiring the use of such information.

Financial Research Using Protocol Analysis

It has been only recently that anything other than "black box" approaches, which ignore what goes on inside the decision maker's mind, has been embraced by researchers in the area of financial decision making. Clarkson (1962) was one of the first researchers in the financial area to examine the decision process as well as its output. He analyzed the protocols of a trust investment banker and utilized the results in the development of a computer simulation of the trust investment process. However, his work was similar to the Brunswick lens studies in that he did not require the computer program to reflect the actual decision processes of the subject.

Biggs (1979) examined the decision processes of eleven financial analysts using protocol analysis. The analysts were each given financial statements for five companies in the paper industry and asked to select the one they felt had the greatest earning power. The protocol analysis data were used to classify the choice process as one or a combination of four a priori choice models: additive compensatory (AC), additive difference (AD), conjunctive (C), or elimination by aspects (EBA). The four models can be distinguished on the basis of two characteristics of the information processing strategies assumed to stem from their use: 1) interdimensional versus intradimensional search, and 2) constant versus variable amount of information searched per alternative.

Model	Search Strategy	
Additive Compensatory	Inter	Constant
Additive Difference	Intra	Constant
Conjunctive	Inter	Variable
Elimination by Aspects	Intra	Variable

The pattern of information search as revealed in the protocol analysis provided evidence of the choice model being used. Three types of analyses were performed on the protocols of each subject: task level analysis, episode analysis, and processing structure analysis. The first and third analyses generated information about the characteristics of the entire decision process while the second focused specifically on the episode where the final choice was made. The protocol analyses indicated that each of the four models was used by at least one analyst. Biggs also designed a post experimental questionnaire to identify the processing model used and assessed the convergence of the two methods. The questionnaire results indicated the use of only the AC, AD, and EBA models, but he concluded that there was "some degree" of convergence for ten of the eleven analysts.

Stephens (1980) used protocol analysis to investigate the decision processes of ten commercial bank lending officers, each of which made a loan decision for one of two companies. Three hypotheses were tested:

> The procedures used for financial statement analysis by bank lending officers will not differ because of:
>
> 1. differences in line of business of a loan applicant,
> 2. inventory valuation method, or
> 3. depreciation method,
>
> and when the inventory and depreciation methods are used consistently no adjustment will be made for these accounting methods.

The primary processing approach used by the loan officers was the calculation of ratios, although absolute values of some financial statement items were considered also. Ratio trends were examined by all subjects and three of the subjects made explicit comparisons of company items and industry standards as contained in Robert Morris Associates' Annual Statement Studies. A comparison of the ratios calculated by each subject supported Stephens' hypotheses.

In addition, Stephens attempted to systematize bank lending decision processes based on a) the commonalities in the protocols of the loan officers evaluating the first company, b) conversations with loan officers, and c) investigations of the literature. The hypothesized decision processes were then tested against the protocols of lending officers who evaluated the second company. The first step involved

> . . . an attempt to identify components of a firm's operations for which information processing activities occurred where outputs of such processes were used for search and/or decision making activities (p. 102).

The eight components he identified are described in Table 6 in Appendix D.

Stephens found that loan officers initially determine the adequacy of the information for making a decision, and then proceed to evaluate the components. His representation of the bank lending decision process is presented in Appendix E. One of Stephens' most important conclusions was that accounting information serves multiple purposes. It was not only used in decision making but also in structuring the decision process by directing attention to items or areas of information which needed further investigation. This use of accounting information is overlooked in "decision only" research.

Protocol analysis was also used in a study by Bhaskar and Dillard (1979). However, the purpose for employing it was quite different from the previously reported studies.

The objective of the research project was the development of a model for the representation of accounting knowledge. The model was developed on an a priori basis and a task analysis (based on the components of the model) was performed to identify the knowledge, inferences, and capabilities necessary for a subject to solve certain accounting problems (in this case, classroom problems in intermediate accounting). Based on their model of the structure of accounting knowledge, Bhaskar and Dillard then developed a semiautomatic protocol analyzer which predicted the process which would be used to solve the problems. Protocols were collected from subjects actually working the problems, encoded, and compared with the hypothesized process. Thus, in this study, rather than being used to generate a model of an individual's decision processes, protocol analysis was used as a method for validating a previously generated model.

Stephens, Shank and Bhaskar (1980) utilized protocol analysis to examine the lending decision processes of four commercial bank loan officers. Each banker was presented with information about a hypothetical company (a case previously developed and used by Stephens (1980)), and asked to decide whether or not a request for a line of credit would be approved. Two different bases for analysis were employed (p. 16):

1. analysis of the information used, segmented into sub-groupings or "components", and

2. analysis of the separate cognitive processes applied to the information.

The components used in the first analysis included those identified by Stephens (1980) plus fourteen new categories (see Table 7 in Appendix D). They concluded that the subjects did not process the information in a sequential compensatory manner, as the Brunswick lens researchers implied with their models. Rather than exhaustively processing the components one at a time, the bankers recycled among the components several times, and there was no evidence of any tradeoff between the items evaluated.

Twelve processes (see Table 8, Appendix D) were identified for use in the second analysis of the protocols based on the contents of the first protocol analyzed and an examination of the literature on comprehension. Stephens, et.al. concluded that the components were not evaluated in any particular order, and that shifts in the component being processed occurred frequently. They hypothesized that insufficient data about a particular component triggers the read process, and that if information about a new component is encountered while reading, the subject begins to process the new component instead of continuing with the processing of the old one. The order of component processing is, therefore, determined, to a large extent, by the presentation of the material, leading to the conclusion that "the prediction of component order is a hopeless enterprise" (p. 21). Other conclusions drawn by these researchers were that the "decision process" does not exist separate from the other phases of information processing, and that their subjects exhibited information processing which was consistent, both among themselves and with the subjects used by Stephens (1980).

Evaluation

The unique characteristic of the protocol analysis methodology is that data are collected about decision processes as they occur. While both protocol analysis and survey research use data generated by a subject's description of his processes, the fact that the subject describes his processes while he is actually making the decision means that a more "natural" behavior, as defined by Tunnell, is being studied. Research has shown that it is difficult for people to lie in a convincing manner about their thought processes while in the middle of those processes. If it is attempted, abnormally long silences occur as the subject processes the information for the decision of interest and then decides what false information should be verbalized. Extended periods of silence can alert a researcher to the possibility of subject deception. The information gathered by the observer about the nonverbal behaviors of the subject can be used to partially verify the processes described in the verbalizations.

The problems of self insight discussed by Nisbett and Wilson (1977) are not as troublesome in protocol analysis as in survey research. Elapsed time between the occurrence of the process and the report on the process was hypothesized to be the chief cause of inaccurate reports. Because the report in protocol analysis is during or immediately after the processing, the elapsed time is minimal. Nisbett and Wilson identified the types of information relevant to decision making processes to which the subject has access (p. 255):

> <H>e knows the focus of this attention at any given point in time, he knows what his current sensations are and has what almost all psychologists and philosophers would assert to be "knowledge" at least quantitatively superior to that of observers concerning his emotions, evaluations, and plans.

The focus of attention, current sensations, evaluations, and plans are all integral parts of decision making about which protocol analysis can provide information.

A researcher using protocol analysis does not have nearly as much influence over the subject's responses as one using a questionnaire or interview. In survey methodologies, the topics about which data are collected are determined by the questions asked, and the range of possible responses is generally quite limited. There are fewer restrictions on subject responses when protocols are used, and, therefore, the data collected is typically much "richer" in content.

Brunswick lens methodologies do not involve the collection of any data about decision processes; they focus solely on the inputs and outputs of the processes. The models which are developed are a function of mathematical formulae rather than of information about the processes. As a result, on strictly a theoretical basis, a process tracing approach, such as protocol analysis, seems to be preferable for the determination of the use, and implied usefulness, of accounting information in financial decisions.

From a practical standpoint, protocol analysis has several limitations as a methodology. Jensen (1977) identified some of these (p. 155):

1. Time and expense in studying even one decision maker. Over time and multiple decision makers in an entire decision process the cost becomes exceedingly great. For broad based studies of numerous decision processes research costs are astronomical.

2. Decision makers under observation and forced to explicate their thought processes aloud may behave differently than under normal circumstances, thereby creating an internal validity problem which is difficult to control.

3. Decision makers who will cooperate in such studies are few and far between. Finding one

> who will participate when controversial issues are under study would be rare.

Item one concerns the tremendous cost to the researcher, both in terms of money and time. The analysis procedures are extremely time consuming, and they generally cannot easily be delegated to either research assistants or computer programs. The time requirement for the subject is also significant. A couple of hours may be necessary to complete the decision process. In addition, item number three mentioned by Jensen pointed out that people may be unwilling to participate due to the sensitivity of the decision process under study. These factors work together to guarantee a sample which is small and nonrandom. Statistical generalization is, therefore, impossible.

The analysis of protocols is a subjective procedure. The subjectivity is necessitated by the richness of detail of the data collected. Subjectivity can affect the analysis in several ways. The identification and definition of categories into which the phrases of a protocol should be classified are determined by the researcher. Thus, two researchers could analyze the same protocol from completely different perspectives. For instance, one might have been interested in the information items used, while the other was concerned only with the cognitive processes which occurred. Secondly, even if two researchers chose the same basis for analysis, the specific categories established might differ, or the guidelines for deciding whether a phrase fell into a certain category could be different. Finally, additional subjectivity arises from the fact that the same researcher may be inconsistent in the classification of the phrases of a protocol at different points in time.

The first two causes of subjectivity in analysis can be controlled by establishing common bases for analysis and common categories within those bases. To some extent, the subjectivity arising from the use of different rules for classifying phrases into a given set of categories can be controlled by explicitly establishing and agreeing upon those rules prior to analysis. The more precisely the guidelines for classification of phrases can be defined, the less the chance that either inter- or intra-researcher inconsistencies will arise. The complexity of the decision process being studied will undoubtedly be a significant determinant of the amount of subjectivity in the analysis procedures. Newell and Simon (1972, p. 184) felt that "the long run solution to these questions of validity and reliability lies in mechanizing the procedure".

The most troublesome potential limitation of protocol analysis is the second one mentioned by Jensen: that verbalization during a decision process may fundamentally change that decision process. There is no doubt that, at best, protocols provide only a partial trace of the processing which has taken place in a subject's mind. It is impossible for a person to verbalize as quickly as he/she can think. Also, many processes are so automatic that the person cannot describe what occurs. The incompleteness of the description is not a fatal flaw. However, if the description is of a fundamentally different process, the contribution which studies using protocol analysis can make to the pool of knowledge about financial decision making is suspect. At this time, a definitive determination of the existence of this limitation cannot be made since there is no reasonable way to directly examine decision processes. Temporarily, at least, the impact of verbalization must be acknowledged as a potential limitation which cannot be controlled. In spite of this and the other implementation problems, protocol analysis seems to maintain its advantage over survey and Brunswick lens methodologies by virtue of the fact that it provides data about information processing as a decision occurs.

CHAPTER 4

METHODOLOGY

The research study discussed in this document was designed to empirically investigate the impact on the lending decisions of commercial bank loan officers of implementing differential accounting requirements for SCH companies. Bankers were chosen as subjects because of the general agreement in the literature that creditors constitute the major external user group of the financial statements of SCH businesses. Four topics were chosen for specific study: earnings per share, deferred income taxes, leases, and inflation adjusted information. The rationale for the selection of these items was discussed in Chapter 2. A protocol analysis methodology was used because it allowed the collection of data about the decision processes of the loan officers. It was believed that such data were the most appropriate for the evaluation of the usefulness of financial statement information.

Development of Experimental Materials

Two cases were constructed for use in this project: a Big GAAP case and a Little GAAP case. Each contained introductory information and four years of audited financial statements, including notes, for the same hypothetical company, Hudson Stores, Inc. (see Appendix F). The introductory material described Hudson Stores, Inc. as a closely held, family run business which was seeking a $100,000 unsecured, line of credit. The total assets of the firm amounted to approximately one million dollars, and revenues averaged approximately $1.6 million.

The results of a study by Cooper, San Miguel, and Stephens (1979) indicated that one of the first behaviors exhibited by bankers presented with a lending decision situation was an assessment of whether an adequate amount of information was available. After evaluating their results, they suggested that researchers provide a minimum of four years of financial statements to insure that a lending decision process would begin. The financial statements included in the Big GAAP case were prepared according to the GAAP appropriate for LPH corporations as of March, 1981. The Little GAAP financial statements were prepared according to the suggestions of proponents of differential accounting requirements in the four areas of interest.

Some information supplements were also prepared for use in the study. One set of supplements was for use with the Little GAAP case. These supplements contained any information on the four topics which had been omitted from the statements. The second set of supplements, for use with either version of Hudson Stores, consisted of additional non-financial statement information which was provided only when a loan officer could not reach a decision without it. There were four supplements, one each covering projected borrowing requirements, long term debt, store locations, and an aging of accounts receivable. This information was not included in the basic case materials because it would not normally be provided in connection with financial statements. The only reason it was used was to prevent premature truncation of the processing of accounting information due to a lack of other information that bankers often use.

The empirical study problem entitled Dawson Stores, Inc., developed by Stephens in 1976 (as published in Stephens, 1980) was the basis of the experimental materials designed for this study. Stephens used the financial statements of Dayton Hudson Corporation for the years 1973 through 1976 to develop the Dawson Stores case. Although prepared under GAAP in 1976 (which would have qualified the case as an example of a SCH company's statements prepared under Big GAAP at the time), changes in GAAP in the intervening period required modifications to the financial statements both to adapt them to a Little GAAP format and to adapt them to a current Big GAAP format. A summary of the differences between the Dawson Stores case and the two Hudson Stores cases is provided in Table 9 in Appendix F. During the modification procedures, care was taken not to change any of the following conditions, which were identified by Stephens (1980, pp. 83-84) as guidelines for focusing the subjects' attention on the processing of accounting information:

1. The loan should be of sufficient size to require financial statement analysis.

2. Collateral evaluation is not a required part of the credit granting process.

3. Selection of a company as borrower to minimize the possible biases from an individual as borrower.

4. The loan to be considered should not violate legal restrictions of a bank.

5. The loan's purpose should not violate any of a bank's policy restrictions.

6. Customer relationships should be satisfactory in relation to the amount of credit requested.

<u>Specific Data Development</u>

The following sections describe the steps involved in modifying Dawson Stores, Inc. and/or developing any additional information needed for the Hudson Stores cases.

Earnings per share. The first distinction between the Big GAAP and Little GAAP versions of Hudson Stores' financial statements was the elimination of the EPS figures from the Little GAAP statements. The Big GAAP statements were identical to Dawson Stores in the presentation of EPS data on the face of the Comparative Statements of Income and Retained Earnings. A Little GAAP supplement containing the EPS data was prepared for presentation to any bankers who required this information for their decision making process.

Deferred income taxes. The second difference between the two versions of the Hudson Stores statements resulted from the elimination of deferred income taxes from the Little GAAP statements. In the Little GAAP Comparative Statements of Income and Retained Earnings, only currently payable income taxes were listed. This resulted in changes in the Comparative Statements of Financial Position also, via the Retained Earnings balances. In addition, the deferred taxes which had been accumulated in prior periods and disclosed in the liabilities section (some current and some noncurrent) were omitted and the amounts added to the Retained Earnings balances.

The noncurrent deferred credits account in Dawson Stores included some deferred income as well as deferred taxes, but a breakdown was not available. The entire amount was omitted, which necessitated the omission of the "increase (decrease) in deferred income" item in the "funds provided by" section of the Comparative Statements of Changes in Financial Position. Those amounts were combined with "other (net)" under "funds used for" for the last two years. That had already been done for the first two years in Dawson Stores.

Also in the Comparative Statements of Changes in Financial Position, the "increase (decrease) in noncurrent deferred income taxes" was eliminated from the section "items not affecting working capital". In the "schedule of changes in the components of working capital", the amounts provided for the item "accrued expenses and others" were adjusted to eliminate the portion pertaining to the current deferred income taxes shown in Dawson Stores. Finally, footnote number five in Dawson Stores, describing the items which had created the deferred taxes was omitted in the Little GAAP case. A Little GAAP supplement describing the impact of deferring income taxes on each of the financial statements and including the information from the Dawson Stores footnote was prepared for presentation to any bankers who required this information for their decisions. The Big GAAP case was identical to Dawson Stores in terms of the presentation of deferred tax information.

Leases. The third topic which received differential treatment in the Hudson Stores cases was leasing activity. In this instance, the lease presentation in Dawson Stores was appropriate for the Little GAAP statements since SFAS No. 13, which required capitalization of certain leases, was not in effect prior to 1977. New information was prepared for inclusion in the Big GAAP statements, based on the descriptions of leasing activities contained in the notes to Dayton Hudson's financial statements. Although Dayton Hudson had not capitalized its leases during the years 1973 through 1976, descriptions of the impact capitalization would have had on earnings in each year was presented. The estimated impact on income was never greater than 1%.

Using 1% as the change (decline) in income resulting from capitalization, modified net earnings figures were calculated for each year, and the decline was attributed to the difference between rental expense actually recorded and the interest and depreciation expense that would have been recorded had the financing leases been capitalized. Thus, the operating expenses in the Big GAAP version of the Hudson Stores case are greater than those in Dawson Stores by 1% of Dawson's net earnings in each year. No attempt was made to adjust the amount of income taxes shown in Hudson Stores for the resulting change in earnings before income taxes. The difference was presumed to be immaterial. (Table 10 in Appendix F summarizes the changes required by the capitalization of the leases for the Big GAAP version of the Hudson Stores' income statements.) The changes in the income figures necessitated changes in the balances of the Retained Earnings account shown on the Comparative Statements of Income and Retained Earnings.

The Retained Earnings balances were also adjusted in the Comparative Statements of Financial Position. Other changes in the Balance Sheets involved the creation of the lease asset and obligation accounts. The present values of future minimum lease payments for financing leases were taken from Dayton Hudson's notes and used as the lease obligation of Hudson Stores. The only adjustment necessary was to divide the total between current and noncurrent classifications, and this was accomplished by listing the actual payments due in the upcoming year as the current obligation. The amounts of the lease asset to be included in the Balance Sheets were plug figures: the total of the lease obligations and the changes in the Retained Earnings account resulting from the changes in Net Earnings.

Several changes were required in the Comparative Statements of Changes in Financial Position as a result of the lease capitalization process. In the "funds provided by operations" section, depreciation on capital leases was included as an "item not affecting working capital". The amounts used were composed of the original rental expense related to financing leases plus the 1% change in Dawson's net earnings for any given year. Technically these amounts were partially depreciation and partially imputed interest expense. However, since imputed interest does not affect working capital either, and since no basis was available for dividing the total into two categories, the total amount was referred to as depreciation.

Another new item listed as providing funds was the "net increase (decrease) in capital lease obligations". Added to the "funds used for" section of Hudson's Big GAAP statements was the item "addition (reduction) of items under capital leases". Finally, the "schedule of changes in the components of working capital" was expanded to include the change in the current portion of the capital lease obligation. As a result, the amounts of change in working capital each year had to be adjusted. The note to the financial statements in Dawson Stores, Inc. about leases was expanded to include a description of the impact on earnings of lease capitalization and to show a breakdown of the minimum future required lease payments between operating and capital leases.

A Little GAAP supplement delineating the impact of lease capitalization on each of the financial statements was prepared for presentation to any loan officers who required this information in order to make their lending decision. Within Hudson's Little GAAP statements, the treatment and presentation of leasing activities was identical to that of Dawson Stores.

Inflation adjusted information. The final distinction between the Big GAAP and Little GAAP versions of Hudson Stores occurred in the area of inflation adjusted information. Based on the requirements of SFAS No. 33, the Big GAAP statements contained supplementary, unaudited constant dollar and current cost information in a note. No inflation adjusted information was included in the Little GAAP statements, making them identical to the Dawson Stores statements in this area. A Little GAAP supplement was prepared for presentation to any banker requiring the information for a decision.

The format of the supplementary schedule in which the inflation adjusted information was disclosed in the Big GAAP case was taken directly from Schedule C in Appendix A of SFAS No. 33. The only difference was the addition of the last two items, "current cost of inventory at year end" and "current cost of property, plant, and equipment at year end". The disclosures required by SFAS No. 33 fell into two categories: those related to the most current fiscal year, and those for which a five year summary was to be presented. The two items mentioned above were the only ones required in the first group, but not in the second. Instead of developing two schedules which duplicated the presentation of many items, these two items were merely added to the bottom of the five year schedule. Due to the recent issuance of SFAS No. 33, only two years of data were required in the five year summary at the time the case was used. However, in the interest of fairly evaluating the usefulness of inflation adjusted information, and based on the Cooper, San Miguel, and Stephens (1979) study, four years of data were developed. (For some items, the fifth year's data were also presented, as required by SFAS No. 33.)

A.) Constant dollar information. The constant dollar information was developed using the Consumer Price Index for All Urban Consumers (CPI-U) published by the Bureau of Labor Statistics (BLS). Because the complete data for 1980 were not available at the time the cases were prepared and used, an estimate of the average 1980 general inflation was developed by extrapolation, a method identified in SFAS No. 33. The rate of inflation between September 1979 and

September 1980 (the last available data) was calculated and this was presumed to give a reasonable estimate of the inflation rate for 1980. This rate was then applied to the average 1979 CPI-U to develop an estimate of the average 1980 CPI-U.

SFAS No. 33 requires adjustment of only the cost of goods sold (COGS) and depreciation data in the calculation of inflation adjusted income from continuing operations (IFCO). Further adjustments are encouraged, but optional. For this project, comprehensive restatement (restatement of all income statement items, not restatement of all transactions) was utilized since this gave a more accurate picture of the impact of inflation on IFCO. The numbers were first restated into constant dollars of the year in which they occurred, and then rolled forward to the 1980 dollars presented in the supplementary schedule.

The sales figures were adjusted for one half the average annual change in the CPI-U in the year in which they occurred under the assumption that the sales occurred uniformly throughout the year. The same adjustment was made for the "other expenses" on the income statements.

An assumption was made that there was little or no depreciation included in the overhead portion of the COGS figures since the company was a retailing firm. The initial step in the adjustment of COGS was the calculation of the inventory turnover period. The use of the last-in, first-out (LIFO) method of inventory valuation meant that the COGS figures were reasonable current. Based on the assumption of uniform sales throughout the year, an adjustment was made for one half of the year's inflation rate. The inventory turnover data revealed the additional adjustment necessary to reflect the delay between inventory purchase and sale.

In order to develop the inflation adjusted depreciation figures, an assumption had to be made about the lives of the items making up property, plant, and equipment (PPE). Dayton Hudson's ten year summary revealed that in ten years they had replaced more than half of their PPE. An assumed average age of the PPE of ten years, therefore, did not seem unreasonable. (This average age was assumed to remain constant over the four years for which data was developed, rather than declining to nine, etc.) The depreciation figures were adjusted by an inflation factor which divided the current year's CPI-U by the CPI-U ten years earlier.

Calculation of the price level gain under constant dollar accounting required several assumptions about the company's net monetary position. Cash and accounts receivable were the only monetary assets, but all the liabilities were classified as monetary since there was no evidence to the contrary. The price level gain was calculated by 1) adjusting the beginning net monetary position for a full year's inflation, 2) adjusting the change in net monetary position for half a year's inflation (on the assumption that the change occurred uniformly throughout the the year), and then 3) subtracting the ending net monetary position from the sum of the results in 1 and 2. The basis for this calculation was the presentation in Walgenbach, Dittrich, and Hanson (1976, pp. 518-520), but information about individual items affecting the net monetary position was not available.

SFAS No. 33 requires adjustment to the historical cost net asset figures only for the increase in inventory and PPE due to inflation. The constant dollar net asset figures were developed in this manner, and then they, along with sales, price level gains, and IPCO figures, were rolled forward to 1980 dollars to be disclosed in the supplementary schedule.

B.) Current cost information. In the development of the current cost IPCO data, adjustments were made only to COGS and depreciation. Indices were again used to make the adjustments. To determine the impact of inflation on inventory items, an index combining two components of the

CPI-U was constructed. The "apparel and upkeep" and "other goods and services" components were believed to contain the types of items in a retailer's inventory. This combination index was used to generate the yearly change in prices. Once again the inventory turnover figures were used to determine the amount of the year's inflation which was used to adjust the COGS figures for the lag between purchase and sale.

The depreciation numbers were adjusted in the same manner and using the same assumptions about fixed asset life as in the constant dollar calculations. However, the index numbers used in the adjustments were taken from the construction index component of the producer price index. Once the current cost IFCO numbers were developed, they also had to be expressed in 1980 dollars.

Another requirement of SFAS No. 33 is the presentation of the "excess of the increase in specific prices over the increase in general price level". These numbers were calculated by comparing the historical cost numbers with both the constant dollar and current cost numbers for inventory and PPE in each year and then analyzing the change between years. Finally, the current cost of the net assets was calculated by adding the increase in value of the inventory and PPE on a current cost basis to the historical cost values of those items. Each of these current cost figures then had to be restated into 1980 dollars for presentation in the schedule.

C.) Other information. SFAS No. 33 requires disclosure of several additional items. The cash dividends per common share were based on the dividends disclosed in Dawson Stores, rolled forward to 1980 dollars. Because Hudson Stores, Inc. was a SCH company, there was assumed to be no public market. However, since SFAS No. 33 requires disclosure of market prices in constant dollars, the item was listed in the schedule and described as unavailable rather than omitted. The average CPI-U used in the constant dollar calculations was also a required disclosure. Lastly, as mentioned above, the current year's current cost for inventory and PPE was included at the bottom of the schedule. The introductory material preceding the schedule in the note (or supplement in the Little GAAP case) was a compilation of narratives provided in examples of actual financial statement disclosures included in various studies of the implementation of SFAS No. 33.

Obviously there were many assumptions and estimates required in the development of the inflation data for this study. Efforts to be reasonable and realistic were made in every step. However, it must be remembered that the accuracy of the data was not a major concern. The issue was whether or not inflation information was useful for the decision processes of commercial bank loan officers, not whether accurate inflation information could be developed.

Pretesting and Evaluation of Cases

The cases were reviewed by several accounting researchers which have been working in the area of lending decisions, including one possessing personal experience as a loan officer. The Little GAAP version of the case was pretested on a banker from one of the banks providing subjects for the study. This allowed a trial run of the data collection process, as well as screening of the believability of the Little GAAP statements.

Data Collection

Four commercial bank loan officers from two Ohio banks participated in the study. There were two male and two female subjects. The original contacts were made with a member of top management at each bank, who then selected the subjects from the set of loan officers at his bank having experience processing credit requests similar to the one in the Hudson Stores cases. An appointment was set up with each of the subjects, and they were informed that they should set aside approximately an hour and a half for the project. At one bank the meetings were held in the bankers' offices, and in the other bank, they occurred in conference rooms used for loan meetings. The data were collected at the officers' places of business in order to enhance the realism of the situation. All data collection sessions occurred within one week.

The subjects were instructed to use their normal procedures in the evaluation of the credit request, just as if it had actually occurred in their organization. The subjects were also asked to verbalize their thoughts during the decision process. The subjects were allowed to ask questions after reading the instructions but prior to looking at the case. A typical question was "what do you want me to do?" and the standard reply was "whatever you normally do when making a credit decision like the one you will be reading." At that point the subjects were also reminded that it was very important for them to verbalize during the process. The sessions were tape recorded and an observer was present in each to make notes about the subjects' nonverbal behaviors. The observer was also responsible for providing any supplements necessary for the bankers to continue processing and/or come to a decision. In general, supplements were presented when a subject stated a tentative conclusion but added that certain information was necessary before a final decision could be reached.

CHAPTER 5

DATA ANALYSIS

A detailed record of all behaviors (both verbal and nonverbal), called a protocol, was prepared from the tape recording and observer notes for each subject. To prepare the protocols for analysis, they were broken down into phrases as described by Newell and Simon (1972). Each phrase was coded with a letter and a number: the letter referred to the loan officer (W, X, Y, or Z) and the number referred to the order of the phrase in the protocol. The phrased protocols are reproduced in Appendix H. Subjects W and X received the Big GAAP version of Hudson Stores and subjects Y and Z analyzed the Little GAAP case.

The two bases for analysis used by Stephens, Shank, and Bhaskar (1980), analysis of components and analysis of processes, were used to analyze the phrased protocols. The categories used for the component analysis included the twenty two used by Stephens, et al. (see Tables 6 and 7 in Appendix D). They did not mention in their discussion that a twenty third category entitled "understands requirements" was used in the analysis of components for classifying the early behaviors of the subjects as they were becoming familiar with the case situation as described in pages 1 and

2. The category was also used in the analysis of components in this study. Four new categories were added, one for each of the topics being studied for the "Big GAAP--Little GAAP" question.

In addition, a special category, "closely held", was established so that references to the closely held, family owned nature of the case firm could be explicitly recognized in the analysis. It is likely that the information about the closely held nature of the company served more of an "attention directing" function, as described by Stephens (1980), rather than being processed as a component in coming to the actual decision. That is, the information evaluation and decision making processes may have been determined, at least partially, by the fact that the company was family owned/closely held. For instance, the subjects mentioned the desirability, if not necessity, of obtaining personal guarantees from the principals of the company. That might not be as important or even considered in other line of credit situations. Loan Officer Y specifically mentioned that with a <u>closely held company</u> it would be unusual not to have the personal guarantees (see phrase Y501). Loan Officer X looked at the payout ratio specifically because of a concern that all of the earnings might be paid out to the family members (see phrases X151-4). The implication was that the closely held nature of the firm invoked a decision process or at least a subroutine which included investigating the dividend payout ratio. This is in contrast to the idea that "closely held" is just another variable, like "payout ratio" that is always evaluated for line of credit decisions. Because the usefulness of accounting information was the issue in this study, and the "attention-directing" property of accounting information represented one way in which it could have been used, this special category was added to the analysis by components.

A category entitled "interaction with observer" was established for those phrases where there was an exchange between the subject and observer not related to the contents of the case. For example, Loan Officer X asked for permission to write on the case materials (see phrase X114). Finally, there were the categories "other" and "unclassifiable". The "other" category was used for various behaviors ranging from reading page 1 (that qualified as "understands requirements" only at the beginning of the session) to making informal comments about bank procedures. The "unclassifiable" category was used only where nothing else seemed appropriate, such as partial sentences which could not be interpreted. A total of thirty one potential categories were available for the analysis by components.

The graphs resulting from the analysis of components for each subject are contained in Appendix I. The vertical axis lists the components processed by the subject in the order in which they were first evaluated. The horizontal axis measures time in terms of the numbered phrases of the protocol. The solid black line, therefore, reveals the order of processing of the components over time.

Beyond the new categories, there is another difference in these graphs from those of Stephens, et al. A section has been added to the bottom of each graph to provide information about the subjects' behavior when a phrase could not be classified into one of the components being used. This typically occurred when the subject was reading a page which contained items which could be classified into more than one category, and there was no additional evidence to determine which component was appropriate. Although there appeared to be significantly more such instances of this occurring in this study as compared to the Stephens, et al. study, many of them resulted from the fact that a more rigorous requirement for classifying the components was used here.

The convention adopted by Stephens, et al. was that a phrase describing reading behavior was classified as being the same component as the next verbalization. For instance, if the subject was reading the balance sheet and then made a comment about the capital assets, both phrases would be coded as "property, plant, and equipment". However, there would be many other components on the balance sheet which the subject could have been reading about without verbalizing. Therefore, the appropriate classification of the phrase would be ambiguous and in this study it would have been listed as "unclassifiable". Knowledge that the subject was processing something on the balance sheet, although general, would be more useful than no information so the new section was added to provide that general information.

These items are measured on the same time line (phrases), but are in a separate section and connected to the main graph by dotted lines so as not to confuse them with the main components of interest or affect the interpretation. Note that phrases describing reading behavior were classified into the components if the interpretation was straightforward. For example, reading page ten in the Big GAAP case qualified as the inflation component since no information relating to other components appeared on that page. Also, reading which occurred between two verbalizations about the same component qualified as the component.

The analysis of processes used the same twelve categories as Stephens, et al. with no additions except for "interaction with observer" and "unclassifiable" which served the same purposes as in the analysis of components. However, there was some ambiguity about how certain phrases should be categorized due to the brevity of their definitions. For instance, did a comparison between two numbers, such as "the amount in 1980 was higher than the amount in 1979" qualify as a calculation? Or was it necessary for the subject to determine a specific numerical difference before a phrase qualified as a calculation? In order to minimize the variability in the handling of phrases between protocols, and to maximize the reproducability of the results, more explicit lists of the behaviors which were classified in some of the categories were made. These lists and related comments are contained in Appendix J. The graphs resulting from the analysis of processes are contained in Appendix K.

Results

General

Descriptive information. All of the loan officers decided to approve the request for the line of credit (see

W212, X257, Y718, Z100), but all four were reluctant to approve it on an unsecured basis (see W213, X258-9, Y499, Z101-2). At the minimum, the subjects were going to investigate the background of and/or ask for personal guarantees from the principals of the company (see W216-9, X303-5, Y438-9, Z101-2). Subjects W, Y, and Z discussed the possibility of arranging the line of credit on a secured basis (see W214-5, Y686-90, Z111-3). As mentioned earlier, some of the hesitancy was directly attributable to the closely held, family owned nature of Hudson Stores.

Table 11 in Appendix L contains summary descriptive statistics related to the protocols. The subjects could be divided into two groups based on the amount of time required to reach a decision. Subjects W and Z required relatively little time (35 and 14 minutes respectively), while subjects X and Y both took more than an hour (64 and 77 minutes respectively). However, a determination of the rate of verbalization during the decision process (phrases of verbal behavior/minutes) indicated the Subject X verbalized at less than half the rate of any of the other subjects, even though the time required to come to a decision was the next to longest. Table 12 in Appendix L shows that Subject X also exhibited a much larger proportion of nonverbal behaviors than the other subjects: 44% as opposed to 18.5, 25, and 14.5%

The difference in time taken to reach a decision was partially explained by the fact that Loan Officers X and Y performed considerably more calculations than their fellow subjects. Subject X performed five types of calculations on the balance sheet information: current ratio, debt to worth ratio, accounts receivable turnover, inventory turnover, and working capital. Six calculations were also performed to investigate the income statement relationships. The gross margin, operating expenses, earnings before taxes, and net earnings were all converted to a percentage of revenue basis, and the payout ratio and sales growth percentages were calculated. All of these calculations were performed for each of the last three years of information. Subject Y computed the same items for the balance sheet plus the quick ratio, accounts receivable as a percentage of total assets, and sales to net worth ratios. The only calculations using the income statement data were gross profit, earnings before taxes, and net earnings all converted to a percentage of revenue basis. Several of the calculations were performed for all four years.

In contrast, subject W calculated a couple of ratios mentally for the most recent year's data (see W74-5, W84), and subject Z made no calculations at all although mention was made of "pretty good" accounts receivable and inventory coverage (Z83-4). The calculation of ratios and inspection of ratio trends are two behaviors that, according to the literature, are generally expected of bankers when reviewing credit requests, particularly in new loan situations. The behavior of these two subjects was, therefore, surprising, particularly subject Z.

It seemed likely that the subject was not treating the case request as if it were a real credit request or at least that significant portions of the decision process had not been verbalized. However, post experimental discussion and comparative analyses of the protocols indicated otherwise. After completing the experiment, Subject Z was quite concerned about whether the correct decision had been made--whether other subjects had come to a different conclusion or done anything differently. The observer stated that each had approved the credit request and that many of the same information items had been evaluated by all of the subjects. Subject Z then asked directly whether other subjects had done anything differently, and it was mentioned that some of the subjects had calculated some ratios before coming to a decision. The reaction to that information was, in effect, "yeah, well, I didn't have to do that, I could tell just by looking at it that it was a pretty good company." This comment implied that subject Z simply did not feel that calculating ratios was necessary for a decision.

Comparing the data in Table 12 (see Appendix L) for Subject Z with that of the other subjects revealed a comparable proportion of verbal to nonverbal behaviors. In addition, Subject Z had the highest rate of verbalization of any of the subjects, which implied that there was not much reason to believe that Subject Z had failed to verbalize more than anyone else.

Comparison with other research. Because of the way the graphs of the analyses of components are constructed, there should be a flow from the upper left to the lower right corners. If the components were analyzed in a sequential manner, as implied by the conclusion of linear processing reached by many of the Brunswick lens researchers, there would be exhaustive processing of one component prior to moving to the evaluation of the next component. This would be reflected in the graph by the solid line moving only to the right and downward. Movements upward in the graph, indicating the reevaluation of a component which has already been processed are violations of sequential processing. An examination of the graphs resulting from the protocols collected in this study revealed a recycling among the components in every case. This was consistent with the results of Stephens, et al. Likewise, there was no evidence in these protocols that tradeoffs between components were made by the subjects. Thus, the Stephens, et al. conclusion that compensatory processing does not occur in bankers' short term line of credit decisions has been supported.

The general lending decision process has been hypothesized to contain three steps (Cooper, et al., 1979):

1. determination of the adequacy of information
2. quick overview of many components
3. detailed analysis of some components

The overview process may be interpreted as a search for "attention directing" information, along the lines of Stephens (1980). The results of the analysis of the components in the protocols gathered in this study were generally consistent with this hypothesized process. The very first comment made by Subject Y was that it was good that Mr. Hudson had provided data covering several years.

The graphs reveal that several topics were typically covered in a relatively short time near the beginning of the protocols. In later phases, longer lines (larger groups of phrases) were associated with the components. This is somewhat difficult to see with the protocol of Loan Officer X because of the low rate of verbalization, especially early in the decision process. The observer had to remind the subject of the importance of verbalizing twice during this period. However, the new graphing method adopted for this study provided indirect evidence that the same processing strategy was being used because the subject moved rather quickly through the pages of the case. It is unlikely that the same component was being processed on all the pages. The graph for Loan Officer Z provided the least support for the hypothesized process, primarily because the entire process was so abbreviated that there was little evidence of the detailed analysis of any of the components.

Other. Three of the subjects made errors during their processing of the case information. Subject W made an error related to the lease information, and both Subjects W and X made errors related to the inflation adjusted information. These will be discussed in the section where the specific results related to the "Big GAAP--Little GAAP" question are reviewed. Loan Officer Z made two mistakes during the decision process. The first occurred in phrases Z104-8 where the amount of the loan was remembered as $35,000 instead of $100,000 during the decision review process. However, the subject looked back at the case material and corrected the error. Another error which was never corrected occurred in phrase Z133 where the average Hudson Stores' deposit was recalled as $70,000 rather than $35,000.

Finally, it was interesting to notice that Subject W had some trouble with the audit report. Since the Big GAAP case was being evaluated, the standard form for an unqualified opinion was included. It is possible that the loan officer had never really read an unqualified audit report closely, but instead relied on the more general cues of audit firm and number of paragraphs. The name of the audit firm used in the cases was fictitious and that may have caused the subject to be suspicious. Another possibility was that the mere fact that the decision situation was part of an experiment made the subject slightly skeptical of everything.

Specific Findings on the Big GAAP--Little GAAP Question

Earnings per share. Neither of the subjects who received the Little GAAP case requested the earnings per share information. The term was never mentioned. Since the case did not contain information about the number of shares of stock outstanding, there was no possibility that they calculated and evaluated EPS data without verbalizing it. Subject X did not make any references to the EPS information provided in the Big GAAP case. Subject W mentioned EPS in phrases 95 through 97. An examination of the graph resulting from the analysis of the processes in W's protocol in Appendix J reveals that these phrases were analyzed as falling into the "paraphrase" category. At this point, subject W was summarizing the content of what was being read, not necessarily using the EPS information for the decision. Many topics were mentioned by the subjects on their initial reading of some information that were never explicitly used or even referred to again. That was true in the case of subject W. One logical opportunity for additional comments on the EPS data was during the processing of the inflation adjusted information. The schedule included in the footnotes of the Hudson Stores Big GAAP case contained per share values on both a constant dollar and a current cost basis, both of which were significantly different from those reported in the basic financial statements. No mention of the EPS data in this schedule was made. However, this could have been due to the subject's unfamiliarity with the inflation data in general.

In spite of the fact that it was never mentioned except in one paraphrasing, it is possible that the EPS data was used to formulate the judgment that Hudson Stores was a satisfactory credit risk. In the phrases classified as the "summary" component, subject W makes a general comment that the financial statements indicate that the company is being conservatively run (see phrase W187). Perhaps the EPS information contributed to this decision, but how it would have done so is not readily apparent. Being a conservatively run company does not necessarily imply large EPS, nor vice versa. In summary, there is little or no evidence contained in the protocols that EPS data is useful to loan officers for making short term line of credit decisions for small and/or closely held companies.

Deferred income taxes. The only subject who mentioned deferred taxes in any way was subject X (see phrases X51, X97-8). In the first instance, deferred taxes were mentioned as belonging in a "no man's land", and they were specifically excluded from the debt value used in the calculation of the debt to worth ratio. In the later phrases, debt to worth ratios were again being calculated (for different years), and the subject mentioned that the deferrals had been "left in because I just want a trend." The implication of these apparently contradictory behaviors seems to be that the subject did not want the deferred tax numbers included in the ratios, but that they were not significant enough to affect the resulting information even if they were. This attitude seemed to stem from something other than just the materiality of the items.

During the preparation of the case material, it was anticipated that a complete lack of information about deferred taxes might be interpreted by the subjects in one of the following ways:

1. There were no timing differences.

2. Deferred taxes had been calculated, but were immaterial and therefore, not listed separately.

If either of these had occurred, it would have been impossible to draw conclusions about the usefulness of the deferred tax information. Alternative one was already taken care of in the depreciaton footnote by the information that different depreciation methods were used for financial statements and taxes. To prevent the occurrence of item two, a statement was added to the depreciation footnote to the effect that deferred taxes had not been calculated.

Interestingly, the pretest subject did comment on the absence of deferred tax information. Nothing was said as the statements themselves were being evaluated, but the line in the depreciation footnote just mentioned caught his attention. He commented that he did not know that omitting the calculation of deferred taxes was acceptable under GAAP. He then returned to the audit opinion, which he had originally accepted as straightforward and "clean", and noticed the phrase "GAAP for smaller and/or closely held businesses." His comment at that point was that he did not realize that there were differential standards. But, even though he noticed the absence of the deferred tax information and this led him to question the reputability of the auditors preparing the statements, he continued his decision making process without ever mentioning a need for or requesting the deferred tax information. In summary, the results of this experiment support the contention that deferred tax information is not very useful to bankers, if at all, in this decision context. It is important to note, however, that in post experimental discussion the pretest subject stated that although he did not request the information in this case, he thought it would possibly be useful in a term loan context. This underscores the need for empirical investigation in all contexts before changes in accounting requirements are implemented.

Leases. Of the two Big GAAP subjects, X spent more time reading the capitalized lease information (see phrases X194-202), but no mention was ever made of its use in or impact on the loan decision. The lease information was examined when it was encountered in the footnotes, but was never sought out or referred to at any other point in the decision process.

Subject W first mentioned the leasing information during the examination of the comparative statements of changes in financial position (see phrase W132) in the context of capital asset acquisition. The subject next mentioned the leases when the footnote information was encountered and read (see phrases W152-5). Apparently the information was misinterpreted as representing transactions for which Hudson Stores was the lessor instead of the lessee (see phrase W155). This may have resulted from an item on the Comparative Statements of Changes in Financial Position entitled "mortgages assumed by purchasers of office properties" about which additional information had been requested earlier (see phrases W108-15).

During a later summary period this loan officer had some questions about the capital acquisitions of Hudson Stores and was presented with the supplement on store locations which revealed that there were seven stores, all of which have been frequently modernized and one of which recently changed locations. Subject W hypothesized that this additional information could explain the increases in capital expenditures and capital leases (see phrases W227-31). Therefore, while both Big GAAP subjects read the capitalized lease information, Subject W apparently made more use of it in the evaluation of the capital acquisitions and ultimately the creditworthiness of Hudson Stores.

Of the two Little GAAP subjects there was an even sharper contrast in behavior related to the lease information. Subject Y made one reference to the leasing information in the context of stating a desire for additional information about future capital acquisitions (see phrases Y546-9). At that point, the subject evidently remembered having seen something about leases while reading another footnote. An investigation of the behavior relating to the footnotes (page seven) as revealed in earlier phrases (see phrases Y390-428) did not indicate that the leasing information had been processed at length. Apparently the subject noticed at least the topic of the last footnote, or perhaps read it, without any verbal or nonverbal behavior indicating it. Similar to Subject W, Subject Y mentioned the lease information only in relation to the company's capital acquisition behavior. It was not evaluated at length and did not affect any of the calculations made, such as the debt to equity ratio.

In contrast, Subject Z required the supplement containing the capitalized lease information very early in the decision process (see phrases Z28-47). The need for the information was very strong. Two other items of information had been mentioned as desirable prior to that point (projected borrowing requirements and availability of personal guarantees of the principal) and then processing continued. In this case, processing ceased when the need for information about the type of leases was requested, and the subject was insistent that the information be provided before processing could resume. Once received, no explicit comments about the impact of the capitalization information were made. However, the comments made when the information was requested indicated that the subject felt it would have an impact on the evaluation of the company. It is obvious that this subject considered the information useful for the decision.

Inflation adjusted information. Neither of the Little GAAP subjects mentioned or requested information about the impact of inflation on Hudson Stores. This could not be attributed solely to ignorance about the availability of such information since neither of them performed any calculations which might assess the impact. Both subjects who received the inflation adjusted information in the Big GAAP case spent considerable time processing it (see phrases W156-81, X203-31). Both expressed unfamiliarity with the data (see phrases W178 and X217). In fact, Subject W misinterpreted the information to be comparative industry information. When the observer stated that it was all information about Hudson Stores (in response to a question from the subject), the subject then looked more carefully and realized that it was adjusted for changing prices. At that point, page nine, which contained information about the development of the inflation data, was read more closely. It originally had been read for only five seconds. Twice the subject stated that an effort was being made to process the information and determine what impact inflation was having (see phrases W174-5, W179-80), but there was never a comment that the determination had been made. In fact on two occasions later in the protocol (see phrases W196 and W246) the subject stated a need to find out from the Hudson Stores management what impact inflation had had on the company. That indicated that the subject had not been successful in evaluating the inflation adjusted information. Another indication of unfamiliarity with the accounting requirements was that an error occurred in phrase W172 when SFAS No. 33 was referred to as No. 13.

Subject X also had trouble determining the meaning and impact of the inflation data. This subject made an error in the processing of the information which was never corrected. A question was asked about whether "current cost" meant historical cost adjusted by an inflation index (see phrases X218-220). The observer did not answer. And although the footnote was reread closely (the subject even verbalized in phrase X222 that current cost meant replacement cost), the information was nevertheless interpreted to represent constant dollar information (see phrases X227-230). This is evident from the fact that while commenting on the difference between the historical cost information and the "constant dollar" information, marks were being made by the current cost data at the bottom of page 10. This subject referred to inflation information one final time in a summary where growth in income was evaluated as minimal (see phrases X252-253).

In summary, neither of the subjects who did not receive inflation adjusted information expressed any need or desire for it. Neither of the subjects who did receive the information seemed to know how to use it, but they both made an effort to process it. The lack of desire for the information on the part of the Little GAAP subjects might be interpreted as support for differential accounting requirements in this area. However, the results from the Big GAAP case indicated that the usefulness of inflation adjusted information might better be evaluated after financial statement users have become more familiar with it.

CHAPTER 6

SUMMARY AND CONCLUSIONS

The research project described in this document was undertaken to accumulate empirical data about the decision processes of one group of users of financial statements: commercial bank loan officers. The particular decision of interest was the granting of an unsecured, short term line of credit. The data gathered was used to evaluate the impact of implementing separate accounting standards for smaller and/or closely held businesses in four areas: earnings per share, deferred taxes, leases, and inflation adjusted information.

The empirical evidence gathered in this study indicated that EPS information is not useful to commercial bank loan officers making short term line of credit decisions for SCH companies. Not only did the Little GAAP subjects not request any information about EPS, but the subjects who received the information initially did not use it for making a decision. One Big GAAP subject mentioned the most current EPS figure, but there was no evidence that the information played a role in the ensuing decision. As far as deferred tax information was concerned, again there was no evidence that any of the subjects felt that the information was necessary or useful in this decision context. The subjects who did not receive it did not request it, and those who received it did not use it. However, even though he did not request it, the pretest subject at least noticed the deferred tax information was missing when he evaluated the Little GAAP version of Hudson Stores.

The evidence from this study indicated that capitalized lease information is useful to bankers making line of credit decisions for SCH businesses. While one Little GAAP subject did not request capitalization information, the other required it in order to come to a decision. The need for the information was apparently very strong since oftentimes the subjects identified information they would like to obtain and yet continued processing without it and came to a decision. However, in Subject Z's case, processing halted until the capitalization information was obtained, indicating that the information was very useful to the decision. Also indicating its usefulness were the behaviors of the Big GAAP subjects. Although a specific description of the impact of the lease capitalization on the credit decision was not verbalized, both of them evaluated the information at length.

Again for the last area under investigation, inflation adjusted information, there was little evidence to suggest that this type of information is useful to loan officers making short term line of credit decisions for SCH companies. The subjects who did not receive it did not request or mention it. Those who received it did not recognize it, misinterpreted it, and in general did not seem to know how to use it. However, they made an effort to use it, and if it had been better understood it might have been useful for the decision. Therefore, it seemed inappropriate to judge the usefulness of inflation adjusted information at this time. Once the users have become more familiar with this type of information, a valid conclusion may be reached.

Because bankers are the primary external users of the financial statements of SCH companies, the results of this study support the proponents of Little GAAP who have suggested that these businesses be exempted from the accounting and reporting requirements related to EPS and deferred taxes. These requirements apparently do not provide very useful information to the readers of the financial statements of SCH enterprises. However, the opponents of differential GAAP received support from this study in the area of lease capitalization information, which was shown to be useful. Of course, this study examined the decision processes of only one set of users of the financial statements of SCH businesses in one context. Further study should be made of other decision makers and decision contexts before changes in accounting and reporting standards are made. This study was an initial step in the empirical examination of the decision processes of the readers of financial statements of SCH enterprises.

Limitations

No attempt was made in this study to consider the costs involved in the preparation and presentation of the financial statement information. Only the benefits, in terms of usefulness, were investigated. In the case of EPS and deferred tax information, the results and implications would not be altered by the consideration of cost data since the benefits were determined to be close to zero. The capitalized lease information was found to be useful to one group of readers of the financial statements of SCH businesses, but eliminating the requirement to present it might still be advisable if the costs associated with its presentation exceed the benefits. Similarly, if inflation adjusted information is found to be useful, the benefits must still be compared with the costs of providing it. The determination of these costs and the quantification of the benefits necessary for cost/benefit analyses were beyond the scope of this study. However, an examination of both the benefits and the costs of information should be made prior to the alteration of any accounting standards.

The results of this study must be considered in light of the limitations to which all protocol analysis studies are subject. The time required by each protocol, both by the subject and the researcher, necessitated the use of only four subjects which were not randomly selected. Obviously statistical generalization from this sample is impossible. However, the advantage of using a methodology which seemed most appropriate for the study of decision processes was felt to outweigh the limitation of a small nonrandom sample. In many research projects there is a conflict between internal and external validity, and internal validity must be considered the primary goal.

Thought processes occur much more rapidly than verbalizations. Even when putting forth maximum effort, it is impossible for a subject to report all thought processes. Therefore, protocol analysis can, at best, provide only a partial trace of decision processes. But the information which is provided is not currently obtainable via other methodologies.

The description of the decision processes may be further limited by the fact that the subject does not always put forth maximum effort to report thought processes. This can result from the subject's intense concentration on making the decision. In this study, the rate of verbalization was calculated for each subject to allow a comparison of verbalization behavior. Subject X's rate of verbalization was significantly lower than those of the other subjects. This could be interpreted as evidence that the description of Subject X's behavior provided by the protocol is significantly less complete. Alternatively, Subject X may just be a slower processor of information. In that case, the graph of Subject X's processes could be just as complete, or more, than the graphs for the other subjects. More sophisticated methods for the collection of information about decision processes are needed before this issue can be resolved. Until then, researchers must continue to emphasize to their subjects the importance of verbalizing.

The protocol analysis methodology is relatively subjective compared to others where the analysis is performed via computer programs. Since different researchers can reach different conclusions when analyzing the same protocol, the validity of the results may be questioned. To minimize the subjectivity in the analysis of the protocols in this study, the same categories and definitions of categories which had been developed by other researchers were used. The categories which were added, based on the specific Big GAAP--Little GAAP topics under study, were unambiguous. Likewise, the categories added to describe behaviors which did not fall into one of the major components of interest were straightforward. The coding of the phrases was performed under more stringent requirements than in previous research to reduce the chances of misclassifying phrases. Finally, the protocols were each analyzed three times to reduce the subjectivity which can arise from inconsistent coding over time by the same researcher.

A small problem which is associated with the current analysis techniques is the measure of time by phrases on the graphs. This causes some distortion in the appearance of the results. For instance, reading a single page for 2 minutes constitutes one phrase, whereas verbalizations taking two minutes are likely to be made up of many phrases. The result is that one component appears to have been more thoroughly examined. That may or may not be true. The advantage of using phrases as the basis of measurement is that it emphasizes the "units" of processing, the individual thoughts or actions which occur. However, graphing the protocols with minutes or seconds as the basis of measurement might provide a different perspective which is useful. If so, future studies could include both alternatives.

The final and perhaps most significant limitation to the study was the fact that the bankers' decision processes may have changed as a result of the requirement to verbalize during the decision making. If so, the data collected described a modified or completely different decision process than that which was desired. Evidence to support or refute this possibility is not available. Even if the decision process was modified, the use of a protocol analysis methodology at least allowed the collection of information about _a_ decision process. This would not have been true of questionnaire or Brunswick lens research where decision processes are not investigated. Therefore, protocol analysis seemed to be a step in the right direction. Use of the protocol analysis methodology in its current form, even with the attendant limitations, allows the refinement of the analysis procedures and/or categories so that when a new, better means for collecting data about decision processes is developed, the mechanism for analyzing them will be available.

Contributions

Two major contributions were made by this research project. First, the impact and appropriateness of the implementation of separate accounting standards for smaller and/or closely held businesses were empirically investigated using the most internally valid methodology available. Only one study had previously been undertaken in this area. The decision to develop differential accounting and disclosure requirements based on company size and ownership characteristics is a critical one, with long range implications for both preparers and users of financial statements. An important decision such as this should not be based on rhetoric, opinion or emotions, but on evidence. This study was a first step in gathering the necessary evidence.

The collection of information about the decision processes of loan officers in the investigation of the Big GAAP--Little GAAP issue also contributed to the store of information about the lending decision process in particular, and financial statement users' decision processes in general. The results of this study were consistent with those of Stephens, Shank, and Bhaskar (1980). All of the subjects recycled through the components during processing. The expected behavior of linear processors of information is the complete evaluation of each component one at a time. There was no indication that any of these subjects engaged in compensatory processing. This also conflicts with the expected behavior of linear processors. In short, this study supports the conclusion of Stephens, et al., that commercial bank loan officers are nonlinear processors of financial statement information.

The second major contribution made by this research project was the development of the new graphing technique. In spite of the great internal validity of protocol analysis, it has not been embraced by accounting researchers. The single most common point of attack on the methodology is its subjectivity. The new graphing technique provides more information and more objective information in a clear and concise manner. The changes to the Stephens, Shank, and Bhaskar (1980) procedures were simple and straightforward, and yet they should result in a significant increase in the reliability of the coding of the phrases of a protocol. Reducing the subjectivity of the analysis procedures should reduce the hesitation many accounting researchers have shown toward the use of protocol analysis. Increased use of the methodology should be encouraged, allowing the rate at which knowledge of financial statement user decision processes is accumulated to increase also.

The accumulation of this knowledge is a prerequisite to the achievement of the accounting profession's ultimate goal of providing useful financial information to decision makers.

Future Research

More research should be undertaken to expand the knowledge of the decision processes of the users of the financial statements of SCH businesses before changes in accounting standards are implemented. The comments of the pretest subject in this study indicated that deferred income tax information may be useful to commercial bank loan officers when evaluating term loan requests of SCH companies. The decision processes of bankers in that and other decision contexts should be investigated. The decision processes of other users of the financial statements of SCH businesses should also be investigated.

Efforts should be made to increase the realism of the research performed. All of the subjects in this study seemed to take the experiment seriously. Nevertheless, they were aware that they were making a hypothetical decision. If possible, future studies should attempt to collect data as the bankers are making real decisions during their normal daily work.

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APPENDICES

APPENDIX A

COMMENTS ON THE "BIG GAAP--LITTLE GAAP" ISSUE

John C. Burton, Arthur Young Professor of Accounting and Finance, Columbia University:

> I have long favored "differential disclosure", which contemplates an approach whereby the magnitude of required disclosures will vary depending upon the users toward which the disclosures are aimed and the cost/benefit considerations applicable to various disclosing entities. The basic accounting measurement model, however, should be applicable to all financial statements.

William R. Gregory, Immediate Past Chairman, AICPA:

> <M>ost present day accounting standards are established in response to the accounting issues of large, publicly held companies. . . . .
> . . . .
> If we are to achieve meaningful communication with the users of financial statements of smaller, privately held business, we need to develop standards that are useful, relevant, and appropriate for them. We need to recognize that there are significant differences in the needs of users of the local entrepreneur's financial statements whose only public may be his local banker.

James J. Leisenring, Chairman, Auditing Standards Board:

> Measurement requirements of generally accepted accounting principles should be the same regardless of the size or ownership of an entity. . . . .
> . . . .
> To develop another class of GAAP would be very costly, confusing to financial statement users, and would ultimately exacerbate the division that exists between small and large firms. . . . .
> . . . .
> The failure to recognize that GAAP should apply to all entities would be a major step backward for our profession, which has struggled to enhance user understanding of financial statements and various reports on those statements.

Robert A. Mellin, Immediate Past Chairman, PCPS Executive Committee:

> Tinkering with measurement standards in the light of present day knowledge could erode respect for accounting. It would be very difficult to justify the rationale whereby the day a company reaches a certain level of assets, sales, or shareholders, the accounting for leases and taxes is to be completely changed.

Robert D. Miller, Chairman, Accounting and Review Services Committee:

> Based on perceived need for assurance, nonpublic entities choose among an audit, review or compilation report. In each type, the report's <u>objective</u> differs. Why not a similar distinction when the objective of the <u>statements</u> is to meet an identified user's needs?

Sandra A. Suran, Chairman, PCPS Technical Issues Committee:

> A totally different set of accounting principles may be the only way to make financial statements truly meaningful and useful to the smaller company. We certainly would end up with a better product than if we attempt to "cut and paste" current principles to adapt them for smaller companies. And we have a natural cutoff - SEC regulated vs. non-regulated companies. SSARS set a precedent for using that basis for differentiating the companies which would be eligible to use the new principles. There would be many questions to answer and many problems to solve, of course. But I don't think there is any easy way to resolve the current "overload" problems for smaller companies and also make their financial statements more useful. And if the AICPA and its standard setting bodies don't become more responsive to the needs of smaller companies and their CPAs, we may face a split in the profession anyway.

Source: AICPA, "The GAAP II Movement: Now or Never?", <u>PCPS Reporter</u> (October, 1980), pp. 2-3.

APPENDIX B

BRUNSWICK LENS MODEL

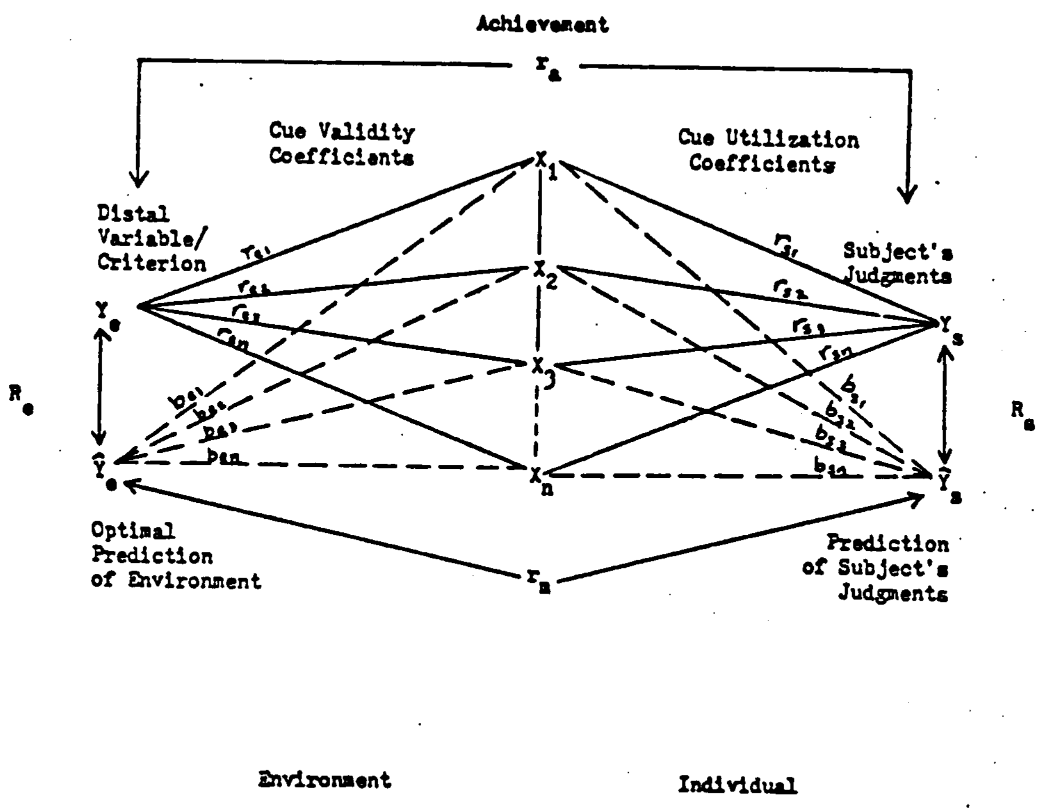

Figure 1. Brunswick lens model.

Definitions of Variables

$X(i)$	= cue in the environment available to the individual (must be measured quantitatively on at least an ordinal scale)
$Y(e)$	= criterion variable = that element of the environment which the individual wishes to estimate
$r(ei)$	= correlation between $X(i)$ and $Y(e)$ = ecological validity of cue $X(i)$
$Y(s)$	= individual's judgment of the value of the criterion variable
$r(si)$	= correlation between $X(i)$ and $Y(s)$ = utilization coefficient of cue $X(i)$ = indication of extent to which cue $X(i)$ was considered by the individual in his estimation of the criterion variable
$r(a)$	= correlation between $Y(e)$ and $Y(s)$ = individual's judgmental accuracy
$r(x(i)x(j))$	= correlation between cues $X(i)$ and $X(j)$ = redundancy in the cues
$\hat{Y}(e)$	= prediction of $Y(e)$ using available cues
$\hat{Y}(s)$	= prediction of $Y(s)$ using available cues and the individual's responses
$b(ei)$	= weight of cue $X(i)$ in predicting $\hat{Y}(e)$
$b(si)$	= weight of cue $X(i)$ in predicting $\hat{Y}(s)$, based on the amount of use judge is making of cue $X(i)$
$R(s)$	= $r(Y(s)\hat{Y}(s))$ = consistency index = how well the individual's judgment can be modeled
$R(e)$	= $r(Y(e)\hat{Y}(e))$ = environmental predictability = how well the criterion variable can be predicted with the available cues
$r(m)$	= matching index = correlation between $\hat{Y}(e)$ and $\hat{Y}(s)$

r (o) = optimality index = correlation between Y (s) and Y (e) = comparison of individual's prediction with the best possible prediction given the available cues

Source: Beach, Lee Roy, "Multiple Regression as a Model for Human Information Utilization," Organizational Behavior and Human Performance (1967), pp. 276-289.

APPENDIX C

VARIABLES USED IN BRUNSWICK LENS STUDIES

TABLE 1

INDEPENDENT VARIABLES USED BY SAVICH (1977)

Variables	Levels
1. Sales	up/down
2. Net Income	up/down
3. Extraordinary Items	income/expense
4. Provision for Income tax	up/down
5. Contingencies	up/down
6. Fully diluted EPS	up/down
7. Primary EPS	up/down
8. Changes in financial position	positive/negative

TABLE 2

INDEPENDENT VARIABLES USED BY LIBBY (1975)

1.	Net Income/Total Assets
2.	Current Assets/Total Assets
3.	Cash/Total Assets
4.	Current Assets/Current Liabilities
5.	Sales/Current Assets

TABLE 3

INDEPENDENT VARIABLES USED BY SLOVIC (1979)

Variables	Levels
1. Yield	low/high
2. Near term prospects	poor/good
3. Earnings quarterly trend	down/up
4. Past year's performance	poor/good
5. Profit margin trend	down/up
6. Earnings yearly trend	down/up
7. Price/earnings ratio	poor/good
8. Shares outstanding	few/many
9. Resistance trend	down/up
10. Support trend	down/up
11. Sales volume trend	down/up

TABLE 4

INDEPENDENT VARIABLES USED BY ASHTON (1974)

1. Are the tasks of both timekeeping and payment of employees adequately separated from the task of payroll preparation?

2. Are the tasks of both payroll preparation and payment of employees adequately separated from the task of payroll bank account reconciliation?

3. Are the names on the payroll checked periodically against the active employee file of the personnel department?

4. Are formal procedures established for changing names on the payroll, pay rates and deductions?

5. Is the payroll audited periodically by internal auditors?

6. Was the internal control over payroll found to be satisfactory during the previous audit?

TABLE 5

INDEPENDENT VARIABLES USED BY JOYCE (1976)

Variable A: Sales Approval

Level 1: All sales orders are *approved* by the credit manager before shipment.

Level 2: Sales orders are shipped upon receipt from salesmen *without approval* by the credit manager.

Variable B: Bad Debt Expense/Sales

Level 1: Unadjusted end-of-year balances show that <the company's> ratio of bad debts to sales is significantly *less* than for last year.

Level 2: Unadjusted end-of-year balances show that <the company's> ratio of bad debts to sales is significantly *greater* than for last year.

Variable C: Write-Off Approval

Level 1: Write-offs of receivables are reviewed and approved by the *controller*.

Level 2: Write-offs of receivables are reviewed and approved by the *credit manager*.

Variable D: Separation of Billing Function and Subsidiary Ledger Maintenance

Level 1: Accounts receivable subsidiary ledger is maintained by a clerk *other than* the one who prepares and mails out the monthly statements to customers.

Level 2: The clerk responsible for the accounts receivable ledger *also* prepares and mails out monthly statements to customers.

TABLE 5
(Continued)

Variable E: Sales/Average Accounts Receivable

Level 1: Unadjusted end-of-year balances show that <the company's> accounts receivable turnover is significantly <u>greater</u> than for last year.

Level 2: Unadjusted end-of-year balances show that <the company's> accounts receivable turnover is significantly <u>less</u> than for last year.

APPENDIX D

CATEGORIES USED IN PROTOCOL ANALYSIS STUDIES

TABLE 6

CATEGORIES USED BY STEPHENS (1980)

---

1. Cash management: the ability of a firm to forecast cash needs of the company.

2. Accounts receivable management: the ability of a firm's management to set credit policies and collect credit extensions.

3. Inventory management: the ability of a firm's management to control their inventory.

4. Accounts payable management: the ability of the company to properly manage within constraints set by trade creditors, i.e., to maintain credit relationships with trade creditors.

5. Working capital management: the joint management of cash, accounts receivable, inventory, and accounts payable.

6. Claims priority: prior claims in assets of a firm.

7. Equity cushion: the amount of deterioration in asset values (from book historical cost) which can be sustained and still allow payment of creditors.

8. Pricing management: the ability of a firm's management to obtain margins consistent with its operating characteristics, debt repayments, and dividend requirements.

TABLE 7

ADDITIONAL CATEGORIES USED BY STEPHENS, SHANK, AND BHASKAR (1980) FOR ANALYSIS BY COMPONENTS

---

1. Audit opinion: type of opinion on the financial statements given by the auditor.

2. Auditor: the audit firm.

3. Bank sales: discussion of possible new non-loan relationships of the bank and the customer.

4. Customer relationships: the existing non-loan relationships of the bank and the company (e.g., deposit relationship).

5. Growth: change in size of company in the past and plans for future.

6. Income taxes and deferred income as installment sales: information processing concerning these accounts.

7. Investment: information processing related to this account.

8. Loan conditions: verbalization concerned with types of notes, interest rates, conditions for use, etc., after decision to approve the loan.

9. Property, plant, and equipment: past changes in and future expenditures for this particular group of accounts.

10. Security: speculation as to possibility of exiting from the unsecured evaluation and collateralizing the loan, either for the request or in the future.

11. Segmenting: profitability of portions of a business enterprise.

12. Summary: verbalization of status of information processing.

TABLE 7
(Continued)

13.	<u>Withdrawals</u>: amount and form of cash distributions to owners.
14.	<u>Year end</u>: the date of the end of the fiscal year.

TABLE 8

CATEGORIES USED BY STEPHENS, SHANK AND BHASKAR (1980) FOR ANALYSIS BY PROCESSES

1. Read: This is the basic reading process. Calls to this process take a wide range of times. That is to say, it is sometimes used to read a whole page and sometimes to read a line only.

2. Paraphrase: This process paraphrases the input from the read process.

3. Query: Processing generates a question.

4. E(Query): This is an elaboration of query, specifying more about the reason for the query.

5. Estimate: A statement where assumptions are made.

6. E(Estimate): An elaboration of an assumption.

7. Informal comment: A comment not relating to the specific task environment.

8. Intention: Subject states plan for processing.

9. Calculation: Manipulation of quantitative data.

10. Design: Subject's suggestions for changes in the company's operations.

11. Flag: Initiation of changes in processing.

12. Decision review: A process where a decision is made and reviewed.

APPENDIX E

STEPHENS' MODEL OF THE BANK LENDING DECISION PROCESS

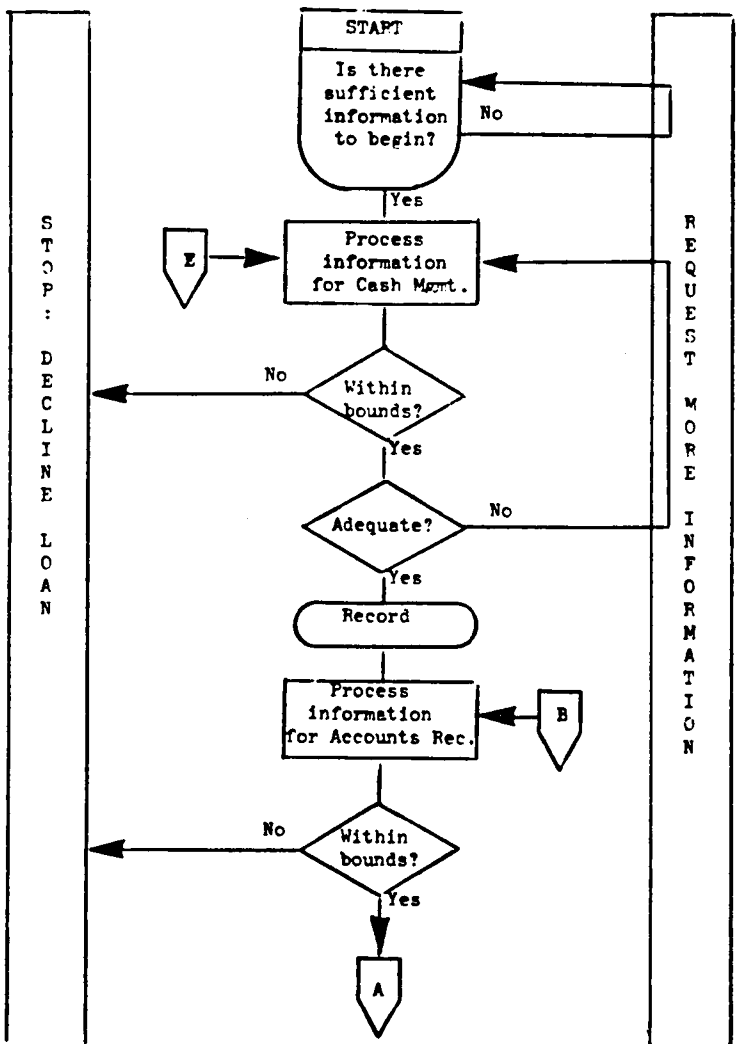

Figure 2. Stephens' representation of the decision processes of commercial bank loan officers.

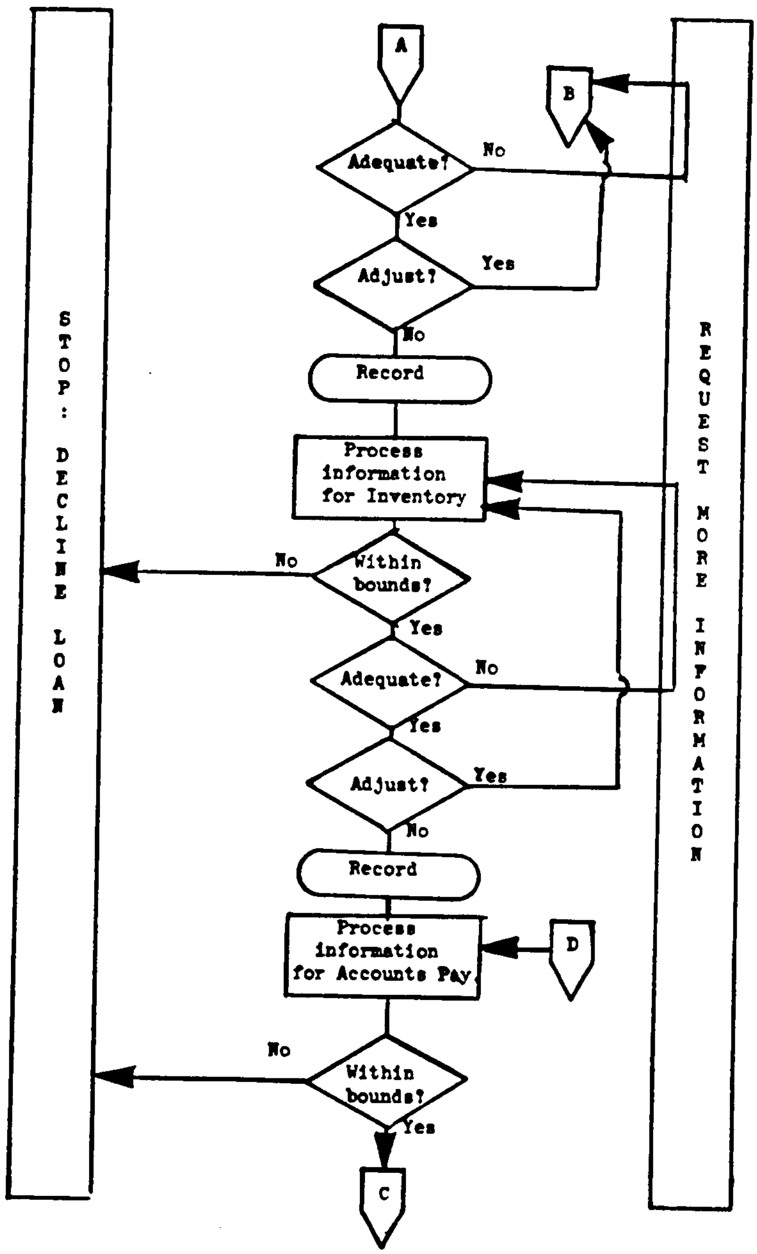

Figure 2. (Continued)

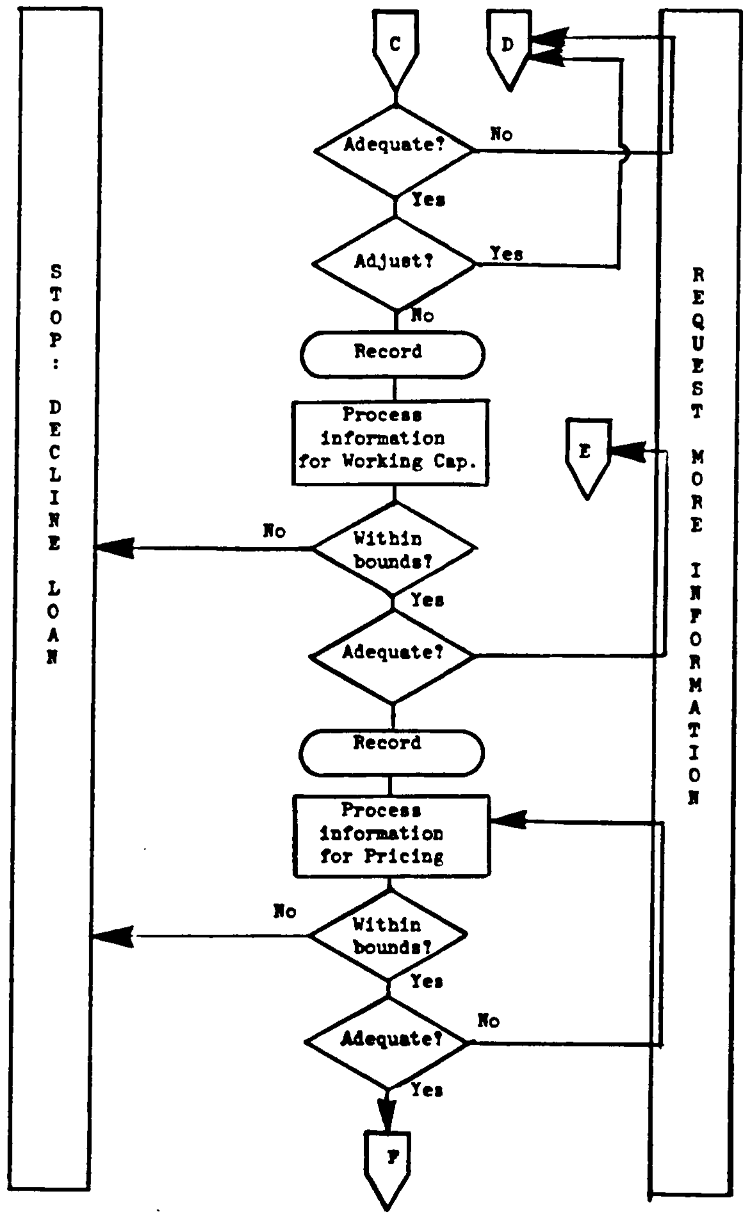

Figure 2. (Continued)

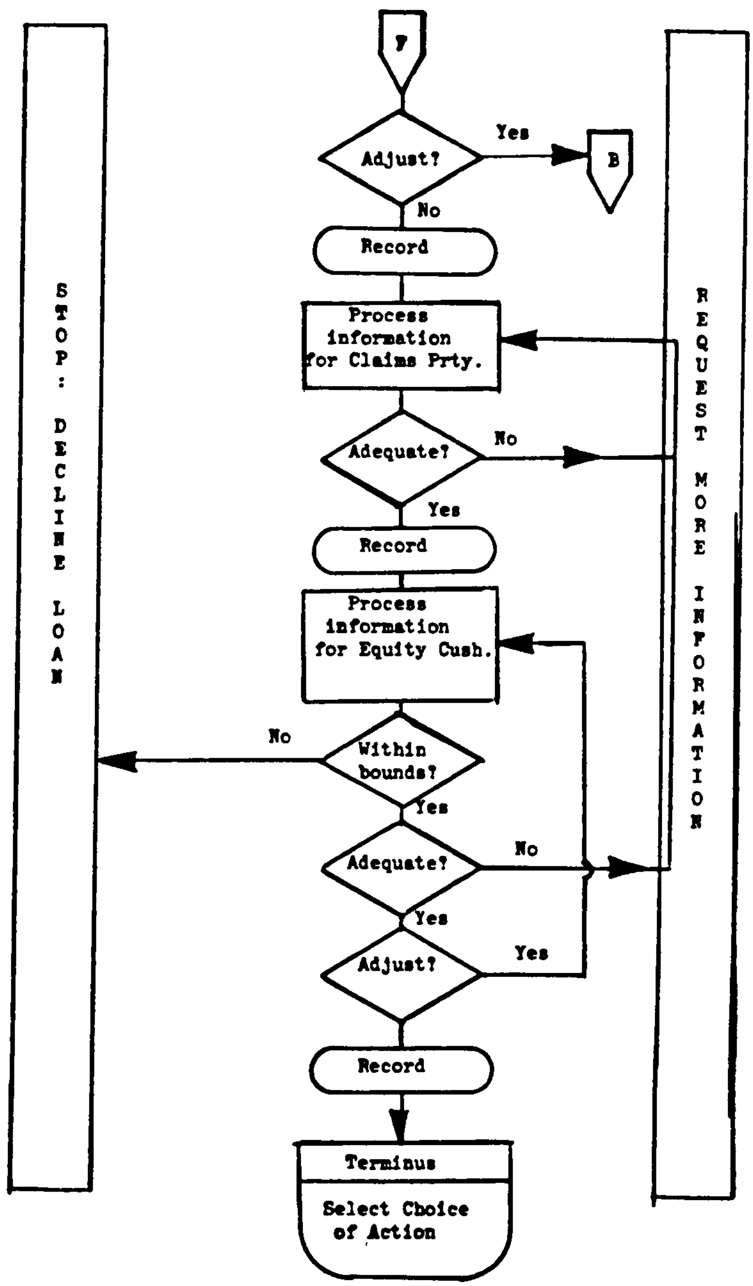

Figure 2. (Continued)

Source: Stephens, Ray G., Uses of Financial Information in Bank Lending Decisions (Ann Arbor: UMI Research Press, 1980), pp. 114-117.

APPENDIX F

DEVELOPMENT OF CASE MATERIAL

TABLE 9

SUMMARY OF DIFFERENCES BETWEEN DAWSON STORES AND HUDSON STORES CASE MATERIAL

Item	Big GAAP version	Little GAAP version
1. Earnings per share	same*	deleted
2. Deferred income taxes	same	deleted
3. Leases	capitalized	same
4. Inflation adjusted information	added to notes	same
5. Introductory information	same	modified audit opinion
6. Dawson Stores supplements	same	same

* 'same' means treated and presented in the same manner as in Dawson Stores, Inc.

TABLE 10

SUMMARY OF CHANGES TO DAWSON STORES CASE MATERIAL REQUIRED BY THE CAPITALIZATION OF LEASES FOR THE HUDSON STORES' BIG GAAP CASE

1. Hudson's Big GAAP Net Earnings = 99% of Dawson's Net Earnings

2. Hudson's Operating Expenses = Dawson's Operating Expenses + 1% of Dawson's Net Earnings

3. Hudson's Earnings Before Income Taxes = Dawson's Earnings Before Income Taxes - 1% of Dawson's Net Earnings

4. Hudson's Retained Earnings = Dawson's Retained Earnings + Cumulative Effect of 1% Changes in Net Earnings

5. Earnings per share figures were recalculated using the modified net earnings data.

APPENDIX G

EXPERIMENTAL MATERIALS

HUDSON STORES, INC. BIG GAAP CASE

Instructions

Attached you will find a bank lending situation which requires a decision. Please treat this situation, described in the attached pages, as if it occurred in your organization and required your decision. Further, please follow the normal practices and procedures you would use in making a decision of this type. During the time you are considering the lending situation in this research you should be aware that a recent memorandum from your chief loan officer stated:

> All loan officers are urged to be aware of possible loan customers in their various daily contacts. The declining cost of lendable funds and availability of credit due to present economic and credit conditions makes it imperative that we actively seek good bank customers.

During the time you are considering this lending situation, and following your regular practices and procedures, you are asked to verbalize your thoughts and other considerations that occur to you. Please do this, no matter how trivial the thoughts may seem. Verbalizing this thought process is critical to this research. The verbal comments you make will be tape recorded; your comments will be held in confidence and in no way attributed to you without your prior permission. There will be an observer present during your decision period to make additional observations.

I wish to emphasize that I am interested in the process by which loan decisions are made, and any implications regarding the feasibility of some proposed changes in accounting requirements, rather than the particular decision itself. Please note that, as in an actual lending situation, there is no correct answer.

If you desire any clarification of the instructions, please ask the observer prior to turning the page and beginning consideration of the lending situation.

Thank you.

A-1

HUDSON STORES, INC.

John Hudson, Jr., President of Hudson Stores, Inc., approached you at your desk. Both John and Hudson Stores, Inc. are deposit customers of your bank and have been for several years. His comments had been directly to the point:

> It appears that we are going to have some short term working capital needs during the next year at Hudson Stores, Inc. Therefore, I would like to obtain a $100,000 line of credit, on an unsecured basis, to cover these short term needs. Could you set up the line of credit for a year to be reviewed when next year's statements are available?
>
> I know from my friends that you need information about the company in order to grant this request, so I have brought a copy of the company's statements for the last four years for you. Could you let me know about the line of credit in a few days? We are having a board meeting in two weeks and I would like to get the appropriate paperwork for you at that time. Sorry to run off, but I have an appointment in twenty minutes with a customer at the store.

In reviewing the reports of previous contacts by bank personnel with Hudson Stores, Inc., you find the following information:

> Hudson Stores, Inc. was incorporated in 1881. The stock has been widely dispersed upon the death of John Hudson, Sr., who had divided his shares among his five children and fourteen grandchildren.
>
> Hudson Stores, Inc., had maintained their deposit accounts with you for many years, even during the years John Hudson, Sr. had managed the company. The accounts had varied over the past few years. Average balances of the accounts totalled $35,000 for the past year. The Company had occasionally purchased certificates of deposit for short periods.
>
> Hudson Stores, Inc. had not utilized bank credit in the last ten years. A recent Dun & Bradstreet report requested by a business development officer reported all trade accounts satisfactory and contained only satisfactory information. The D&B report showed the officers were John as President and his brother Bill as Vice President and Treasurer. The directors were the officers, their two sisters and two cousins, the latter four residing in other states. Credit terms included both revolving (30 day) accounts and installment sales.
>
> The call report from the business development officer reported the premises orderly and well located for this chain of small retail softgoods and hardgoods stores (based upon a visit of 3 of 7 locations), all located in your trade area. The president was happy with his recent bank services, but in the opinion of the business development officer there was little possibility for further business. The meeting was shortened due to the arrival of a customer.

The financial statements left with you by John Hudson are attached. (Please note that the format of these statements is for the purpose of reducing the size of the research packet only.) Each year's financial statement contained the following auditor's opinion.

To the Board of Directors and Stockholders
Hudson Stores, Inc.

We have examined the statement of financial position of Hudson Stores, Inc. as of January 31, 19__ and the related statements of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned financial statements present fairly the financial position of Hudson Stores, Inc. at January 31, 19__, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

/S/Chambers and Sterling
Certified Public Accountants

HUDSON STORES, INC.
COMPARATIVE STATEMENTS OF FINANCIAL POSITION

	1977	1978	1979	1980
Assets				
Currents Assets:				
Cash	$ 8,212	$ 10,808	$ 54,526	$ 70,496
Accounts Receivable (Net)	220,154	231,315	259,878	289,774
Inventories	200,026	183,309	217,029	237,722
Supplies and Prepaid Expenses	5,420	7,698	7,033	5,773
Total Current Assets	$433,812	$433,130	$ 538,466	$ 603,765
Investments & Other Assets	22,103	24,453	12,436	15,496
Property, Plant & Equipment (Net)	378,234	398,888	414,236	439,015
Leased Property Under Capital Leases (Net)	31,882	36,561	35,235	34,276
Total Assets	$866,031	$893,032	$1,000,373	$1,092,552
Equities				
Current Liabilities:				
Accounts Payable	$ 88,711	$ 89,666	$ 135,922	$ 174,807
Taxes Other Than Income Taxes	29,148	29,949	31,883	32,138
Accrued Liabilities	31,560	34,930	52,010	60,944
Income Taxes Currently Payable	17,033	17,606	37,778	36,961
Deferred Income Taxes, Installment Sales	28,785	30,882	37,203	45,298
Current Portion of Long Term Debt & Capital Lease Obligations	12,117	14,810	17,736	14,719
Total Current Liabilities	$207,354	$217,843	$ 312,532	$ 364,867
Long Term Debt	268,771	263,822	241,211	226,329
Deferred Credits (taxes)	20,470	22,486	18,776	23,268
Capital Lease Obligations	29,162	33,295	32,496	32,072
Shareholder's Equity:				
Capital Stock	10,000	10,000	10,000	10,000
Retained Earnings	330,274	345,586	385,358	436,016
Total Equities	$866,031	$893,032	$1,000,373	$1,092,552

HUDSON STORES, INC.
COMPARATIVE STATEMENTS OF INCOME AND RETAINED EARNINGS

	1977	1978	1979	1980
Revenues	$1,407,476	$1,504,469	$1,690,480	$1,856,013
Cost of Revenues	985,845	1,067,983	1,166,363	1,271,304
Gross Profit	$ 421,631	$ 436,486	$ 524,117	$ 584,709
Operating Expenses	368,622	386,663	417,612	449,105
Earnings Before Income Taxes	$ 53,009	$ 49,823	$ 106,505	$ 135,604
Income Taxes:				
Current	18,951	21,181	53,116	62,568
Deferred	7,031	3,711	2,585	8,030
	$ 25,982	$ 24,892	$ 55,701	$ 70,598
Net Earnings	$ 27,027	$ 24,931	$ 50,804	$ 65,006
Retained Earnings, Beginning of Year	312,164	330,274	345,586	385,358
Less: Dividends	8,917	9,619	11,032	14,348
Retained Earnings, End of Year	$ 330,274	$ 345,586	$ 385,358	$ 436,016
Earnings Per Share (10,000 shares issued & outstanding)	$2.70	$2.49	$5.08	$6.50

HUDSON STORES, INC.
COMPARATIVE STATEMENTS OF CHANGES IN FINANCIAL POSITION

	1977	1978	1979	1980
Funds Provided By:				
Operations:				
Net Earnings	$ 27,027	$ 24,931	$ 50,804	$ 65,006
Items Not Affecting Working Capital:				
Depreciation & Amortization:				
Property & Equipment	25,279	27,559	29,861	32,603
Capital Leases	3,687	4,230	4,882	4,993
Equity in Loss of Joint Ventures	--	--	2,840	2,929
Increase (Decrease) in Noncurrent Deferred Income Taxes	2,337	1,614	(3,736)	(65)
Other	910	789	1,504	126
Funds Provided by Operations	$ 59,240	$ 59,123	$ 86,155	$ 105,592
Increase in Long Term Debt	17,639	8,000	7,437	16,755
Disposals of Property & Equipment	9,681	10,589	2,268	22,101
Increase (Decrease) in Deferred Income	(*)	(*)	(52)	4,460
Net Increase (Decrease) in Capital Lease Obligations	29,162	4,133	(799)	(424)
Total	$ 115,722	$ 81,845	$ 95,009	$ 148,484
Funds Used For:				
Addition to Property, Plant & Equipment	$ 55,775	$ 58,160	$ 39,786	$ 79,483
Mortgages Assumed by Purchasers of Office Properties and Pre-payment on Long Term Debt	7,907	12,949	16,098	7,812
Scheduled Reductions of Long Term Debt	9,124	11,019	13,950	23,825
Addition (Reduction) of Items Under Capital Leases	35,569	8,909	3,556	4,034
Cash Dividends	8,917	9,619	11,032	14,348
Investments	1,328	2,113	28	3,543
Other (Net)	(3,067)	(9,753)	(87)	2,475
Increase (Decrease) in Working Capital	169	(11,171)	10,646	12,964
Total	$ 115,722	$ 81,845	$ 95,009	$ 148,484

* Included under "Other (Net)" under "Funds Used For".

HUDSON STORES, INC.
COMPARATIVE STATEMENTS OF CHANGES IN FINANCIAL POSITION
(Continued)

	1977	1978	1979	1980
Increases (Decreases) in Components of Working Capital:				
Cash	$ (9,645)	$ 2,596	$ 43,717	$ 15,970
Accounts Receivable	29,121	11,161	28,563	29,896
Merchandise Inventories	2,190	(16,717)	33,720	20,693
Supplies & Prepaid Expenses	530	2,278	(665)	(1,260)
Increase in Current Assets	$ 22,196	$ (682)	$ 105,335	$ 65,299
Accounts Payable	6,861	955	46,256	38,885
Accrued Expenses and Others	12,077	6,268	25,335	17,284
Income Taxes, Currently Payable	(741)	573	20,172	(817)
Current Portions of Long Term Debt & Capital Lease Obligations	3,830	2,693	2,926	(3,017)
Increase in Current Liabilities	$ 22,027	$ 10,489	$ 94,689	$ 52,335
Net Increase (Decrease)	$ 169	$ (11,171)	$ 10,646	$ 12,964

NOTES TO FINANCIAL STATEMENTS

1. Retail customer accounts receivable are written off in full when any portion of the unpaid balance is past due twelve months. The allowance for losses arising from uncollectible customer accounts receivable is based on historical bad debt experience and current aging of the accounts.

Accounts Receivable	1977	1978	1979	1980
Thirty day accounts	$ 5,203	$ 5,788	$ 3,087	$ 2,465
Deferred payment accounts	200,496	208,377	238,646	276,540
Other accounts	18,841	23,882	26,796	19,309
Less allowance for losses	(4,386)	(6,732)	(8,651)	(8,540)
	$220,154	$231,315	$259,878	$289,774

2. Substantially all inventories are recorded at cost on the last-in, first-out (LIFO) method. Inventories at January 31 are stated less the following amounts which would have been determined under the retail method without regard to last-in, first-out principles.

1977	1978	1979	1980
$21,800	$39,900	$43,064	$50,749

3. Property, Plant and Equipment is carried at cost less accumulated depreciation. Depreciation is computed using the straight line method for financial reporting purposes and accelerated methods for tax purposes.

	1977	1978	1979	1980
Land	$ 86,776	$ 88,846	$ 72,915	$ 78,696
Building and improvements	357,152	388,481	443,100	459,164
Fixtures and equipment	100,880	109,659	109,797	123,237
Construction in progress	25,274	23,361	20,438	26,986
Accumulated depreciation	(191,848)	(211,459)	(232,014)	(249,068)
	$378,234	$398,888	$414,236	$439,015

4. Deferred income taxes are provided for income and expenses which are recognized in different accounting periods for financial reporting than for income tax purposes. The timing differences and the related deferred taxes are as follows:

	1977	1978	1979	1980
Excess of tax over book depreciation	$2,155	$1,704	$1,930	$ 357
Deferred income on installment sales	5,048	1,796	5,958	8,019
Other	(172)	211	(5,303)	(346)
Total	$7,031	$3,711	$2,585	$8,030

5. The majority of the corporation's leases require contingent rentals which are based upon a percentage of sales in excess of stipulated amounts. Additional payments for real estate taxes, insurance, and other expenses, where required, are included in operating costs in the accompanying statements of income and retained earnings. The impact of the lease capitalization on the results of operations is:

	1977	1978	1979	1980
Reduction in Rent Expense	$3,414	$3,978	$4,369	$4,336
Interest and Depreciation on Capital Leases	(3,687)	(4,230)	(4,882)	(4,993)
Effect on: Earnings Before Income Taxes	$ (273)	$ (252)	$ (513)	$ (657)

Future minimum lease payments under noncancellable leases are:

	Operating Leases	Capital Leases
1981	$14,963	$ 3,899
1982	14,446	3,876
1983	13,664	3,725
1984	13,369	3,681
1985	13,170	3,645
After 1985	91,674	50,498
Total Minimum Lease Payments	$161,286	$69,324
Capitalized Lease Obligations (1980)		$35,971

The leases have been capitalized using incremental interest rates in effect at the inception of the leases. These interest rates range between 4% and 10%.

6. In an effort to produce financial information that discloses the effects of inflation, the Financial Accounting Standards Board has issued Statement #33, "Financial Reporting and Changing Prices." The following supplemental unaudited information was prepared to illustrate the effects of changing prices on traditional measures of income and value. Because the required disclosures are experimental in nature, two approaches to calculating the effects of inflation have been required.

The first approach adjusts the historical cost financial statement dollars to dollars of the same general purchasing power. This adjustment to common units of measurement - constant dollars - is accomplished by using an index which measures inflation. Statement 33 prescribes the use of the Consumer Price Index for All Urban Consumers. The CPI-U index encompasses a wide range of commodities, such as food, housing and fuel costs. Consequently, it is important to note that the restated constant dollar amounts do not purport to reflect the individual prices or cost of particular assets, goods or services in the current market. The restatements serve only to correct distortions caused by recording transactions in dollars of varying purchasing power over a period of time. All income statement items were restated in the calculation of the income numbers adjusted for general inflation.

The second approach to determining the impact of inflation involves the use of current costs. This method reflects the changes in specific costs of the company's inventory and property, plant and equipment from the dates they were originally acquired to the present. The objective is to match the estimated current costs of the assets actually used in the company's operations against the current revenues. The adjusted earnings then include the current cost of replacing these assets rather than the historical costs actually expended to acquire them. The current costs differ from the constant dollar amounts to the extent that the specific costs of the company's assets have increased more or less rapidly than general inflation.

Current replacement costs have been used to value the inventory and property, plant, and equipment for the current cost information. Because of the rapid turnover of inventories and the use of LIFO costing, the cost of goods sold, as shown in the financial statements, normally is a fairly good approximation of current cost at the time of sale. However, such amounts have been adjusted, in the calculation of current cost income, for the effects of inflation during the time lag between purchases and sale of merchandise using various internally generated indices. For fixed assets, construction indices have been applied to the costs of the assets.

Depreciation adjustments, under both the general purchasing power and current cost approaches, have maintained the same methods, useful lives, and salvage values as used in computing historical cost depreciation.

Statement 33 requires that income tax provisions not be modified for the effect of either constant dollar or specific price adjustments. Therefore, the effective income tax rate based on historical earnings increases when compared with inflation adjusted earnings. This increase points up the serious impact on earnings of income taxes in an inflationary economy.

The "gain from decline in purchasing power of net amounts owed" represents a benefit to the company resulting from having net outstanding debt which it is assumed will be repaid in dollars of less value. The amount is calculated using the company's net monetary liabilities at the beginning and end of each year. Monetary assets and liabilities are those which are or will be converted into a fixed number of dollars regardless of the effects of inflation. This amount does not represent funds available for distribution to shareholders or income as it is presently defined in the financial statements.

The "excess of increase in specific prices over increase in general price level" represents the increase in value during the year due to increases in specific prices for inventory and property, plant and equipment over that which is attributed to the increase in value due to the effects of general inflation.

FIVE-YEAR COMPARISON OF SELECTED SUPPLEMENTARY FINANCIAL DATA ADJUSTED FOR EFFECTS OF CHANGING PRICES
(in thousands of 1980 dollars, except per share figures)

	1976	1977	1978	1979	1980
Sales	1920.7	1964.0	1961.5	2014.3	1973.9
Historical Cost Information Adjusted for General Inflation:					
Income (Loss) from Continuing Operations		(7.8)	(14.4)	(3.2)	(0.2)
Income (Loss) from Continuing Operations Per Common Share		(0.78)	(1.44)	(0.32)	(0.02)
Net Assets at Year End		880.0	887.5	909.8	938.6
Current Cost Information:					
Income (Loss) from Continuing Operations		(4.6)	(11.8)	7.8	4.7
Income (Loss) from Continuing Operations Per Common Share		(0.46)	(1.18)	0.78	0.47
Excess of Increase in Specific Prices Over Increase in General Price Level		(7.2)	2.4	2.6	15.1
Net Assets At Year End		824.0	837.9	867.8	916.5
Other Information:					
Gain From Decline in Purchasing Power of Net Amounts Owed		25.7	28.3	38.0	36.6
Cash Dividends Declared Per Common Share	1.25	1.20	1.21	1.24	1.43
Market Price Per Common Share at Year End			(No Public Market)		
Average Consumer Price Index	170.5	181.5	195.3	217.7	245.3
Current Cost of Inventory at Year End					241.5
Current Cost of Property, Plant and Equipment at Year End					905.7

HUDSON STORES, INC. LITTLE GAAP CASE

Instructions

Attached you will find a bank lending situation which requires a decision. Please treat this situation, described in the attached pages, as if it occurred in your organization and required your decision. Further, please follow the normal practices and procedures you would use in making a decision of this type. During the time you are considering the lending situation in this research you should be aware that a recent memorandum from your chief loan officer stated:

> All loan officers are urged to be aware of possible loan customers in their various daily contacts. The declining cost of lendable funds and availability of credit due to present economic and credit conditions makes it imperative that we actively seek good bank customers.

During the time you are considering this lending situation, and following your regular practices and procedures, you are asked to verbalize your thoughts and other considerations that occur to you. Please do this, no matter how trivial the thoughts may seem. Verbalizing this thought process is critical to this research. The verbal comments you make will be tape recorded; your comments will be held in confidence and in no way attributed to you without your prior permission. There will be an observer present during your decision period to make additional observations.

I wish to emphasize that I am interested in the process by which loan decisions are made, and any implications regarding the feasibility of some proposed changes in accounting requirements, rather than the particular decision itself. Please note that, as in an actual lending situation, there is no correct answer.

If you desire any clarification of the instructions, please ask the observer prior to turning the page and beginning consideration of the lending situation.

Thank you.

B-1

HUDSON STORES, INC.

John Hudson, Jr., President of Hudson Stores, Inc., approached you at your desk. Both John and Hudson Stores, Inc. are deposit customers of your bank and have been for several years. His comments had been directly to the point:

> It appears that we are going to have some short term working capital needs during the next year at Hudson Stores, Inc. Therefore, I would like to obtain a $100,000 line of credit, on an unsecured basis, to cover these short term needs. Could you set up the line of credit for a year to be reviewed when next year's statements are available?
>
> I know from my friends that you need information about the company in order to grant this request, so I have brought a copy of the company's statements for the last four years for you. Could you let me know about the line of credit in a few days? We are having a board meeting in two weeks and I would like to get the appropriate paperwork for you at that time. Sorry to run off, but I have an appointment in twenty minutes with a customer at the store.

In reviewing the reports of previous contacts by bank personnel with Hudson Stores, Inc., you find the following information:

> Hudson Stores, Inc. was incorporated in 1881. The stock has been widely dispersed upon the death of John Hudson, Sr. who had divided his shares among his five children and fourteen grandchildren.
>
> Hudson Stores, Inc., had maintained their deposit accounts with you for many years, even during the years John Hudson, Sr. had managed the company. The accounts had varied over the past few years. Average balances of the accounts totalled $35,000 for the past year. The Company had occasionally purchased certificates of deposit for short periods.
>
> Hudson Stores, Inc. had not utilized bank credit in the last ten years. A recent Dun & Bradstreet report requested by a business development officer reported all trade accounts satisfactory and contained only satisfactory information. The D&B report showed the officers were John as President and his brother Bill as Vice President and Treasurer. The directors were the officers, their two sisters and two cousins, the latter four residing in other states. Credit terms included both revolving (30 day) accounts and installment sales.
>
> The call report from the business development officer reported the premises orderly and well located for this chain of small retail softgoods and hardgoods stores (based upon a visit of 3 of 7 locations), all located in your trade area. The president was happy with his recent bank services, but in the opinion of the business development officer there was little possibility for further business. The meeting was shortened due to the arrival of a customer.

The financial statements left with you by John Hudson are attached. (Please note that the format of these statements is for the purpose of reducing the size of the research packet only.) Each year's financial statement contained the following auditor's opinion.

To the Board of Directors and Stockholders
Hudson Stores, Inc.

We have examined the statement of financial position of Hudson Stores, Inc. as of January 31, 19__ and the related statements of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned financial statements present fairly the financial position of Hudson Stores, Inc. at January 31, 19__, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles for smaller and/or closely held companies applied on a basis consistent with that of the preceding year.

/S/Chambers and Sterling
Certified Public Accountants

HUDSON STORES, INC.
COMPARATIVE STATEMENTS OF FINANCIAL POSITION

	1977	1978	1979	1980
Assets				
Current Assets				
Cash	$ 8,212	$ 10,808	$ 54,526	$ 70,496
Accounts Receivable (Net)	220,154	231,315	259,878	289,774
Inventories	200,026	183,309	217,029	237,722
Supplies & Prepaid Expenses	5,420	7,698	7,033	5,773
Total Current Assets	$433,812	$433,130	$538,466	$ 603,765
Investments & Other Assets	22,103	24,453	12,436	15,496
Property, Plant & Equipment (Net)	378,234	398,888	414,236	439,015
Total Assets	$834,149	$856,471	$965,138	$1,058,276
Equities				
Current Liabilities				
Accounts Payable	$ 88,711	$ 89,666	$135,922	$ 174,807
Taxes Other Than Income Taxes	29,148	29,949	31,883	32,138
Accrued Liabilities	31,560	34,930	52,010	60,944
Income Taxes	17,033	17,606	37,778	36,961
Current Portion of Long Term Debt	9,124	11,019	13,959	10,820
Total Current Liabilities	$175,576	$183,170	$271,552	$ 315,670
Long Term Debt	268,771	263,822	241,211	226,329
Shareholders' Equity				
Capital Stock	10,000	10,000	10,000	10,000
Retained Earnings	379,802	399,479	442,375	506,277
Total Equities	$834,149	$856,471	$965,138	$1,058,276

HUDSON STORES, INC.
COMPARATIVE STATEMENTS OF INCOME AND RETAINED EARNINGS

	1977	1978	1979	1980
Revenues	$1,407,476	$1,504,469	$1,690,480	$1,856,013
Cost of Revenues	985,845	1,067,983	1,166,363	1,271,304
Gross Profit	$ 421,631	$ 436,486	$ 524,117	$ 584,709
Operating Expenses	368,349	386,411	417,099	448,448
Earnings Before Income Taxes	$ 53,282	$ 50,075	$ 107,018	$ 136,261
Income Taxes	18,951	21,181	53,116	62,568
Net Earnings	$ 34,331	$ 28,894	53,902	$ 73,693
Retained Earnings, Beginning of Year	312,164	337,578	356,853	399,723
Less: Dividends	8,917	9,619	11,032	14,348
Retained Earnings, End of Year	$ 337,578	$ 356,853	$ 399,723	$ 459,068

HUDSON STORES, INC.
COMPARATIVE STATEMENTS OF CHANGES IN FINANCIAL POSITION

	1977	1978	1979	1980
Funds Provided By:				
Operations:				
Net Earnings	$ 34,331	$ 28,894	$ 53,902	$ 73,693
Items Not Affecting Working Capital:				
Depreciation & Amortization	25,279	27,559	29,861	32,603
Equity in Loss of Joint Ventures	--	--	2,840	2,929
Other	910	789	1,504	126
Funds Provided by Operations	$ 60,520	$ 57,242	$ 88,107	$109,351
Increase in Long Term Debt	17,639	8,000	7,437	16,755
Disposals of Property & Equipment	9,681	10,589	2,268	22,101
Total	$ 87,840	$ 75,831	$ 97,812	$148,207
Funds Used For:				
Additions to Property, Plant & Equipment	$ 55,775	$ 58,160	$ 39,786	$ 79,483
Mortgages Assumed by Purchasers of Office Properties & Prepayment on Long Term Debt	7,907	12,949	16,098	7,812
Scheduled Reductions of Long Term Debt	9,124	11,019	13,950	23,825
Cash Dividends	8,917	9,619	11,032	14,348
Investments	1,328	2,113	28	3,543
Other (Net)	(3,067)	(9,753)	(35)	(1,985)
Increase (Decrease) in Working Capital	7,856	(8,276)	16,953	21,181
Total	$ 87,840	$ 75,831	$ 97,812	$148,207

HUDSON STORES, INC.
COMPARATIVE STATEMENTS OF CHANGES IN FINANCIAL POSITION
(Continued)

	1977	1978	1979	1980
Increases (Decreases) in Components of Working Capital:				
Cash	$ (9,645)	$ 2,596	$ 43,717	$15,970
Accounts Receivable	29,121	11,161	28,563	29,896
Merchandise Inventories	2,190	(16,717)	33,720	20,693
Supplies & Prepaid Expenses	530	2,278	(665)	(1,260)
Increase in Current Assets	$ 22,196	$ (682)	$105,335	$65,299
Accounts Payable	$ 6,861	$ 955	$ 46,256	$38,885
Accrued Expenses & Others	5,901	4,171	19,014	9,189
Income Taxes	741	573	20,172	(817)
Current Portions of Long Term Debt	837	1,895	2,940	(3,139)
Increase in Current Liabilities	$ 14,340	$ 7,594	$ 88,382	$44,118
Net Increase	$ 7,856	$ (8,276)	$ 16,953	$21,181

NOTES TO FINANCIAL STATEMENTS

1. Retail customer accounts receivable are written off in full when any portion of the unpaid balance is past due twelve months. The allowance for losses arising from uncollectible customer accounts receivable is based on historical bad debt experience and current aging of the accounts.

Accounts Receivable	1977	1978	1979	1980
Thirty day accounts	$ 5,203	$ 5,788	$ 3,087	$ 2,465
Deferred payment accounts	200,496	208,377	238,646	276,540
Other accounts	18,841	23,882	26,796	19,309
Less allowance for losses	(4,386)	(6,732)	(8,651)	(8,540)
	$220,154	$231,315	$259,878	$289,774

2. Substantially all inventories are recorded at cost on the last-in, first-out (LIFO) method. Inventories at January 31 are stated less the following amounts which would have been determined under the retail method without regard to last-in, first-out principles.

1977	1978	1979	1980
$21,800	$39,900	$43,064	$50,749

3. Property, Plant and Equipment is carried at cost less accumulated depreciation. Depreciation is computed using the straight line method for financial reporting purposes and accelerated methods for tax purposes. No calculation of deferred taxes has been made.

	1977	1978	1979	1980
Land	$ 86,776	$ 88,846	$ 72,915	$ 78,696
Building and improvements	357,152	388,481	443,100	459,164
Fixtures and equipment	100,880	109,659	109,797	123,237
Construction in progress	25,274	23,361	20,438	26,986
Accumulated depreciation	(191,848)	(211,459)	(232,014)	(249,068)
	$378,234	$398,888	$414,236	$439,015

4. Annual minimum rentals on long term noncancellable leases are as follows:

1981	$ 18,862
1982	18,322
1983	17,389
1984	17,050
1985	16,815
Beyond 1985	142,172

Contingent rentals are based upon a percentage of sales. Most leases require additional payments for real estate taxes, insurance and other expenses which are included in operating costs in the accompanying statement of income and retained earnings.

HUDSON STORES, INC.
SUPPLEMENT

Long-Term Debt

The long-term debt of Hudson Stores, Inc., is composed of mortgage loans from three savings institutions on the store properties which the company occupies. There is no debt agreement which places restrictions on the company's operations or financing.

HUDSON STORES, INC.
SUPPLEMENT

Store Locations

Hudson Stores, Inc. has operated seven stores for the past six years. All store locations have been modernized frequently. One store location was moved during the past year to a new location two blocks from the previous location.

HUDSON STORES, INC.
SUPPLEMENT

Accounts Receivable Information

1. Thirty day accounts are revolving charge accounts which are billed every thirty days. By recency of payment, these accounts are classified as follows:

Thirty days or less	Thirty to sixty days	Over sixty days
$ 2,195	$ 221	$ 49

2. Deferred payment accounts are monthly payment accounts requiring at least 10% of the outstanding balance principal payments with interest rates of 15%. By recency of payment, these accounts are classified as follows:

Thirty Days or less	Thirty to ninety days	Over ninety days
$246,121	$22,123	$8,926

3. Other accounts are for sales contracts from three to five years from the sales of office properties. By recency of payment, these accounts are classified as follows:

Thirty days or less	Thirty to sixty days	Over sixty days
$17,571	$1,738	-0-

HUDSON STORES, INC.
SUPPLEMENT

Projected Borrowing Requirements

Hudson Stores, Inc. projects the following borrowing requirements for the next twelve months of operations:

Month	Amount
May	$ 25,000
June	$ 10,000
July	-0-
August	-0-
September	-0-
October	$ 15,000
November	$ 40,000
December	$100,000
January	$ 30,000
February	-0-
March	-0-
April	-0-

SUPPLEMENTS FOR LITTLE GAAP CASE

HUDSON STORES, INC.
SUPPLEMENT

Earnings Per Share

	1977	1978	1979	1980
Earnings per share (10,000 shares issued and outstanding)	$3.43	$2.89	$5.39	$7.37

HUDSON STORES, INC.
SUPPLEMENT

Deferred Income Taxes

The following accounts and amounts would have appeared in the statements of financial position of Hudson Stores, Inc. if they had been calculating deferred income taxes:

	1977	1978	1979	1980
Equities				
Deferred Income Taxes, Installment Sales (current)	$ 28,785	$ 30,882	$ 37,203	$ 45,298
Deferred Credit-Taxes (noncurrent)	20,470	22,486	18,776	23,268
Retained Earnings	330,547	346,111	386,396	437,711

The impact of deferred taxes on the results of operations would have been:

	1977	1978	1979	1980
Earnings before income taxes	$ 53,282	$ 50,075	$107,018	$136,261
Income Taxes:				
Current	18,951	21,181	53,116	62,568
Deferred	7,031	3,711	2,585	8,030
	$ 25,982	$ 24,892	$ 55,701	$ 70,598
Net Earnings	$ 27,300	$ 25,183	$ 51,317	$ 65,663

Deferred income taxes would have been provided for income and expenses which are recognized in different accounting periods for financial reporting than for income tax purposes. The timing differences and the related deferred taxes would have been as follows:

	1977	1978	1979	1980
Excess of tax over book depreciation	$ 2,155	$ 1,704	$ 1,930	$ 357
Deferred income on installment sales	5,048	1,796	5,958	8,019
Other	(172)	211	(5,303)	(346)
Total	$ 7,031	$ 3,711	$ 2,585	$ 8,030

HUDSON STORES, INC.
SUPPLEMENT

Capitalization of Leases

The following accounts and amounts would have appeared in the statements of financial position of Hudson Stores, Inc. if their financing leases had been capitalized according to Statement of Financial Accounting Standards No. 13, "Accounting for Leases":

	1977	1978	1979	1980
Asset				
Leased Property under Capital Leases (net)	$31,882	$36,561	$35,235	$34,276
Equities				
Current Lease Obligations	2,993	3,791	3,777	3,899
Capital Lease Obligations	29,162	33,295	32,496	32,072
Retained Earnings	330,274	345,586	385,358	436,016

The impact of the lease capitalization on the results of operations would have been:

	1977	1978	1979	1980
Reduction in rent expense	$ 3,414	$ 3,978	$ 4,369	$ 4,336
Interest and depreciation on capital leases	(3,687)	(4,230)	(4,882)	(4,993)
Effect on:				
Earnings before income taxes	$ (273)	$ (252)	$ (513)	$ (657)

Future minimum lease payments under noncancellable leases are:

	Operating Leases	Capital Leases
1981	$ 14,963	$ 3,899
1982	14,446	3,876
1983	13,664	3,725
1984	13,369	3,681
1985	13,170	3,645
After 1985	91,674	50,498
Total minimum lease payments	$161,286	$ 69,324
Capitalizable lease obligations (1980)		$ 35,971

The leases would have been capitalized using incremental interest rates in effect at the inception of the leases. These interest rates range between 4% and 10%.

HUDSON STORES, INC.
SUPPLEMENT

Inflation Adjusted Results of Operations

In an effort to produce financial information that discloses the effects of inflation, the Financial Accounting Standards Board has issued Statement #33, "Financial Reporting and Changing Prices." The following supplemental unaudited information was prepared to illustrate the effects of changing prices on traditional measures of income and value. Because the required disclosures are experimental in nature, two approaches to calculating the effects of inflation have been required.

The first approach adjusts the historical cost financial statement dollars to dollars of the same general purchasing power. This adjustment to common units of measurement - constant dollars - is accomplished by using an index which measures inflation. Statement 33 prescribes the use of the Consumer Price Index for All Urban Consumers. The CPI-U index encompasses a wide range of commodities, such as food, housing and fuel costs. Consequently, it is important to note that the restated constant dollar amounts do not purport to reflect the individual prices or cost of particular assets, goods, or services in the current market. The restatements serve only to correct distortions caused by recording transactions in dollars of varying purchasing power over a period of time. All income statement items were restated in the calculation of the income numbers adjusted for general inflation.

The second approach to determining the impact of inflation involves the use of current costs. This method reflects the changes in specific costs of the company's inventory and property, plant and equipment from the dates they were originally acquired to the present. The objective is to match the estimated current costs of the assets actually used in the company's operations against the current revenues. The adjusted earnings then include the current cost of replacing these assets rather than the historical costs actually expended to acquire them. The current costs differ from the constant dollar amounts to the extent that the specific costs of the company's assets have increased more or less rapidly than general inflation.

Current replacement costs have been used to value the inventory and property, plant, and equipment for the current cost information. Because of the rapid turnover of inventories and the use of LIFO costing, the cost of goods sold, as shown in the financial statements, normally is a fairly good approximation of current cost at the time of sale. However, such amounts have been adjusted in the calculation of current cost income, for the effects of inflation during the time lag between purchases and sale of merchandise using various internally generated indices. For fixed assets, construction indices have been applied to the costs of the assets.

Depreciation adjustments, under both the general purchasing power and current cost approaches, have maintained the same methods, useful lives, and salvage values as used in computing historical cost depreciation.

Statement 33 requires that income tax provisions not be modified for the effect of either constant dollar or specific price adjustments. Therefore, the effective income tax rate based on historical earnings increases when compared with inflation adjusted earnings. This increase points up the serious impact on earnings of income taxes in an inflationary economy.

The "gain from decline in purchasing power of net amounts owed" represents a benefit to the company resulting from having net outstanding debt which it is assumed will be repaid in dollars of less value. The amount is calculated using the company's net monetary liabilities at the beginning and end of each year. Monetary assets and liabilities are those which are or will be converted into a fixed number of dollars regardless of the effects of inflation. This amount does not represent funds available for distribution to shareholders or income as it is presently defined in the financial statements.

The "excess of increase in specific prices over increase in general price level" represents the increase in value during the year due to increases in specific prices for inventory and property, plant and equipment over that which is attributed to the increase in value due to the effects of general inflation.

FIVE-YEAR COMPARISON OF SELECTED SUPPLEMENTARY FINANCIAL DATA ADJUSTED FOR EFFECTS OF CHANGING PRICES
(In thousands of 1980 dollars, except per share figures)

	1976	1977	1978	1979	1980
Sales	1920.7	1964.0	1961.5	2014.3	1973.9
Historical Cost Information Adjusted for General Inflation:					
Income (Loss) from Continuing Operations		(7.8)	(14.4)	(3.2)	(0.2)
Income (Loss) from Continuing Operations Per Common Share		(0.78)	(1.44)	(0.32)	(0.02)
Net Assets at Year End		880.0	887.5	909.8	938.6
Current Cost Information:					
Income (Loss) from Continuing Operations		(4.6)	(11.8)	7.8	4.7
Income (Loss) from Continuing Operations Per Common Share		(0.46)	(1.18)	0.78	0.47
Excess of Increase in Specific Prices Over Increase in General Price Level		(7.2)	2.4	2.6	15.1
Net Assets At Year End		824.0	837.9	867.8	916.5
Other Information:					
Gain From Decline in Purchasing Power of Net Amounts Owed		25.7	28.3	38.0	36.6
Cash Dividends Declared Per Common Share	1.25	1.20	1.21	1.24	1.43
Market Price Per Common Share at Year End			(No Public Market)		
Average Consumer Price Index	170.5	181.5	195.3	217.7	245.3
Current Cost of Inventory at Year End					241.5
Current Cost of Property, Plant and Equipment at Year End					905.7

APPENDIX H

PHRASED PROTOCOLS

Loan Officer W.

W1 I guess, first of all, before I, as an of-, as a lending officer, the first things that I would look for basically in any type of credit is, is naturally the, what's called the, the four C's of credit, per se, um.

W2 Going from there it just may be taking that approach

W3 and breaking it down piece by piece,

W4 looking at, uh, the information available, uh,

W5 trying to get a feel for what the present financial condition of the company is

W6 as well as what the future, uh, prospects of the company's product line, etc., would be.

W7 Uh, try to get a feel for the individuals involved, uh,

W8 the management of the corporation, uh,

W9 trying to get a feel for their expertise, uh,

W10 how each one fits into their particular role within the company

W11 and what they add to the company.

W12 Uh, uh, from that I would, uh, do any type of credit investigation

W13 and review processes on the financial statements itself

W14 whether it's just a matter of taking a look at the, at the financial statements

W15 and maybe the, the, uh, the situation is so, um, ordinary

W16 that it doesn't take much research.

W17 Uh, if it would take research,

W18 then we would usually perform a, you know, a full analysis on the company,

W19 either myself

W20 or quite possibly through our analytical support group of the bank.

W21 Um, and from there on I would just try to make, uh, uh, some type of decision.

W22 Do you want to turn it off while I'm reading this?

W23 <No.>

W24 Oh, ok.

W25 <Reads page 1 for 29 seconds.>

W26 First paragraph relates to the request of $100,000

W27 line of credit

W28 on an unsecured basis, um,

W29 for short term working capital needs.

W30 In as much as it is a, I presume a retail store, uh,

W31 the line of credit would probably be used for ordering inventories, uh, during peak seasons.

W32 That would be my first assumption.

W33 <Reads page 1 for 42 seconds.>

W34 Ok, although I am not aware of the company itself,

W35 it appears that they have been a bank customer for several years, uh,

W36 it's a long established, uh, store

W37 within our immediate area.

W38 <Reads page 1 for 4 seconds.>

W39 The average balances have totalled, what, $35,000 uh,

W40 which would be an indication that the company does have some liquidity,

W41 particularly when they, uh, purchase, purchase CD's during short periods.

W42 <Reads page 1 for 7 seconds.>

W43 The fact that they have not utilized the bank over last ten years

W44 is, is a positive, uh, indication

W45 of their, uh, one either their cash flow

W46 or their just management.

W47 <Reads page 1 for 28 seconds.>

W48 The call report indicates that the retail shop was, uh, in order.

W49 And it contained hard goods and soft goods.

W50 Uh, what would that consist of?

W51 When they say hard goods, soft goods, is that apparel?

W52 <Soft goods is apparel.>

W53 Ok, hard goods being . . . ?

W54 <Up to furniture.>

W55 Ok.

W56 <Reads page 1 for 11 seconds.>

W57 <Turns to page 2 and reads for 34 seconds.>

W58 Uh, from the financial statements it looks like the, um, I'm looking at audited statements,

W59 um, it does not really relate or state that, whether that is, is related to a review

W60 or a full audit.

W61 Just makes the indication that they have, uh, done all the auditing procedures as they consider necessary in the circumstances.

W62 <Reads page 2 for 8 seconds.>

W63 <Turns to page 3 and reads for 11 seconds.>

W64 <Brief glance at page 4, but returns to page 3.>

W65 The company's financial statements are from '77 through '80.

W66 The four years re-, reflect a, uh, gradual growth.

W67 Uh, liquidity,

W68 and cash,

W69 and receivables, uh, have improved.

W70 Inventory levels have remained about the same,

W71 from, uh, approximately $200,000.

W72 Current liabilities have steadily grown,

W73 particularly in the accounts payable area,

W74 and the liquidity is still appears very good,

W75 two to one ratio.

W76 Uh, long term debt has been, uh about the same for the last four years, uh,

W77 it does show that it has declined somewhat.

W78 Additional information regarding what type of debt that is, uh, would be needed.

W79 Since they have not had any bank borrowings for the last ten years,

W80 one would assume that ei-, that is either, uh, mortgage debt

W81 or debt from stockholders.

W82 <Reads page 3 for 17 seconds.>

W83 Stockholders' equity has, has shown growth in the retained earnings entry,

W84 and the debt to worth ratio of the company is less than, uh, one to one,

W85 approximately is .75 to one.

W86 <Turns to page 4.>

W87 Looking at the earnings statement,

W88 uh, revenues have increased by about $100,000 each year.

W89 Uh, cost of goods sold has also increased by about the same margin.

W90 Gross margin has, uh, remained about the same percentage.

W91 Uh, operating expenses do not reflect any flagrant or unusual . . . increases.

W92 The company has s-, reflected net earnings after taxes, uh, each year,

W93 1978 was the down year,

W94 however, s-, 1980 reflected a $15,000 growth from the previous year.

W95 Earnings per share has increased each year,

W96 now is at 6.5

W97 six dollars and a half per share.

W98 <Brief glance at page 5, but returns to page 4.>

W99 Overall, the company's earning trend has, has been very positive.

W100 It appears that the company, uh, has been managed well.

W101 <Turns to page 5 and reads for 12 seconds.>

W102 Looking at the, uh, statement of changes in the financial position . . .

W103 <Reads page 5 for 11 seconds.>

W104 it shows that each, the company's increased its long term debt each year . . .

W105 <Reads page 5 for 11 seconds.>

W106 by adding to property and equipment.

W107 <Reads page 5 for 31 seconds.>

W108 Mortgages assumed by purchasers . . .

W109 Could I ask a question?

W110 What would be the entry 'mortgages assumed by purchasers of office properties and, and prepayment of long term debt'?

W111 <You can request additional information.>

W112 Ok, uh, the item on the comparative statements, sources and uses of funds, uh, needs further exploration, uh, the entry 'mortgages assumed by purchasers of office properties and prepayments on long term loans,

W113 uh, it would as-, there again s-, it would assume or one can assume that that is only again related to purchases of fixed assets,

W114 either by assumption of either debt

W115 or prepayment by long term debt.

W116 <Reads page 5 for 7 seconds.>

W117 <Turns to page 6 and reads for 8 seconds.>

W118 Uh, comparative changes in financial position reflect cash has increased,

W119 uh, however, it declined the last year between '79 and '80.

W120 Accounts receivable, uh, marginal change.

W121 Um, merchandise of inventories, uh, a little reduction.

W122 Accounts payable, a small reduction.

W123 Accrued expenses, a small reduction.

W124 And current portions of long term debt, uh, there was a, only about a $5,000 change.

W125 The inventory reflected a $13,000 decline between '79 and '80.

W126 Cash also showed decline of about $15,000.

W127 The question would be with inventory declining, uh,

W128 being converted to either receivables or cash

W129 uh, why also did the cash figure decline, uh,

W130 but there again, capital assets

W131 through long term debt

W132 and lease obligations

W133 increased,

W134 so apparently those, those funds went into that type of long term capital expenditures.

W135 <Turns to page 7 and reads for 10 seconds.>

W136 Customers' accounts receivables

W137 <Turns to page 6.>

W138 have showed little change from '79 to '80.

W139 <Turns to page 7.>

W140 Their, uh, aging of those receivables reflect a greater percentage in deferred payment accounts.

W141 One would have to investigate to find out what type of quality accounts those are.

W142 Uh, their loss exposure has increased somewhat, I'm, I'm sorry, their allowance for losses have increased somewhat each year.

W143 Uh, but it, as a whole, represents a, a small percentage.

W144 <Turns briefly to page 6, but returns to page 7.>

W145 With the growth in sales each year,

W146 it looks like they've done an adequate job in controlling bad debts.

W147 <Reads page 7 for 29 seconds.>

W148 Uh, property, plant and equipment in footnote, uh, reflects that the greatest as-, greatest increase is in building and improvements between '79 and '80

W149 and also fixtures and equipment.

W150 One would have to look at the depreciation schedules to see how fast they're, they're depreciating some assets.

W151 <Reads page 7 for 20 seconds.>

W152 <Turns to page 8 and reads for 11 seconds.>

W153 Um, the company, a question should be asked to find out if the company is leasing equipment, uh, . . .

W154 <Reads page 8 for 24 seconds.>

W155 Evidently the company is leasing either furniture or equipments to, uh, respective purchasers.

W156 <Reads page 8 for 29 seconds.>

W157 <Turns to page 9 and reads for 5 seconds.>

W158 <Turns to page 10.>

W159 <Turns to page 4.>

W160 <Turns to page 10 and reads for 7 seconds.>

W161 Um, this five year comparison of selected, supplementary financial data,

W162 that's just interest, industries, comparative industries?

W163 I'm not sure what this information is.

W164 <No, that's their data.>

W165 That's their, the company's data?

W166 <Reads page 10 for 7 seconds.>

W167 Oh, ok, this is adjusted for the effects of changing prices.

W168 <Reads page 10 for 5 seconds.>

W169 <Turns to page 9 and reads for 1 minute, 14 seconds.>

W170 <Turns to page 10.>

W171 At this point, I'm looking into footnote six

W172 which has to do with the, uh, Statement 13 issued from the s-, Financial Accounting Standards, regarding the effects of inflation.

W173 <Compares pages 4 and 10.>

W174 I'm trying to get an idea of what type of effect it has had on their inventory reporting

W175 and the impact on their, their statement.

W176 Sales have been reported in excess of their revenues for the periods of '77 through '79,

W177 but in 1980, uh, reflect a decline.

W178 I'm not particularly accustomed to seeing this type of financial statement.

W179 I'm trying to determine what type of impact it has had

W180 or it, it is having.

W181 <Reads page 10 for 21 seconds.>

W182 <Turns to page 3 and reads for 5 seconds.>

W183 In summary, uh, giving consideration to the request for $100,000 working capital

W184 (with?) a line of credit

W185 uh, without having prior knowledge

W186 or limited knowledge of their operations, uh,

W187 I would summarize their financial statements as being, as reflecting the company being a, a conservative run operation.

W188 Uh, nothing unusual appears to be apparent, from the statements.

W189 <Turns to page 1.>

W190 Uh, I would want to get a clarification from the company on their intended use of the line of credit,

W191 and why, all of a sudden, they feel it's necessary

W192 since they have gone ten years without borrowing from the bank,

W193 uh, one would have to find out

W194 or get the management's opinion

W195 on what aspects are changing within the company,

W196 what impact inflation is actually having, uh, on their operation,

W197 the product line, uh, being a retail store,

W198 uh, knowing that market conditions are presently soft,

W199 what impact is that having on their operations

W200 and what are they doing, uh, to counteract that softness.

W201 The company appears . . .

W202 <Turns to page 4.>

W203 <Turns to page 5.>

W204 to have, uh, keeps adding to their capital asset base

W205 and one would question, have to question why,

W206 whether it's just improvement in property

W207 or additions to property.

W208 Without knowing the company or the principals

W209 uh, that's one thing that I would want to get a better feel for.

W210 <Turns to page 1.>

W211 But based upon their request for $100,000 line of credit,

W212 this officer would probably approve that request.

W213 Whether I would do it on an unsecured basis or not would be something I would have to look into further.

W214 If, if security was taken,

W215 it would be in the form of receivables and inventory.

W216 If not,

W217 definite, uh, support from their, the officers of the company, uh, would be necessary,

W218 that in the form of a personal guarantee

W219 from possibly the chief operating officers and treasurer.

W220 <Reads page 1 for 24 seconds.>

W221 <Loan Officer W receives supplements on store locations and projected borrowing requirements.>

W222 <Reads supplements for 19 seconds.>

W223 Additional information provided, uh, indicates that they have operated seven stores

W224 for the past six years.

W225 Uh, the stores have been frequently modernized,

W226 which, uh, could be a reason for the, the increase in capital expenditures

W227 and capital leases.

W228 Uh, one store was completely moved, uh, to (two?) . . . two blocks.

W229 Uh, I would have to question whether that was, what type of move was that?

W230 Uh, I assume that if they did not own the building they moved to,

W231 then that's one of the reasons their lease expenses have in-, have increased.

W232 Uh, projected borrowing requirements reflect, uh, a seasonal use in May and June

W233 with debt being retired for three months

W234 and then picking up toward the latter part of the year.

W235 Uh, increasing inventory for, uh, the holiday season.

W236 With that added information, uh, I would still approve the loan.

W237 uh, that information has not given me much bearing, uh, in regards to the collateral.

W238 I would probably still do it on an unsecured basis

W239 with the principals, uh, guaranteeing the loan.

W240 If the, if the principals would balk at guaranteeing this loan,

W241 I would probably want to dwell a little more into the figures

W242 to find out, uh, what their long term plans are,

W243 particularly for the improvements of properties, fixtures, W244 and what type of interim statements they may have to show me what they're currently doing,

W245 what their sales trends have been at a recent date,

W246 what impact the inflationary period

W247 and the economy has had, has had.

W248 But as much as they have been with the bank for ten years or, or more

W249 and reflected a positive growth trend, uh,

W250 I would probably approve this loan.

W251 If guarantees were not offered,

W252 were not available, uh,

W253 possibly receivables and inventory would be taken as collateral.

Elapsed time: 35 minutes.

Loan Officer X.

X1 <Reads page 1 for 10 seconds.>

X2 Well, it's important that they have been deposit customers for several years.

X3 <Reads page 1 for 12 seconds.>

X4 They have requested $100,000,

X5 <Writes '$100,000' on piece of paper.>

X6 short term working capital,

X7 <Writes 'st' on the paper.>

X8 on a line of credit structure.

X9 <Writes 'line of credit' on the paper.>

X10 <Reads page 1 for 3 seconds.>

X11 Unsecured.

X12 <Reads page 1 for 1 minute, 40 seconds.>

X13 Trade credit is satisfactory.

X14 <Writes 'trade-satisfactory' on the paper.>

X15 <Reads page 1 for 32 seconds.>

X16 It's significant that they're family, family owned,

X17 closely held.

X18 <Reads page 1 for 32 seconds.>

X19 <Turns to page 2 and reads for 26 seconds.>

X20 Audited statement.

X21 <Writes 'audited' on the paper.>

X22 <Turns to page 3 and reads for 11 seconds.>

X23 There has been moderate growth.

X24 <Reads page 3 for 7 seconds.>

X25 <Turns to page 4 and reads for 11 seconds.>

X26 <Turns to page 3 and reads for 4 seconds.>

X27 <Flips toward back of case.>

X28 There aren't ratios calculated on this . . .?

X29 <No.>

X30 <Stops on page 7 and reads for 42 seconds.>

X31 <Flips back to page 3 for 5 seconds.>

X32 <Returns to page 7 and reads for 59 seconds.>

X33 <Turns to page 8 and reads for 1 minute, 11 seconds.>

X34 <Turns to page 9 and reads for 7 seconds.>

X35 <Turns to page 10 and reads for 34 seconds.>

X36 <Turns to page 3 and reads for 7 seconds.>

X37 <Can you tell me what you're doing? Speak up about what you're doing?>

X38 Ok, uh, I'm just looking over the financial statement right now.

X39 Look at uh, um, balances,

X40 and, uh, uh, proportions of debt to worth

X41 and current assets to current liabilities,

X42 and just general things like that.

X43 <If you could say them as you are looking at the specific ones, so I know what you're looking at.>

X44 Ok. Current liabilities, uh, is well covered by current assets,

X45 a little less than two to one.

X46 I'll just . . .

X47 <Computes current ratio for 1980 as 1.65 and writes it on the paper.>

X48 1.65 to one.

X49 Ok, total debt to worth.

X50 <Begins calculation.>

X51 I, uh, we, we put deferred credits in kind of a nowhere no man's land, um, . . .

X52 <Computes debt to worth for 1980 as .86 and writes it on the paper.>

X53 So debt to worth is about .86, to one,

X54 which is very reasonable, very reasonable.

X55 The current of 1.65 is, is satisfactory, um, um, um,

X56 considering that type of business, retail.

X57 Depending on the, uh, . . .

X58 <Flips back and forth between pages 3 and 4 and calculates.>

X59 I'm checking the turnovers now.

X60 <Computes the accounts receivable turnover for 1980 as 56 days and writes it on the paper.>

X61 Accounts receivable is 56 days approximately, in '80.

X62 <Computes inventory turnover for 1980 as 67 days and writes it on the paper.>

X63 Inventory is 67 days in '80.

X64 <Computes accounts receivable turnover for 1979 as 55 days and writes it on the paper.>

X65 55 days in '79 for accounts receivable,

X66 <Computes inventory turnover for 1979 as 67 days and writes it on the paper.>

X67 and 67 days of inventory in '79.

X68 <Begins calculation of accounts receivable turnover for 1978.>

X69 When we get statements like this,

X70 our credit department puts them in common, common, uh, uh, statements,

X71 in, in, uh, ratios and, uh, percentages,

X72 and figures up all the turnovers.

X73 I usually don't go through this.

X74 <Computes accounts receivable turnover for 1978 as 55 days and writes it on the paper.>

X75 55 days in '78.

X76 <Computes inventory turnover for 1977 as 62 days and writes it on the paper.>

X77 62 days in inventory in '78.

X78 So it looks like they have been managing the current assets, uh, at least on a level basis over the past three years.

X79 Trend is, is more important.

X80 <Reads page 3 for 50 seconds.>

X81 Fixed assets are increasing,

X82 but not at a, uh, significantly high rate.

X83 <Reads page 3 for 53 seconds.>

X84 Their long term debts have been paying off, running down, running off.

X85 <Reads page 3 for 26 seconds.>

X86 <Begins calculating.>

X87 Figuring up debt to worth

X88 and current ratios

X89 for the two prior years.

X90 Taking off the deferrals.

X91 <Computes debt to worth for 1979 as .9 and writes it on the paper.>

X92 .9 for '79.

X93 <Computes debt to worth for 1978 as .73 and writes it on the paper.>

X94 .73 for '78.

X95 <Computes current ratio for 1978 as 1.98 and writes it on the paper.>

X96 In '78 the current position rose, 1.98.

X97 I left the deferrals in

X98 because I just want a trend.

X99 <Computes current ratio for 1979 as 1.72 and writes it on the paper.>

X100 1.72 in '79.

X101 <Writes 'trend down' on the paper next to current ratio values.>

X102 <Reads page 3 for 30 seconds.>

X103 Figuring up working capital . . .

X104 <Computes working capital for 1980 as 215 and writes it on the paper.>

X105 215 in '80.

X106 <Computes working capital for 1979 as 226 and writes it on the paper.>

X107 226 in '79.

X108 <Computes working capital for 1978 as 240 and writes it on the paper.>

X109 240 in '78.

X110 <Turns to page 4.>

X111 I'm just going to get percentages on the income statement.

X112 The gross margin first.

X113 <Computes the gross margin as a percent of revenues for 1978 as 28.9.>

X114 Ok, can I write on this?

X115 <Yes.>

X116 Is this going to be used for anybody else?

X117 <No.>

X118 <Writes 28.9 next to gross profit figure of 1978 in case.>

X119 Ok, operating expenses.

X120 <Computes operating expenses as a percent of revenues for 1978 as 25.7 and writes it on the case.>

X121 <Computes earnings before taxes as a percent of revenues for 1978 as 3.32 and writes it on the case.>

X122 <Computes net earnings as a percent of revenues for 1978 as 1.7 and writes it on the case.>

X123 Checking the dividends . . .

X124 payout ratio.

X125 <Computes payout ratio for 1978 as 38.6 and writes it on the case.>

X126 <Computes payout ratio for 1979 as 22 and writes it on the case.>

X127 <Computes payout ratio for 1980 as 21.5 and writes it on the case.>

X128 <Computes gross profit as a percent of revenues for 1979 as 31.0 and writes it on the case.>

X129 <Computes gross profit as a percent of revenues for 1980 as 31.5 and writes it on the case.>

X130 <Computes operating expenses as a percent of revenues for 1979 as 24.7 and writes it on the case.>

X131 <Computes operating expenses as a percent of revenues for 1980 as 24.2 and writes it on the case.>

X132 <Computes earnings before taxes as a percent of revenues for 1979 as 6.3 and writes it on the case.>

X133 <Computes earnings before taxes as a percent of revenues for 1980 as 7.3 and writes it on the case.>

X134 <Computes net earnings as a percent of revenues for 1979 as 3.0 and writes it on the case.>

X135 <Computes net earnings as a percent of revenues for 1980 as 3.5 and writes it on the case.>

X136 And sales growth percentage.

X137 <Computes sales growth percentage for 1978 as 6.9% and writes it on the case.>

X138 <Computes sales growth percentage for 1979 as 12.4% and writes it on the case.>

X139 <Computes sales growth percentage for 1980 as 9.8% and writes it on the case.>

X140 Ok, as far as the operations go, the um, the company has been growing,

X141 but, uh, if I did not have the use of common, uh, size statements,

X142 or in, uh, adjusted for inflation,

X143 I would have guessed they didn't have much of, of real growth in the company.

X144 Um, their gross profit has been, uh, increasing,

X145 uh, slightly,

X146 uh, which is good.

X147 Their earnings, uh, before income tax, uh,

X148 their operating expenses have been decreasing as a percent of sales, uh,

X149 which is again good.

X150 Their, uh, profitability then, in general, has been, uh, increasing,

X151 and they, uh, as far as their dividend payout policy to date, it has been, uh, well, lower than 50%,

X152 and, uh, I'm looking at that just concerned that they're paying out all of their earnings to their,

X153 it's closely held,

X154 paid to the family.

X155 So I would say operationally, that they've been fairly solid in the last, uh, just looking across three years.

X156 <Turns to page 5, but then immediately turns to page 3.>

X157 And for right now their balance sheet proportions are, uh, uh, good

X158 or fair.

X159 Uh, there's a couple of negative trends there, uh,

X160 in the working capital position, uh, the, in the current position

X161 and that's probably one thing I'd want to look at a little, uh, more.

X162 Particularly in a fund flow kind of statement.

X163 Which I'll do,

X164 since it's not here.

X165 <Turns to page 5.>

X166 Oh no, here it is, that's right. Excuse me.

X167 <Reads page 5 for 34 seconds.>

X168 <Flips back and forth between pages 3 and 5 for 41 seconds and does some calculations.>

X169 I'm just checking one of the figures.

X170 <Reads page 5 for 33 seconds.>

X171 <Turns to page 7 and reads for 23 seconds.>

X172 <Turns to page 5 and reads for 17 seconds.>

X173 Oh, ok, I was wondering where these figures came from

X174 and I see it's on a, not on a net basis,

X175 <Puts check marks on page 5 next to 'disposals of property and equipment' and 'addition to property, plant, and equipment'.>

X176 for reductions in long term debt.

X177 <Reads page 5 for 1 minute, 44 seconds.>

X178 Well, I don't have any major problems with the fund flow statement.

X179 It looks like they're investing a little more in property and equipment,

X180 that was last year when they had (inaudible),

X181 but they got rid of something too, so

X182 <Reads page 5 for 12 seconds.>

X183 no particular problem.

X184 <Turns to page 6 and reads for 43 seconds.>

X185 <Turns to page 7.>

X186 I'm just going to read the notes,

X187 and see if there is anything in there I should pick up.

X188 <Reads page 7 for 1 minute, 36 seconds.>

X189 Straight line depreciation . . .

X190 <Underlines 'straight line method' in the case.>

X191 <Reads page 7 for 12 seconds.>

X192 . . . in the statement.

X193 <Reads page 7 for 27 seconds.>

X194 <Turns to page 8 and reads for 1 minute, 3 seconds.>

X195 <Turns to page 3 and reads for 4 seconds.>

X196 <Turns to page 8 and reads for 3 seconds.>

X197 <Folds case so can see pages 3 and 8 at the same time.>

X198 Just looking at the leases.

X199 <Reads for 44 seconds.>

X200 Interest rates between 4 and 10 percent?

X201 <Laughs.>

X202 Ok.

X203 <Reads page 8 for 1 minute, 8 seconds.>

X204 <Turns to page 9 and reads for 42 seconds.>

X205 Hmmm.

X206 <Reads page 9 for 1 minute, 13 seconds.>

X207 <Turns to page 10 and reads for 12 seconds.>

X208 <Turns to page 4 and reads for 8 seconds.>

X209 <Folds case so can see pages 4 and 10 at the same time.>

X210 <Reads for 36 seconds.>

X211 And it shows in the, uh, constant dollar statements, show the, there hasn't been real growth in the last year.

X212 And in real dollars it's actually been a decline in, in income.

X213 <Reads for 1 minute, 4 seconds.>

X214 <Turns to page 9 and reads for 24 seconds.>

X215 Can I ask you questions about this, or is that not to be done?

X216 <Not really.>

X217 Well, I'm just not familiar with the, uh, the accounting statement.

X218 Um, the assets are, uh, shown at, when you say current cost,

X219 that would be the cost, the historical cost, uh, with the, uh, inflation index?

X220 I mean it's not a replacement cost or . . .

X221 <Reads page 9 for 18 seconds.>

X222 . . . means replacement cost . . .

X223 <Reads page 9 for 1 minute, 29 seconds plus the time to turn over the tape.>

X224 <Turns to page 10 and reads for 42 seconds.>

X225 <Folds the case so can see pages 3 and 10 at the same time.>

X226 <Reads for 43 seconds.>

X227 Uh, the inventory valuation on constant, uh, dollar, or the in-, inflation factor is not significantly different.

X228 <Circles number on page 10 for 'current cost of inventory at year end'.>

X229 Of course, property, plant and equipment are.

X230 <Draws an arrow on page 10 pointing toward the number for 'current cost of property, plant,

and equipment at year end'.>

X231 <Reads page 10 for 9 seconds.>

X232 <Turns to page 1 and reads for 49 seconds.>

X233 <Turns to page 3 and reads for 8 seconds.>

X234 <Turns to page 4 and reads for 2 seconds.>

X235 <Turns to page 5 and reads for 18 seconds.>

X236 I'm just trying to figure out now why they need to borrow money.

X237 <Turns to page 2 and reads for 10 seconds.>

X238 <Turns very briefly to instructions.>

X239 <Turns to page 1 and reads for 35 seconds.>

X240 <Turns to page 4 and reads for 4 seconds.>

X241 <Flips back and forth between pages 3 and 4 for 11 seconds.>

X242 Are we supposed to tell you if we were to do the loan, how we would structure it or just that-?

X243 <That would be helpful too.>

X244 <Turns to page 4 and reads for 3 seconds.>

X245 <Turns to page 5 and reads for 10 seconds.>

X246 <Turns to page 3 and reads for 9 seconds.>

X247 <Turns to page 5 and reads for 17 seconds.>

X248 Well, I would say the company shows the ability to meet their, uh, their obligations,

X249 and have met their current obligations.

X250 <Writes word 'company' on paper and begins flipping through the pages of the case as talking.>

X251 Um, their operations . . . have been, uh, fairly stable, X252 <Stops on page 10.>

X253 although, um, not showing any particular growth in, in, income.

X254 <Turns to page 4.>

X255 I don't see any major problems developing within the next year.

X256 <Reads page 4 for 13 seconds.>

X257 I wouldn't have any trouble setting up a $100,000 line of credit

X258 however, I'm, I'm a little uncomfortable about the uh, ownership, closely held ownership of the company,

X259 and the fact that it would be unsecured,

X260 or that, I mean, it's family owned.

X261 <Turns to page 1 and reads for 12 seconds.>

X262 A lot of this would come down to, uh, uh, references that

X263 you know, people who have done, have dealt with them in the bank.

X264 They haven't borrowed before,

X265 so they don't have a credit reputation.

X266 <Reads page 1 for 12 seconds.>

X267 I worry a little bit why they need the money.

X268 Uh, what the cause of borrowing is.

X269 Uh, unless they're planning some, uh, substantial growth this, this next year

X270 which they have not experienced in the past,

X271 so I, I doubt that would be the case.

X272 <Turns to page 4 and reads for 15 seconds.>

X273 So I . . .

X274 <Reads page 4 for 30 seconds.>

X275 <Turns to page 5 and reads for 9 seconds.>

X276 <Turns to page 3 and reads for 9 seconds.>

X277 Um.

X278 <Reads page 3 for 6 seconds.>

X279 I would probably have several other questions I would want to ask them about the operation,

X280 and get, uh, maybe a cash flow statement for the year,

X281 their, uh, projections for the year.

X282 <Loan Officer X receives Supplement on Projected Borrowing Requirements.>

X283 Oh.

X284 <Reads supplement for 28 seconds.>

X285 Well, it's obviously, uh, it's just seasonal requirements,

X286 but why haven't they had those in the past?

X287 <Reads page 3 for 20 seconds.>

X288 You don't have any projections, operating projections for the year?

X289 <No, you should just assume that they did a cash flow statement and that's what they came up with, the net.>

X290 Um hum.

X291 <Reads for 10 seconds.>

X292 And you want a decision based on just this, what I have in front . . .?

X293 <If you can make one. If you can't make a decision then you can tell me what you need in order to

be able to reach a decision.>

X294 Um hum. Well, I don't have any problem with $100,000 credit to this company.

X295 As far as structuring it I think the, you know, the, uh, line of credit situation is very appropriate for the year,

X296 renewable in a year, um, uh,

X297 <Pauses for 10 seconds.>

X298 and I think, I think unsecured credit would be fine.

X299 I would say usually we have a better feel for who the customer is before we uh, before we, uh, uh,

X300 have had some kind of relationship, um, before it's a family owned business,

X301 and offer unsecured and unguaranteed credit, um,

X302 and that's probably something that, that would come into play in this kind of request.

X303 Just do a, a background of the family,

X304 and the, uh, management.

X305 I would probably investigate that.

X306 Saying that that all checked out, um, I, I would extend the credit.

Elapsed Time: 1 hour, 4 minutes.

Loan Officer Y.

Y1 <Reads page 1 for 15 seconds.>

Y2 It's nice that he's brought in four years of statements.

Y3 Most times we don't see that right off the bat.

Y4 <Reads page 1 for 13 seconds.>

Y5 So obviously we're not going to have a lot of time to spend with him certainly,

Y6 so most of the information that we have is here in the package.

Y7 <Reads page 1 for 14 seconds.>

Y8 Stock is widely dispersed at this point.

Y9 I'd like to know how it is actually divided,

Y10 who has the largest percentage of ownership.

Y11 <Reads page 1 for 29 seconds.>

Y12 I'm assuming, without speaking with the customer, that the president and the vice-president and treasurer, those two officers, I'm assuming would have a large percentage of the total stock holdings.

Y13 <Observer says no.>

Y14 Ok.

Y15 <Reads page 1 for 13 seconds.>

Y16 <Turns to page 2 and reads for 29 seconds.>

Y17 So we do have audited statements,

Y18 and we have them for several years,

Y19 which is good, as I mentioned earlier.

Y20 <Turns to page 3 and reads for 25 seconds.>

Y21 In quickly looking over the comparative statements, in the current assets, we do have a, a good increase from 1977 through 1980, as far as absolute dollars.

Y22 We'll get into that a little more carefully as we go into the analysis.

Y23 Investments and other assets.

Y24 Other assets, I'm not real sure what they are including in that.

Y25 <Turns to page 7.>

Y26 We do not, ok, we do have the notes.

Y27 <Reads page 7 for 10 seconds.>

Y28 <Turns to page 3 and reads for 2 seconds.>

Y29 Their investments have dropped,

Y30 and I'm not exactly sure what they are classifying as investments and other assets.

Y31 I would be curious to know that.

Y32 Fixed assets have gone up,

Y33 but not, not substantially.

Y34 The total asset base has increased,

Y35 as has the net worth,

Y36 so they've had, uh, some good increases there over a period of time.

Y37 <Reads page 3 for 11 seconds.>

Y38 Long term obligations have been reducing,

Y39 and they do not have any short term obligations

Y40 except for their normal accounts payable and taxes, things of that sort.

Y41 <Turns to page 4.>

Y42 I'm just quickly going over the numbers right now,

Y43 without getting into a full scale analysis,

Y44 which I'll do shortly.

Y45 Revenues again have increased absolute.

Y46 Gross profit, earnings continue to increase.

Y47 <Reads page 4 for 5 seconds.>

Y48 Nice retention.

Y49 <Turns to page 5.>

Y50 <Turns briefly to page 6.>

Y51 <Turns to page 5 and reads for 10 seconds.>

Y52 I'm looking now at the, the funds statement,

Y53 and, under the categories for funds provided by operations,

Y54 your net earnings, your items not affecting working capital, depreciation, amortization, fine.

Y55 Then we a category in here which I'd like to have have explained,

Y56 even though it's not a large amount out of the total,

Y57 it's equity in loss of, in joint ventures,

Y58 and they did not have that category in 1977 and 1978,

Y59 '79, 1980, however, it was included.

Y60 <Places mark on case next to joint ventures item.>

Y61 I don't know what that represents.

Y62 I'd like to.

Y63 <Reads page 5 for 6 seconds.>

Y64 In 1979 through 1980 they had some good increases in the funds provided by the operations.

Y65 Also have come up with large increases in long term obligations.

Y66 They dropped substantially from '77 through '78,

Y67 remained relatively constant through '79,

Y68 and had a sharp increase again in, in 1980;

Y69 it's more than doubled.

Y70 In which case, if you go over to the funds used for, the application . . .

Y71 additions to property, plant, and equipment,

Y72 so, obviously, have, have financed purchase of property, plant, equipment via the long term obligations.

Y73 I'd like to know what the terms are,

Y74 <Turns to page 7.>

Y75 although it may be provided in some of the notes.

Y76 <Reads page 7 for 5 seconds.>

Y77 Notes appear not to be totally complete.

Y78 I'd like to have some information on their long term obligations.

Y79 <Turns to page 5 and reads for 20 seconds.>

Y80 Investments again relatively constant,

Y81 except for, except for 1979, investments were extremely low.

Y82 So for '79, 1980 they had a nice increase in the working capital.

Y83 <Turns to page 3.>

Y84 Now, let's go back and start analyzing the balance sheet a little more carefully.

Y85 <Prepares calculator.>

Y86 <Reads page 3 for 15 seconds.>

Y87 Ok, on accounts receivable, I'd like to see what the turnover is.

Y88 <Turns to page 4.>

Y89 Um, for 1979, need your total revenues.

Y90 <Inaudible number mentioned. Performs calculations using pages 3 and 4.>

Y91 Ok, the turnover, 6.5.

Y92 <Writes '6.5' on piece of paper.>

Y93 Now, see how their collection period has done.

Y94 <Computes collection period for 1979 as 55 days and writes '55 day' on the paper.>

Y95 55.

Y96 That's .4 days.

Y97 <Writes '.4' on the paper.>

Y98 That'll be for 1979.

Y99 Let's flip back over to the narrative.

Y100 <Turns to page 1 and reads for 16 seconds.>

Y101 <Turns to page 3.>

Y102 I would like to know from Mr. Hudson what his normal terms are.

Y103 Looking at 1979, 55 days.

Y104 For 1980 . . .

Y105 <Computes collection period for 1980 as 56 days and writes '56' on the paper.>

Y106 That's remained relatively constant for that period of time.

Y107 Let's take 1978.

Y108 <Computes collection period for 1978 as 55.>

Y109 So he's been averaging for that period of time approximately 55, 56 days on his receivables.

Y110 <Writes 'A/R turnover - 55 days - 56' on the paper.>

Y111 I'd like to know how that compares with his normal terms.

Y112 <Reads page 3 for 15 seconds.>

Y113 Again looking at the account receivables, all we, all that we have is a net figure.

Y114 I'd like to know what kind of reserve he normally maintains,

Y115 and, also, by the same token, I'd like to know what experience he has had with any of his problem accounts.

Y116 I do not see any notes receivable in here, however, in the categories.

Y117 In which case it appears as if he has had relatively good luck,

Y118 and yet, without knowing what the experience has been actually over the review period, um,

Y119 it's difficult to say, I'm just making an assumption at this point in time.

Y120 Again, as we would normally do in the current asset totals,

Y121 the supplies and the prepaid expenses, we would normally subtract out,

Y122 and that would give us a current asset figure which is more representative.

Y123 Before going to that, let me just quickly run the inventory figures.

Y124 <Begins calculating using pages 3 and 4.>

Y125 Starting now with 1978 and looking at the inventory figures and the turnovers.

Y126 <Calculates the inventory turnover for 1978 as 5.83.>

Y127 In 1978, it looks like 5.8,

Y128 <Writes '5.83' on the paper and computes the turnover in days in 1978 as 62.>

Y129 so for 62 days in 1978.

Y130 <Writes '62 days' on the paper.>

Y131 Let's see what the other periods come out to be.

Y132 1979 . . .

Y133 <Begins calculating.>

Y134 It looks pretty close again.

Y135 <Computes the inventory turnover in 1979 as 5.37 and 67 days and writes '5.37' and '67' on the paper.>

Y136 67 days versus 62 days,

Y137 so it's turning a little bit slower, but not, not appreciably.

Y138 <Begins calculating.>

Y139 It's going to be about the same.

Y140 <Computes the inventory turnover in 1980 as 5.35 and 67 days and writes '5.35' and '67' on the paper.>

Y141 So in 1980 and 1979, same, same turnover for the inventories.

Y142 Little bit slower by about 5 days or so, compared with 1978 and . . .

Y143 However, if you flip back over to 1977 . . .

Y144 What I'm doing really is taking three years at this point in time.

Y145 We have a lot of information here,

Y146 which is very good to have,

Y147 but I'm just taking three years comparative in most of the information,

Y148 but since the, if you take a look at the revenues for 1977 versus 1978,

Y149 it only increased absolute dollars by about 100,000.

Y150 however, the cost of revenues for 1977 was $985,000,

Y151 in 1978, it was 1.67,

Y152 and yet the inventory level in 1977 versus 1978 was a lot higher,

Y153 so let's just flip back over and see what the days were in 1977.

Y154 <Computes the inventory turnover in 1977 as 4.93 and 73 days and writes '4.93' and '73' on the paper.>

Y155 So there has been an improvement.

Y156 In 1977 the inventory turn was 73 days.

Y157 It improved in 1978, which was the low period, 62 days.

Y158 Increased a little bit in 1979,

Y159 and remained constant in 1980.

Y160 So he has improved or did improve in 1977,

Y161 or in 1978 he was able to drop it substantially,

Y162 and it has been, remained relatively constant from there.

Y163 <Turns to page 1 and reads for 36 seconds.>

Y164 Um, I was just running back over the narrative, on the type of store,

Y165 getting, not being all that familiar with, with a retail soft good, hard good operation from the standpoint of looking at the, the inventory, the turnover for that particular operation,

Y166 I'd like to compare with some industry standards

Y167 and see if they, uh, match well with their, their other competitors.

Y168 Yet, by the same token, he has done a good job since 1977 in reducing it

Y169 and also keeping it constant.

Y170 Uh, however, without knowing what the industry norms would be, it's difficult to make a, uh, a true assessment on something like that.

Y171 However, he's turning it several times a year,

Y172 which is good to see.

Y173 He went from, um, 4.93 in 1977 to 5.35 in 1980,

Y174 so he's turning it more frequently,

Y175 which is nice to see.

Y176 <Turns to page 3.>

Y177 Ok, let's, let's calculate his working capital position.

Y178 We're going to have to subtract out supplies and prepaid expenses.

Y179 <Writes in each column of the comparative balance sheets the amounts to be subtracted from the current assets.>

Y180 <Computes the adjusted current assets for 1978 as 425,432 and writes it in the 1978 balance sheet column.>

Y181 <Begins calculation for 1979.>

Y182 And again I'm just running 1978 through 1980.

Y183 <Computes the adjusted current assets for 1979 as 531,433 and writes it in the 1979 balance sheet column.>

Y184 <Computes the adjusted current assets for 1980 as 597,992 and writes it in the 1980 balance sheet column.>

Y185 Um, let's, let's take a look at the, the current liabilities,

Y186 make sure we don't have to take out anything in those.

Y187 Accounts payable, taxes, accrued liabilities, current-, ok.

Y188 So calculating a current position . . .

Y189 <Computes the working capital in 1978 as 242,262 and writes it at the bottom of the 1978 balance sheet column in a row labelled 'WC1'.>

Y190 in 1978, it was 242,000.

Y191 In 1979 . . .

Y192 <Computes the working capital in 1979 as 259,881 and writes it at the bottom of the 1979 balance sheet column.>

Y193 it increased a little bit up to 260 approximately.

Y194 1980 . . .

Y195 <Computes the working capital in 1980 as 282,322 and writes it at the bottom of the 1980 balance sheet column.>

Y196 Ok, let's see what the current ratios look like now.

Y197 He's had some good increase there.

Y198 <Writes 'current ratio' at the bottom of the page as a label for a new row.>

Y199 <Computes the current ratio in 1978 as 2.32.>

Y200 Ok, in 1978, 2.32.

Y201 <Writes '2.32' at bottom of 1978 balance sheet column.>

Y202 1979 . . .

Y203 <Computes the current ratio in 1979 as 1.96.>

Y204 ok, it dropped down, 1.96.

Y205 <Writes '1.96' at bottom of 1979 balance sheet column.>

Y206 1980 . . .

Y207 <Computes the current ratio in 1980 as 1.89.>

Y208 it dropped down again to 1.89.

Y209 <Writes '1.89' at bottom of 1980 balance sheet column.>

Y210 So he's relying more heavily on his current assets at this particular point in time.

Y211 And again his current liabilities have increased,

Y212 primarily in the long term obligations, the current portion of the long term obligations.

Y213 Uh, his taxes, accrued, accruals have increased, income taxes.

Y214 Primarily it's in the accounts payable.

Y215 <Reads page 3 for 6 seconds.>

Y216 I'd like to see an aging of his payables,

Y217 s-, see what's in there,

Y218 see if there's anything that's extremely old, uh,

Y219 if he's past due on one or two several accounts, one or two major accounts,

Y220 uh, that's of concern.

Y221 It's, the current ratio is, is under 2.0.

Y222 We'd like to see it at least around that level.

Y223 <Reads page 3 for 19 seconds.>

Y224 Ok, let's see . . .

Y225 <Reads page 3 for 11 seconds.>

Y226 Let's take a look at the, at his debt to net worth.

Y227 He doesn't have any, any goodwill or any other intangibles in the asset category.

Y228 So what we're looking at as far as the listing on the shareholders' equity, we would not have to make adjustments here.

Y229 <Draws parentheses around total current liabilities and long term debt in columns for 1978 through 1980 to indicate what is to be added in calculation of total debt.>

Y230 Ok, his debt to net worth (inaudible).

Y231 <Computes total liabilities in 1978 as 446,992 and writes it by the 1978 items.>

Y232 <Computes total liabilities in 1979 as 512,763 and writes it by the 1979 items.>

Y233 <Computes total liabilities in 1980 as 541,999 and writes it by the 1980 items.>

Y234 <Writes 'debt:N/W' at bottom of page as label for new row.>

Y235 Ok, so his liabilities, 1978 . . .

Y236 <Computes the debt to equity ratio in 1978 as 1.09 and writes it at the bottom of the page.>

Y237 Ok, 1.09.

Y238 His liabilities increased substantially, absolute dollars, in 1979.

Y239 <Computes the debt to equity ratio in 1979 as 1.13.>

Y240 So the ratio increased again a little bit up to 1.13.

Y241 <Writes '1.13' at the bottom of the page.>

Y242 1980 . . .

Y243 <Computes the debt to equity ratio in 1980 as 1.05.>

Y244 However, it dropped again to 1.05.

Y245 <Writes "1.05" at the bottom of the page.>

Y246 So even though his accounts payables increased in 1980,

Y247 <Turns to page 4.>

Y248 which would make sense because his revenues increased substantially.

Y249 <Turns to page 3.>

Y250 Um, he was also reducing his long term obligations,

Y251 as well as his current portion of the long term debt so,

Y252 I'm assuming those were mortgages on the, on the property and plant.

Y253 <Reads page 3 for 9 seconds.>

Y254 Ok, let's switch over to the income statement.

Y255 <Turns to page 4 and reads for 8 seconds.>

Y256 We've got, we've had some nice absolute increases in the revenues.

Y257 Let's see what some of the percentages and profitability ratios will give us.

Y258 <Marks 1978 column with parenthesis connecting revenue and gross profit figures.>

Y259 <Reads page 4 for 9 seconds.>

Y260 <Computes gross profit percentage in 1978 as 29% and writes it on the case next to the gross profit figure.>

Y261 1978, the gross profit margin was 29%.

Y262 1979 . . .

Y263 <Computes gross profit percentage in 1979 as 31% and writes it on the case.>

Y264 31%.

Y265 Slight increase there percentagewise.

Y266 1980 being the, the highest level in the review period.

Y267 <Computes gross profit percentage in 1980 as 31%.>

Y268 Um, increased a small amount.

Y269 <Writes 31% on the case.>

Y270 So while he had a, a substantial increase in the actual revenues,

Y271 the cost of the, cost of goods was not controlled perhaps as much as it could have been,

Y272 with the gross profit coming out to be approximately the same as what it was in 1979.

Y273 Higher sales between '79 and '80,

Y274 and yet the profit margin remained the same.

Y275 Um, let's see what he did from the standpoint of the, the operating expenses.

Y276 <Reads page 4 for 10 seconds.>

Y277 <Computes earnings before income taxes as a percentage of revenues in 1978 as 3% and writes it on the case next to the 1978 earnings before income taxes figure.>

Y278 <Computes earnings before income taxes as a percentage of revenues in 1979 as 6.3% and writes it on the case.>

Y279 Ok, his, his operating margin before tax, 1978 was 3%.

Y280 1979, 6.3%.

Y281 1980 . . .

Y282 <Computes earnings before income taxes as a percentage of revenues in 1980 as 7% and writes it on the case.>

Y283 increased again,

Y284 so he did a good job in 1980 with the profit margin remaining stable.

Y285 Increased revenues in 1980 compared with 1979,

Y286 the gross profit margin remained constant,

Y287 except for a small increase.

Y288 However, the net 1979 stands at 6.3,

Y289 1980 at 7%,

Y290 so he did a better job in 1980 in controlling his expenses, his operating expenses.

Y291 Let's see what the net figures indicate.

Y292 I think before we go to that I'm just going to, to jump back over to 1977 and see what those figures indicate.

Y293 <Computes earnings before income taxes as a percentage of revenues in 1977 as 3.7% and writes it on the case.>

Y294 Well, 1980 was the, the best year of the review period then certainly.

Y295 1977 was 3.7,

Y296 '78, 3%,

Y297 up to 6.3,

Y298 and the high in, 7% in 1980.

Y299 Now we get to your taxes.

Y300 Alright your retention here, 28 . . .

Y301 <Computes net earnings as a percentage of revenues in 1978 as 1.9% and writes it on the case next to the net earnings figure.>

Y302 Alright, the after tax profit margin, 1978, was 1.9%.

Y303 1979 . . .

Y304 <Computes net earnings as a percentage of revenues in 1979 as 3.1% and writes it on the case.>

Y305 was a good increase, percentagewise,

Y306 and obviously dollarwise also,

Y307 up to 3.1%.

Y308 Absolute dollars there was a nice increase in 1980.

Y309 See what the percentages will show us.

Y310 <Computes net earnings as a percentage of revenues in 1980 as 3.9%.>

Y311 3.9%.

Y312 <Writes 3.9% on the case.>

Y313 <Computes net earnings as a percentage of revenues in 1977 as 2.4% and writes it on the case.>

Y314 So he's had some fluctuation.

Y315 1977, his profit margin was 2.4,

Y316 down to 1.9.

Y317 There was the expenses probably which, the operating expenses which were s-, directly attributable to that decrease,

Y318 but then it went back up in 1979 to 3.1,

Y319 1980, up to a high of 3.9%.

Y320 So he's had some good numbers there, absolute dollars, percentages, uh,

Y321 the trend as far as his profitability,

Y322 and his total revenues appears to be encouraging.

Y323 Um, he had some good expense control in 1980.

Y324 <Reads page 4 for 19 seconds, occasionally briefly flipping to page 3.>

Y325 Some more comparatives.

Y326 Ok, sales figures to his net worth.

Y327 <Writes 'sales:NW' as label for new row on bottom of page 3.>

Y328 <Uses pages 3 and 4 to compute the sales to net worth percentage in 1978 as 3.67 and writes it in the 1978 column.>

Y329 1978 was 3.67.

Y330 1979 . . .

Y331 <Computes sales to net worth percentage in 1979 as 3.74 and writes it in the 1979 column.>

Y332 3.74.

Y333 1980 . . .

Y334 <Computes sales to net worth percentage in 1980 as 3.60 and writes it in the 1980 column.>

Y335 It took a little bit of a dip, 3.60,

Y336 this was again comparing the three years,

Y337 but it still looks to be sufficient levels.

Y338 1980 seemed to be a,

Y339 <Turns to page 4.>

Y340 a year of increased sales,

Y341 increased profitability in, in absolute dollars,

Y342 <Turns to page 3.>

Y343 and there was an increase in the accounts payable <inaudible word due to phone ringing>.

Y344 Ok, let's see what the receivables look like as a-, in relationship to the total asset figure.

Y345 1980 figures . . .

Y346 <Computes ratio of accounts receivable to total assets in 1980 as .27 and writes 'A/R:total assets .27%' in 1980 column on page 3 under total assets figure.>

Y347 <Computes ratio of accounts receivable to total assets in 1979 as .27 and writes it in the 1979 column.>

Y348 so far seems to be relatively constant here.

Y349 <Computes ratio of accounts receivable to total assets in 1978 as .27 and writes it in the 1978 column.>

Y350 <Computes ratio of accounts receivable to total assets in 1977 as .27 and writes it in the 1977 column.>

Y351 That has remained constant throughout the review period.

Y352 which is, is good to see,

Y353 he's not relying on his, uh, on his trade creditors, I mean on, on his uh, on his customers.

Y354 Let's see what else we've got here, um.

Y355 I'd like to see an aging of the accounts receivable figures,

Y356 see if there's any problems there,

Y357 if he sells to uh, several large, large customers

Y358 and that would make up the bulk of the receivables,

Y359 or whether or not they are spread out relatively evenly again-, amongst a variety of customers.

Y360 See if there are any problems within that account receivable total.

Y361 <Reads page 3 for 8 seconds.>

Y362 <Turns to page 5 and reads for 3 seconds.>

Y363 <Turns to page 6 and reads for 14 seconds.>

Y364 I'm looking now at the comparative statement of changes in the financial position, on the increases and the decreases in the components within the working capital.

Y365 <Reads page 6 for 6 seconds.>

Y366 In the accounts receivables, 1977 through 1978, it took a substantial decrease,

Y367 went back up in 1979,

Y368 and then 1980 slight increase, absolutewise.

Y369 Increase in the current assets within the four year review period,

Y370 '77, '78, uh, in 1977 the increase was 22,000,

Y371 in 1977, um, negative $682.

Y372 And then you go back up into a positive figure in 1979, up to 100,000, 105,000.

Y373 You, in 1978 you had the, the decrease in the inventory for, for almost, uh, 17,000,

Y374 which caused that, that negative figure, the decrease in the current assets for the total review period.

Y375 1980 has a small reduction from nine-,

Y376 well, not small, but absolutewise,

Y377 between 1979 and 1980 it goes from 105,000 down to 65,000.

Y378 The receivables, ok, that remains relatively constant,

Y379 where it is, is a dip in the cash,

Y380 in which case you look down at the accounts payable, and that was reduced.

Y381 The accruals were reduced.

Y382 So your reductions in the cash between 1979, nine-, 1978,

Y383 <Makes dash marks next to cash, inventory, and accounts payable numbers in 1979 and 1980.>

Y384 we had the reduction in the cash,

Y385 receivables remained relatively constant,

Y386 they had a reduction in the inventory levels.

Y387 And the numbers, numbers bear it out in the reduction in the accounts payable.

Y388 And then also in the accruals.

Y389 <Reads page 6 for 14 seconds.>

Y390 <Turns to page 7.>

Y391 I'm just looking back over to some of the notes.

Y392 Alright, they did have one explanation.

Y393 A retail customer accounts receivable written off in full when any portion of the unpaid balance is past due twelve months. Alright.

Y394 <Reads page 7 for 10 seconds.>

Y395 And current aging of the accounts . . .

Y396 <Reads page 7 for 7 seconds.>

Y397 thirty day accounts, and the totals,

Y398 <Turns to page 1.>

Y399 Deferred payment accounts.

Y400 I'm looking back on the, on the written statement whether or not it's explained in there.

Y401 <Reads page 1 for 5 seconds.>

Y402 <Turns to page 7.>

Y403 I'd like to know what those deferred payments accounts are, Y404 how they are billed for those account receivables.

Y405 If we're looking at your thirty day accounts,

Y406 and then take into consideration that the vast majority of their accounts receivable are these deferred payment accounts,

Y407 then you take a look at your account receivable turnover which we had calculated previously,

Y408 and that probably follows then, uh, if we're looking at an average of anywhere from 63 to 67 days as a receivable turnover,

Y409 depending upon what the terms of those deferred payment accounts are.

Y410 <Underlines 'deferred payment accounts' on page 7.>

Y411 I would assume that they must be meeting their terms,

Y412 but I'd like to ask the customer what those payment accounts actually represent,

Y413 and what the terms are.

Y414 Uh, it looks like the vast majority of their customers are on deferred payments.

Y415 <Reads page 7 for 7 seconds.>

Y416 Then you have other accounts, representing what, I'm not really sure,

Y417 and your allowance for losses.

Y418 And it states here that the allowance losses arising from uncollectible customer accounts receivable is based on historical bad debt experience.

Y419 So you look at the total dollar amount that's outstanding at the end of, of each year,

Y420 and you look at the allowance, and it, it really is not substantial.

Y421 What would, what would concern me without an explanation would be that, would be the heavy, uh, amount which is in that deferred accounts payable, I mean, accounts receivable.

Y422 <Makes a mark next to the 1980 balance listed in the note.>

Y423 If in fact we were to take,

Y424 even though they are requesting an unsecured line of credit,

Y425 if in fact we were to take an assignment on the receivables, um,

Y426 with progress payments, collectibility would be questionable.

Y427 Fixed assets, property, plant, and equipment, carried at cost.

Y428 Land, building and improvements, fixtures and equipment, construction in progress.

Y429 <Turns to page 1.>

Y430 Must be doing some addition.

Y431 <Reads page 1 for 25 seconds.>

Y432 <Turns to page 3 and reads for 7 seconds.>

Y433 Alright, he is requesting a $100,000 line of credit,

Y434 unsecured basis.

Y435 <Turns to page 1 and reads for 12 seconds.>

Y436 It is a closely held company,

Y437 in which case, as we mentioned earlier, we had the total stock ownership in the company dispersed amongst several members of the family.

Y438 I don't know if they would have any aversion to personally guaranteeing the obligation,

Y439 but I certainly would approach them in that regard.

Y440 <Turns to page 3.>

Y441 And in line with the review of, of their, their personal financial situation,

Y442 would ask for personal statements,

Y443 <Turns to page 1.>

Y444 certainly on the, on the majority shareholders.

Y445 <Turns to page 3.>

Y446 Otherwise I think what we would be looking at would be a secured line of credit,

Y447 lien on all of the, all the assets of the company,

Y448 primarily on the accounts receivable and the inventories.

Y449 He's had some good steady growth in the company.

Y450 <Turns to page 4.>

Y451 He continues to be profitable.

Y452 <Turns to page 3.>

Y453 A debt to net worth, in 1980 it dropped from a 1.3 down to a 1.5, uh,

Y454 with the line of credit available, uh, it's going to increase somewhat.

Y455 However, looking at the total equity position of the company,

Y456 <Turns to page 1.>

Y457 I think it would be, uh, worthy of pursuing,

Y458 although be-, before I made any kind of ultimate decision, I would like to see an aging of those payables,

Y459 and I would like to know a little bit more about the stock ownership of the company.

Y460 I just want to make sure that I'm not missing something in the, in the beginning of the, the narrative.

Y461 <Reads page 1 for 11 seconds.>

Y462 He's asking for an answer in a few days.

Y463 Well, he's given us substantial information on the, on the number of years worth of statements.

Y464 <Turns to page 4.>

Y465 It would be good if we could take a look at the, uh, at a more complete breakdown of the operating expenses.

Y466 Since we had some fluctuation in those expense numbers within the review period,

Y467 I'd like to know what the officers are taking out of the company.

Y468 Would like to see what the depreciation figures are,

Y469 salaries, things of that sort.

Y470 Being able to more completely review the operating numbers

Y471 instead of just merely looking at, at a, uh, uh, a gross number for the operating expenses,

Y472 and being able to, uh, or having it as a result, to really look at the total numbers without being able to, uh, investigate more carefully the individual makeup of that expense figure.

Y473 However, it is good that he has been able to give us this,

Y474 <Turns to page 3.>

Y475 the financial information for four years.

Y476 A lot of times we don't get that.

Y477 In reviewing the ratios, the numbers, the percentage increases, I mentioned he has had some, some good years here,

Y478 continues to have a good retention.

Y479 <Turns to page 1.>

Y480 We do have an au-, an audited statement.

Y481 One thing I would do when we get that, uh, aging of the accounts payables,

Y482 <Turns to page 3.>

Y483 in order to make sure there is nothing unusual within that total, uh,

Y484 it stands in 1980 at $175,000,

Y485 <Turns to page 1.>

Y486 in the aging, if there are some, uh, large concentrations with one or two accounts,

Y487 I'd just like to quickly, uh, uh, make a trade, uh, or get a trade report on those accounts.

Y488 It states here the, uh, the D&B report all, all trade accounts were satisfactory.

Y489 Um, however, from the standpoint of using D&B, I would really prefer to use our, our own personal information,

Y490 and go back to the accounts themselves and verify that.

Y491 <Reads page 1 for 9 seconds.>

Y492 Now one thing which is a-, again I had missed it earlier, the credit terms included both revolving thirty day accounts and installment sales.

Y493 And it looks like the greatest percentage would be in the installment sales.

Y494 <Flips through the case, but returns to page 1 and reads for 18 seconds.>

Y495 I'm just again reviewing some of the, the background information here.

Y496 The customer has, uh, has been a bank customer for several years.

Y497 It's an old established company.

Y498 The unsecured basis for the line of credit, um,

Y499 would not do it unsecured unless in fact we, we had the personal guarantees of the owners of the company, whoever they may be,

Y500 and a determination on that would not be able to be made without seeing the financial position of those individuals.

Y501 Of closely held corporations such as what we have here, um, it would be very rare not to have the personal guarantees.

Y502 <Reads page 1 for 10 seconds.>

Y503 Average balances, $35,000,

Y504 that's a nice account.

Y505 Every now and then appear to d-, uh, to have excess funds,

Y506 and have been investing in CDs.

Y507 Haven't had to utilize bank credit.

Y508 Presumably have been able to handle it, uh, either internally themselves,

Y509 <Turns to page 3.>

Y510 although in, in recent years they don't seem to have, have put in any of their own money in the, the form of, uh, of debt.

Y511 It looks as if everything from the standpoint of the, the equity position of the company has been actual retention of profits.

Y512 <Turns to page 4.>

Y513 The profitability levels appear to be good,

Y514 a continual increase in revenues.

Y515 Uh, let's just get . . .

Y516 <Reads page 4 for 14 seconds.>

Y517 Dividend levels seem to be appropriate within each one of the review periods for the, the profitability of the company, in any given year.

Y518 <Turns to page 3.>

Y519 Don't want to see the debt get, debt too much out of line.

Y520 I would like to have a little more information,

Y521 <Turns to page 7.>

Y522 uh, again I'm not so sure if we do have all the notes, perhaps we do,

Y523 but one thing which would be missing,

Y524 and we would be able to get it from, from the customer I would assume,

Y525 <Turns to page 3.>

Y526 is a breakdown of those long term obligations.

Y527 Uh, and then to be able to take the, the current portion in, in any given year,

Y528 uh, calculate what it's going to be, let's say, from 1980, '81, excuse me, uh,

Y529 <Turns to page 4.>

Y530 look at cash flow which has been generated from the the company.

Y531 Need to know the depreciation figures to get a truer reflection of that cash flow number, uh.

Y532 <Turns to page 3.>

Y533 Assuming that they have not had any problems in meeting their, their long term obligations, uh,

Y534 we could always verify that if we felt that it was necessary.

Y535 But again without having a little more information as far as who the, the holder of that note is it's difficult to say.

Y536 <Loan Officer Y receives Supplement on Long Term Debt which is read for 8 seconds.>

Y537 Ok, on three of their, of their store locations.

Y538 It helps, and yet, by the same token, uh, again, looking at the cash flow situation, and just making an assessment of, uh,

Y539 assuming at this point in time that they have not had any problems meeting their long term obligations, uh,

Y540 without knowing a little bit more detail about each individual loan,

Y541 what the terms are,

Y542 how much longer they have to run,

Y543 um, I would like to also know what their plans are in the next couple of years,

Y544 especially within the next year when the line of credit would be available,

Y545 what they expect to be doing, if anything, from the standpoint of capital acquisitions.

Y546 Um, obviously, uh, they own a couple of their stores,

Y547 whether or not they, they own all of them, I think there was some information in here . . .

Y548 <Turns to page 7.>

Y549 Long term noncancellable leases . . .

Y550 <Turns to page 3.>

Y551 Whether or not they expect to open up any new stores,

Y552 in which case whether or not they are going to, uh, incur any additional long term obligations in, in the next year,

Y553 which would be the period of time when, when the line of credit would be available.

Y554 Um, yes, it helps, your supplement helps, and yet by the same token, I think I'd like to see a little bit more information.

Y555 <Reads page 3 for 16 seconds.>

Y556 And . . .

Y557 <Turns to page 5 and reads for 13 seconds.>

Y558 <Turns to page 6 and reads for 6 seconds.>

Y559 I'm just looking back over some of the changes

Y560 <Turns to page 5.>

Y561 in the funds statement.

Y562 <Reads page 5 for 9 seconds.>

Y563 Uh, the disposals of property and equipment,

Y564 the funds were provided by increase in long term obligations.

Y565 Alright, if you, you look at the review period from 1979 to 1980, the increase in long term obligations went up,

Y566 almost doubling.

Y567 The disposals of the property and the equipment also increased substantially, um.

Y568 <Turns to page 3.>

Y569 Looking back over to the, the balance sheet . . .

Y570 <Reads page 3 for 9 seconds.>

Y571 Ok, long term obligations

Y572 and the plant and equipment net . . .

Y573 <Reads page 3 for 9 seconds.>

Y574 <Turns to page 5 and reads for 9 seconds.>

Y575 I'd like to know what the disposals were, uh,

Y576 I'm assuming he sold off some property, perhaps,

Y577 and this again is looking, comparing between 1979 and 1980.

Y578 There was also 'mortgages assumed by purchasers of office properties and payment on long term debt'.

Y579 This is in the uses of funds.

Y580 <Reads page 5 for 9 seconds.>

Y581 Except for the period 1977 to 1978, the net result, the changes in their financial position, in their working capital, um, have had good increases in the working capital position.

Y582 <Turns to page 3.>

Y583 Um, though as we saw earlier, we've had a decrease in the, in the current ratio itself, um, in the review period,

Y584 and again I was doing 1978 through 1980, it goes from 2.32 down to 1.89.

Y585 Uh, heavier in the, let's see in the accounts receivable, reliance there,

Y586 also in the, in the inventories.

Y587 One thing which we didn't calculate,

Y588 going along with the current ratio,

Y589 looking at the, at the liquidity,

Y590 let's take the cash and the accounts receivable

Y591 <Marks parentheses around cash and accounts receivables numbers in 1978, 1979, 1980.>

Y592 and compare it with the current liability totals,

Y593 see what the reliance is there.

Y594 <Computes total of cash and accounts receivable in

1978 as 242,123 and writes it next to the 1978 column.>

Y595 <Computes total of cash and accounts receivable in 1979 as 314,404 and writes it next to the 1979 column.>

Y596 <Computes total of cash and accounts receivable in 1980 as 360,270 and writes it next to the 1980 column.>

Y597 Let's see, if we're taking the cash and the accounts receivable in relation to the current liabilities . . .

Y598 <Computes quick ratio in 1978 as 1.32 and writes it at the bottom of page 3 just below the current ratio in the 1978 column.>

Y599 1978 calculates at 1.32,

Y600 for a current ratio of 2.32,

Y601 <Computes quick ratio in 1979 as 1.16 and writes it in the 1979 column.>

Y602 1.16 in 1979,

Y603 and 36, 26 . . .

Y604 <Computes quick ratio in 1980 as 1.14 and writes it in the 1980 column.>

Y605 1.14,

Y606 in 1978 there was a much higher reliance on the inventory to meet the current liabilities, uh,

Y607 in, in 1979 it goes to 1.16,

Y608 1980, 1.14,

Y609 stays relatively the same,

Y610 yet by the same token, there, there really is a good reliance on that inventory level.

Y611 Um, not having been out and visiting with the company, Y612 I'd like to know what, what the inventory is comprised of, uh,

Y613 <Turns to page 1.>

Y614 I personally would like to go out and visit them,

Y615 even though we have a call report from the business development officer, uh,

Y616 I am assuming that I have not been out there to meet with the people

Y617 and to see the location myself.

Y618 I would do that, um.

Y619 <Turns to page 3.>

Y620 I don't know that it would be necessary in these particular circumstances, knowing what we do about the company with the financial information,

Y621 that I, I would do it certainly prior to any credit extension.

Y622 But I certainly would like to get out there, uh, as soon as possible and meet with them,

Y623 see the location.

Y624 It always is of value, never can hurt, and if anything, it can help substantially.

Y625 <Turns to page 1.>

Y626 But the information that we have here in the writeup from the other bank people,

Y627 from Dun and Bradstreet, things of that sort,

Y628 uh, I think we can assume what the company is going to look like as far as the premises, things of that sort.

Y629 <Turns to page 3.>

Y630 But I would just like to know a little more about the, what their inventory is comprised of.

Y631 <Turns to page 4.>

Y632 I would say looking at their profitability ratios,

Y633 their liquidity ratios,

Y634 with the background information that we have,

Y635 the amount of financial data which is available for the review,

Y636 I think we can see a good trend here,

Y637 e-, even though there are some things which, uh, perhaps they should be, they should be looking at,

Y638 and we should be re-, reviewing, uh, uh, to a greater extent.

Y639 <Turns to page 3.>

Y640 I think we certainly would want to pursue it without a doubt, uh,

Y641 I would, would just like to have an aging of the pay-, of the receivables,

Y642 aging of the payables,

Y643 would like to know a little more about the, the ownership of the company,

Y644 and how it is structured,

Y645 presumably would want to have the personal statements,

Y646 assuming we would have the, the individual stockholders on the note, uh,

Y647 and I think, depending upon that o-, ownership

Y648 and the financial condition of, of those individuals,

Y649 may or may not require personal guarantees.

Y650 <Loan Officer Y receives Supplement on Aging of Accounts Receivables which is read for 11

seconds.>

Y651 Ten percent of the outstanding balance principal-

Y652 <Reads supplement for 22 seconds.>

Y653 Alright, no problem presumably, excuse me, on thirty day accounts,

Y654 and the deferred payment accounts, the majority of those are picked up within 30 to 90 days.

Y655 There are some problems there in the over 90 day category.

Y656 <Reads supplement for 8 seconds.>

Y657 From the standpoint of us lending on, on the receivables then,

Y658 with the deferred payment account, uh,

Y659 of which a vast majority of their accounts receivables are that type of account, uh,

Y660 what we really would be relying upon more than anything else I think would be the inventory.

Y661 There is value, yes, to the receivables,

Y662 but from the standpoint of, uh, of a bank lending on the receivables,

Y663 and especially on a deferred payment account, uh,

Y664 if for some reason their customers happen not to pay them, uh,

Y665 even though there's interest rates, whatever, uh,

Y666 I think it would be, be difficult to best for us to collect on something like that.

Y667 I think the aging both on the thirty day accounts and the deferred payment accounts indicate that, uh, on your sales contracts, on everything, on your accounts receivable totals, they do not seem to have a lot of problems.

Y668 Yet by the same token, the deferred payment account being the largest proportion of the total account receivable balance, um,

Y669 I think it hampers our, our ability to, uh, uh, use that, or to view that asset as one which we would use for purposes of lending.

Y670 I think really what we're looking at now is the, uh, ability of the company to generate their profits,

Y671 which they have been doing,

Y672 <Turns to page 3.>

Y673 looking at the other assets of the company, which primarily would be the, uh, inven-, inventory and the cash position,

Y674 looking at the ownership of the company,

Y675 presumably having the personal guarantees then as a result.

Y676 Um, on the accounts receivable, the deferred payment accounts . . .

Y677 <Turns to page 1.>

Y678 this is a retail soft good, hard good store.

Y679 Ok, um, so in which case the majority of these accounts receivables are from individuals I'm assuming, as a result, uh,

Y680 <Reads page 1 for 6 seconds.>

Y681 <Turns to page 3.>

Y682 That makes it even more difficult for us to ac-, actually look at the accounts receivable and view them as something which, uh, is a good and hard asset.

Y683 So I think now what we are looking at primarily would be the, the profitability of the company over the period of time,

Y684 which we've been able to analyze with the comparative numbers.

Y685 Uh, I think without a doubt we would, uh, want to see the individuals guaranteeing on the, on the obligation.

Y686 We would still nonetheless take a, a, presumably take a secured position,

Y687 but it would be on the inventories and th-, and the rest of the assets which they would have,

Y688 not a direct buying obviously,

Y689 or a direct mortgage on the property certainly,

Y690 but just a general filing on the corporate assets.

Y691 <Turns to page 4.>

Y692 But they have had some good earnings ability.

Y693 <Turns to page 3.>

Y694 The equity position in the firm looks good.

Y695 It is a long standing customer of the bank, and

Y696 <Turns to page 1.>

Y697 it is also an old established company itself, um.

Y698 They've been banking with us here,

Y699 we wouldn't want to lose them to our competition at this point.

Y700 Um, they have been able to invest with us from time to time.

Y701 <Turns to page 3.>

Y702 So I think my questions now would be primarily, um, ownership of the company, um,

Y703 accounts payable, if in fact there are any real problems in those payables,

Y704 and once we know the ownership of the company, covering with them, uh, any aversion to, problems with personal guarantees.

Y705 On something like this especially I think we would, uh, need to have the personal guarantees.

Y706 The type of receivable that we're dealing with as, as a receivable from an individual,

Y707 and especially with deferred payments on it, uh,

Y708 in, in liquidation, not that we're looking at the worst case, but certainly, in liquidation if something were to happen with Hudson Stores,

Y709 um, it would be difficult for us to collect from those individuals,

Y710 and so the value of the receivables,

Y711 while their experience has, has not been unfavorable certainly with problem accounts,

Y712 nonetheless it would be difficult for the bank as the lender to step in and continue collecting on those account receivables.

Y713 Um, I think once we got the information on the ownership,

Y714 and the payables, um,

Y715 I think we could get an answer back to him very quickly.

Y716 He had asked for an answer in a few days,

Y717 I think we certainly could oblige him with that,

Y718 and presumably it, it would be a favorable inclination.

Y719 <Observer asks for a clarification about the necessity of personal guarantees.>

Y720 Um, I would feel that we would need the personal guarantees.

Y721 But we'd still want to know what the ownership is,

Y722 and what we normally would be looking at would be the majority stockholders.

Y723 In other words, if we had somebody who's in there with one percent or two percent ownership, right, um, we would not necessarily be interested in their personal guarantee.

Y724 Uh, you had mentioned earlier about, um, um, John Hudson as the president and his brother, Bill, as vice president and treasurer, that they would not necessarily as officers of the corporation, um, as president and v.p. would not necessarily, uh, be construed to be the largest stockholders.

Y725 <Observer nods affirmatively.>

Y726 Ok, uh, yet by the same token they are the ones who are operating it,

Y727 as compared with the individuals, uh, who perhaps would have a larger percentage of ownership in the company.

Y728 Um, with it being a family situation, um, I think we'd just have to sit down with them, and, and, and, uh, review our feelings on the personal guarantees.

Y729 They might have some aversions to having, um, family members who are not involved in the day to day operations guaranteeing on, o-, on the debt.

Y730 Um, however, we want the, the individuals who are involved,

Y731 both in the operations, and, and the ownership of the company, uh, uh,

Y732 to guarantee and promise that, yes, if something were to happen to Hudson Stores,

Y733 that, uh, we would be able to receive payment, or work with them to receive our final payment.

Y734 But a lot of times when you're involved with a family situation,

Y735 and you do have individuals who are operating the company, but do not necessarily have majority, uh, ownership in the firm, Y736 then you get in, into some problems,

Y737 so I think we could negotiate that presumably, and work with them, um.

Y738 We would not want to antagonize them,

Y739 and yet by the same token I think we feel that, uh, we would want to have their guarantees,

Y740 and so we would work with them in trying to resolve whatever problems or misunderstandings they may have in that regard.

Y741 <Observer asks if receiving the guarantees and satisfactory information about the accounts payable would be all that was necessary in order to grant the credit.>

Y742 Um hmm, um hmm, yes.

Elapsed time: 1 hour, 17 minutes.

Loan Officer Z.

Z1 <Reads page 1 for 1 minute, 32 seconds.>

Z2 <Turns to page 2 and reads for 12 seconds.>

Z3 <Turns to page 3 and reads for 3 seconds.>

Z4 Ok, one thing I'd want to see is, uh,

Z5 for short term,

Z6 is, uh, you know, month to month projections

Z7 just to see where their, you know, where their needs were going to arise

Z8 or, you know, what caused their needs.

Z9 <Reads page 3 for 3 seconds.>

Z10 Another thing, is the guy going to sign, you know, personally,

Z11 or willing to sign personally?

Z12 <Reads page 3 for 15 seconds.>

Z13 Ok, is this thing, uh, is this like the thousands omitted or . . . ?

Z14 <No.>

Z15 No, this is just the way it is, ok.

Z16 <Reads page 3 for 13 seconds.>

Z17 Ok, total equities . . .

Z18 Ok, is that . . . ?

Z19 I don't understand that.

Z20 I mean, I mean, . . . I always thought of equity being, um, capital stock or retained earnings.

Z21 <The whole section is titled 'equities'.>

Z22 Oh, ok, well, I don't, I don't like that.

Z23 'Cause, I mean, part of that's liabilities as far as I'm concerned.

Z24 <Turns to page 4 and reads for 17 seconds.>

Z25 <Turns to page 5 and reads for 5 seconds.>

Z26 <Turns to page 6 and reads for 4 seconds.>

Z27 <Turns to page 7 and reads for 29 seconds.>

Z28 Ok, as far as the leases, uh, . . .

Z29 are, uh, those operating leases or capitalized leases or . . . ?

Z30 Because it doesn't really indicate how much, uh, as far as outstanding.

Z31 <Well, you can ask for additional information from the->

Z32 Yeah, I'm asking for additional . . .

Z33 <Well, I mean, from the . . . you can state that you would need to acquire additional information.>

Z34 Well, I would need additional information then,

Z35 for the, you know, what the lease, well, what their lease obligations were

Z36 because right now the company, I'd say, isn't really leveraged,

Z37 but, I mean, it could be a lot more leveraged

Z38 de-, depending on how much they, you know, they had in the way of leases,

Z39 and I would say if it's a . . .

Z40 well, if I'm reading this right,

Z41 it's a retail sort of store,

Z42 and I would think that they would have a lot of, maybe, you know, leases

Z43 that you would need to know about.

Z44 Because that drives up their, uh, liabilities.

Z45 <Loan Officer Z receives Supplement on Leases.>

Z46 Yeah.

Z47 <Reads supplement for 4 seconds.>

Z48 Do you have any projections over there?

Z49 <Loan Officer Z receives Supplement on Projected Borrowing Requirements.>

Z50 <Reads new supplement for 10 seconds.>

Z51 Ok, was this taken from a, like a receipts and disbursements sort of-

Z52 <Yes, you can assume that they did that first and this is the end result.>

Z53 That, that's the end result, is their cash . . . ok.

Z54 <Reads lease supplement for 17 seconds.>

Z55 Why, why are they calling this equities?

Z56 Or the, you know, liabilities,

Z57 why did they call them, why did they . . . ?

Z58 Did they change that?

Z59 Don't know?

Z60 <It doesn't make any difference, that's just terminology.>

Z61 Oh.

Z62 <Turns to page 5 and reads for 10 seconds.>

Z63 Let's see, they had an aging of accounts receivable somewhere, didn't they?

Z64 <Flips through pages and stops on page 7. Reads for 24 seconds.>

Z65 Ok, I think that the other thing, if they have an aging of accounts receivables

Z66 and accounts payables?

Z67 <Well, not payables.>

Z68 But accounts receivables . . .

Z69 <Yes. Loan Officer Z receives Supplement on Aging of Accounts Receivable.>

Z70 Ok.

Z71 <Reads supplement for 7 seconds. Flips to 3.>

Z72 Ok, I would say that . . .

Z73 Do they, do they have like any operating profit projections or anything?

Z74 <No.>

Z75 No? Ok.

Z76 <You can state, again you can state that you would ask for certain things.>

Z77 Well, you know, I would think, yeah, I would say, you know, in looking at this thing, um,

Z78 that, um, that I'd, I think I could probably not have too much in the way of a problem making loan.

Z79 Because it looks to me like it, um, historically their, their cash flow's been pretty good,

Z80 And they don't have too, I mean, their, their current portions of term debt aren't that great

Z81 so that, you know, if something would happen to turn into long term money

Z82 they could repay it from income.

Z83 And they ought to have, um, pretty good inventory

Z84 and accounts receivable coverage.

Z85 The only other thing I'd have to, to see would, I'd like to check the, to see who all has, uh, filed, uh,

Z86 or who all had collateral interest in the, in the property,

Z87 and whether the accounts receivable or inventory was, uh, was pledged.

Z88 And that would be something I would need to either get from the customer,

Z89 or I could do it myself,

Z90 from, you know, checking the secretary of state,

Z91 just to see who had a secured interest in it.

Z92 But I'd say that if, if, you know, if the accounts receivable and inventories weren't pledged

Z93 then I think it's a probably . . . you know, we would probably make the loan

Z94 and the other thing would be the, the personal statement of, uh, the guy

Z95 whether Mr. Hudson, whether he wanted to sign personally for the loan.

Z96 <Loan Officer Z receives Supplement on Long Term Debt which is read for 8 seconds.>

Z97 Yeah.

Z98 <Reads supplement for 2 seconds.>

Z99 Yeah, ok, I would say that, you know, if the, the assets were unencumbered,

Z100 I would say that, you know, we would probably do it

Z101 assuming we would probably require the principal of the company, Mr. Hudson,

Z102 to sign the, the loan personally.

Z103 <Observer asks about the impact of not receiving a personal guarantee.>

Z104 Well, then I would say we, I'd say for the amount,

Z105 if he's asking for $35,000,

Z106 I think that's what he's asking for . . .

Z107 <Turns to page 1.>

Z108 Oh, $100,000. Hmmm.

Z109 I would say that that might be a, uh, I would s-, I'd say we probably would do it anyhow.

Z110 <You would go ahead and make the loan?>

Z111 Uh, well, what we'd do is we'd, we'd have a blanket lien

Z112 on all the assets of the company

Z113 other than the, uh, you know, other than the real estate, I would say.

Z114 <And with that you would go ahead and approve this line of credit?>

Z115 I, I would say in the end we probably would

Z116 but we'd fight like crazy to, I think, to get him to sign personally

Z117 just because, you know, he runs the company

Z118 and basically his management's going to determine how well the company does

Z119 and it's sort of up,

Z120 even though we, we would look, be looking for the company to repay it

Z121 you know, it's kind of a good faith act on his part

Z122 to, to show his intent to, you know, to run the company in a, in a reasonable manner.

Z123 And, uh, you know, uh, you know, put his name on the line.

Z124 'Cause we're, you know, we're, you know, we're taking the, the obligation to make the loan

Z125 and, and so if we're going to take the risk

Z126 then we think he ought to take the risk, too.

Z127 But, you know, if push came to shove,

Z128 and, depending on, you know, if we hadn't had this account before,

Z129 or whatever,

Z130 and it looked like, you know, it was going to be a good account, you know,

Z131 we might be, uh, we might be willing to do it.

Z132 <Well, how would you tell then whether it was a good account or not?>

Z133 Well, based on their, their depository account of $70,000

Z134 against a, a loan of $100,000,

Z135 our yield on the loan would be pretty good

Z136 And so basically we'd be lending him back his own money.

Z137 But I think generally on a small closely held company

Z138 we like to have, you know, the, the owner,

Z139 or the principal,

Z140 you know, the guy that's running the company to sign it.

Z141 Again, you know, if it was a new account

Z142 and, and, you know, the company's had a fairly good, you know, track record

Z143 I'd say that we would, we would probably, you know, be willing to do without his signature.

Z144 <Ok, so let's say that->

Z145 I'd say the negotiating point

Z146 would be for the personable signature.

Z147 <Ok, if you got that they you would have no qualms about->

Z148 Yeah, I wouldn't have any qualms doing it

Z149 and if we didn't, we'd probably still end up doing it

Z150 but, but, you know, we'd take a second look at it.

Z151 Because it, it always bothers me a little bit when somebody won't sign personally.

Elapsed time: 14 minutes.

APPENDIX I

GRAPHS OF ANALYSIS OF PROTOCOLS BY COMPONENTS

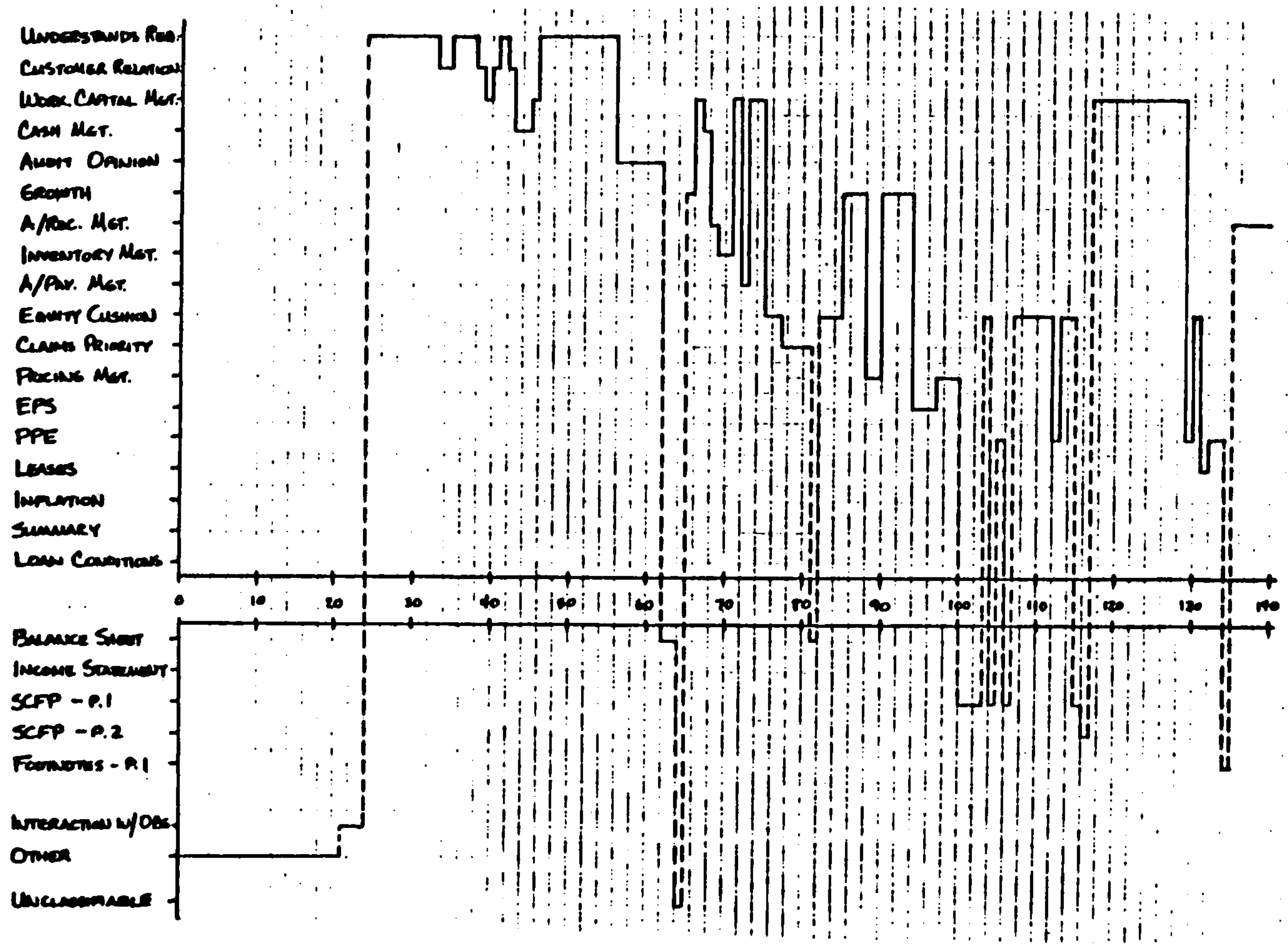

Figure 3. Loan Officer W—Analysis by Components

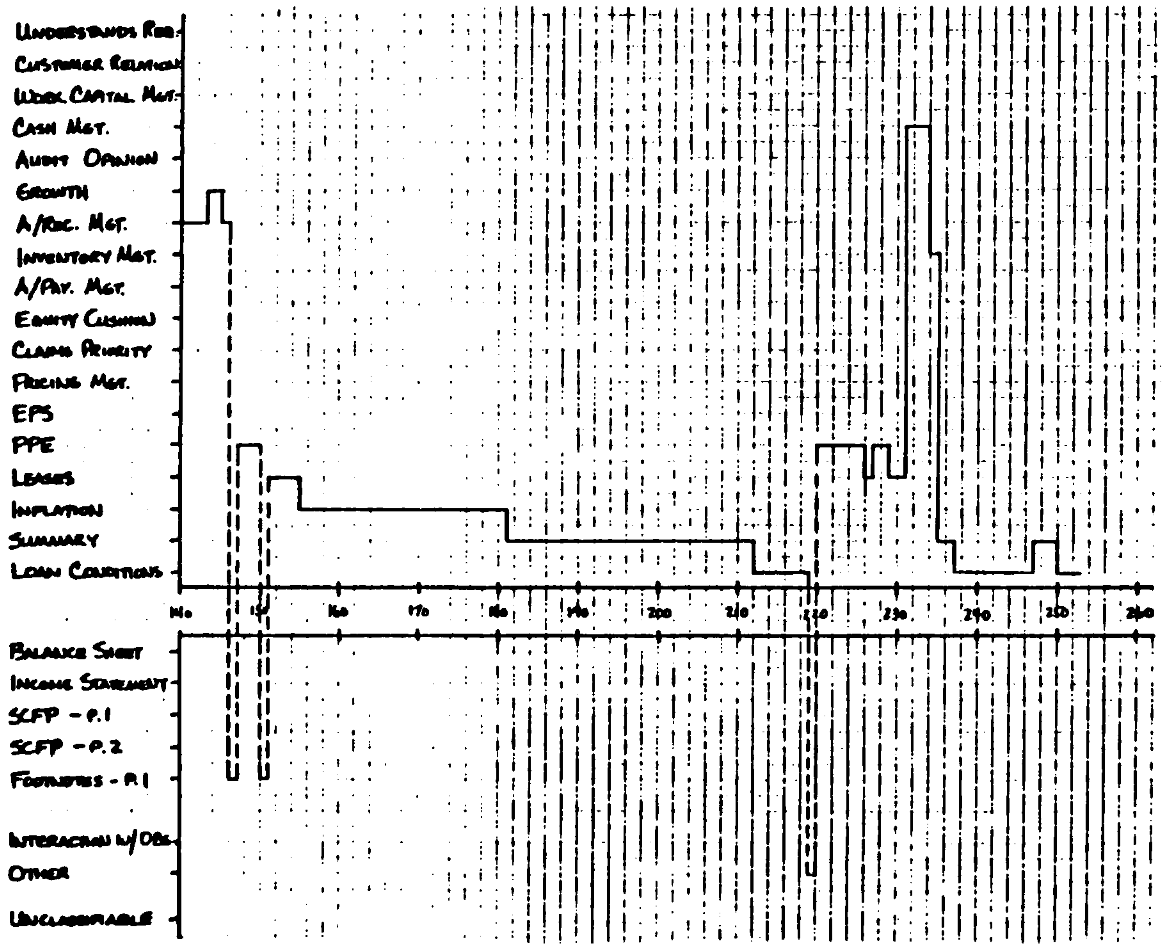

Figure 3. (Continued)

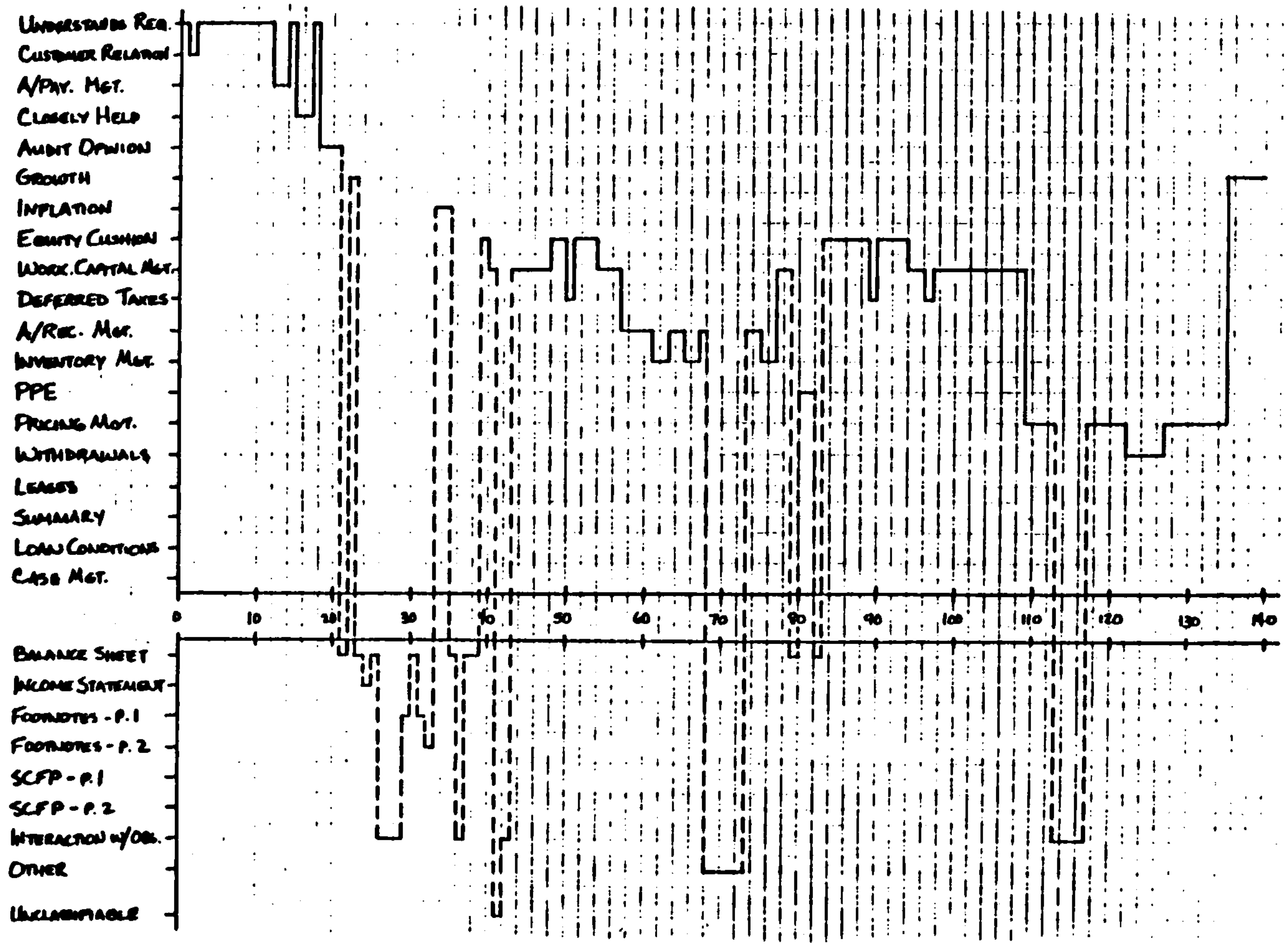

Figure 4. Loan Officer X—Analysis by Components

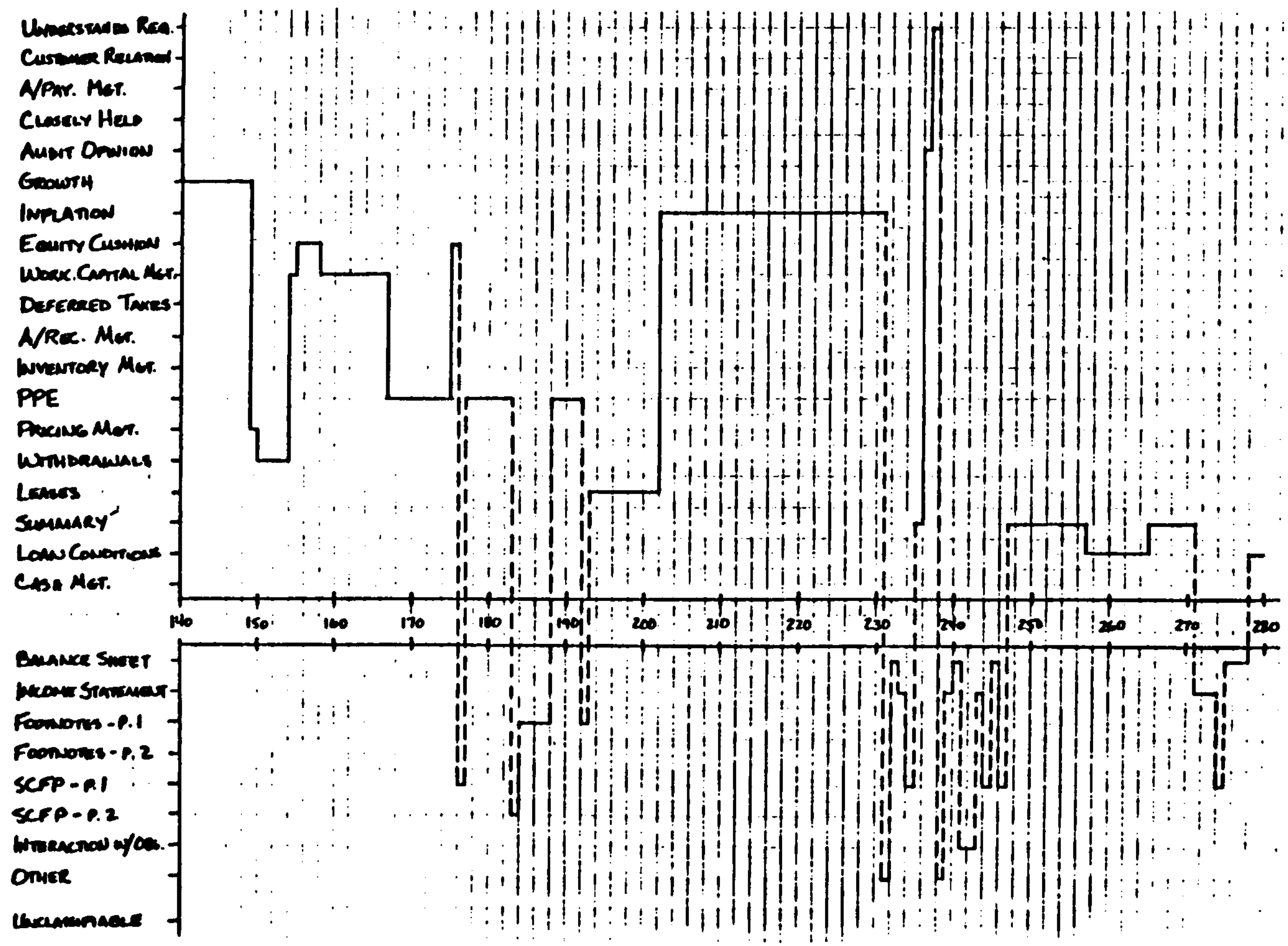

Figure 4. (Continued)

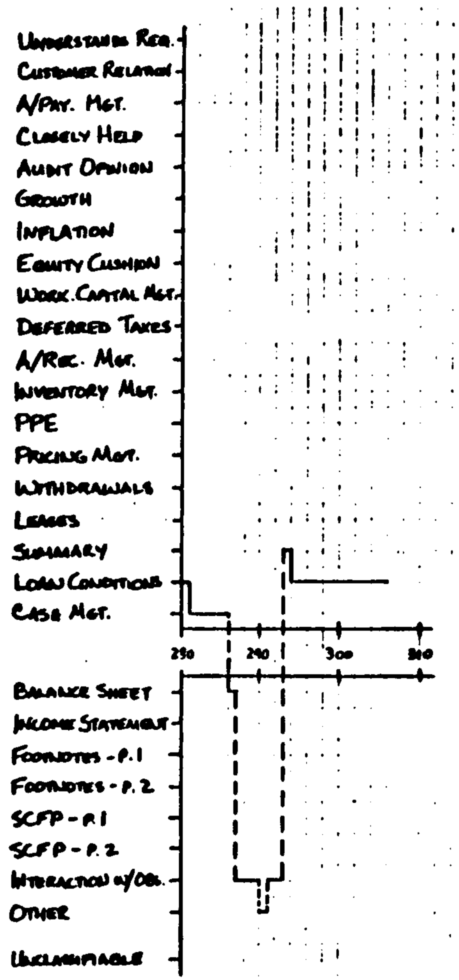

Figure 4. (Continued)

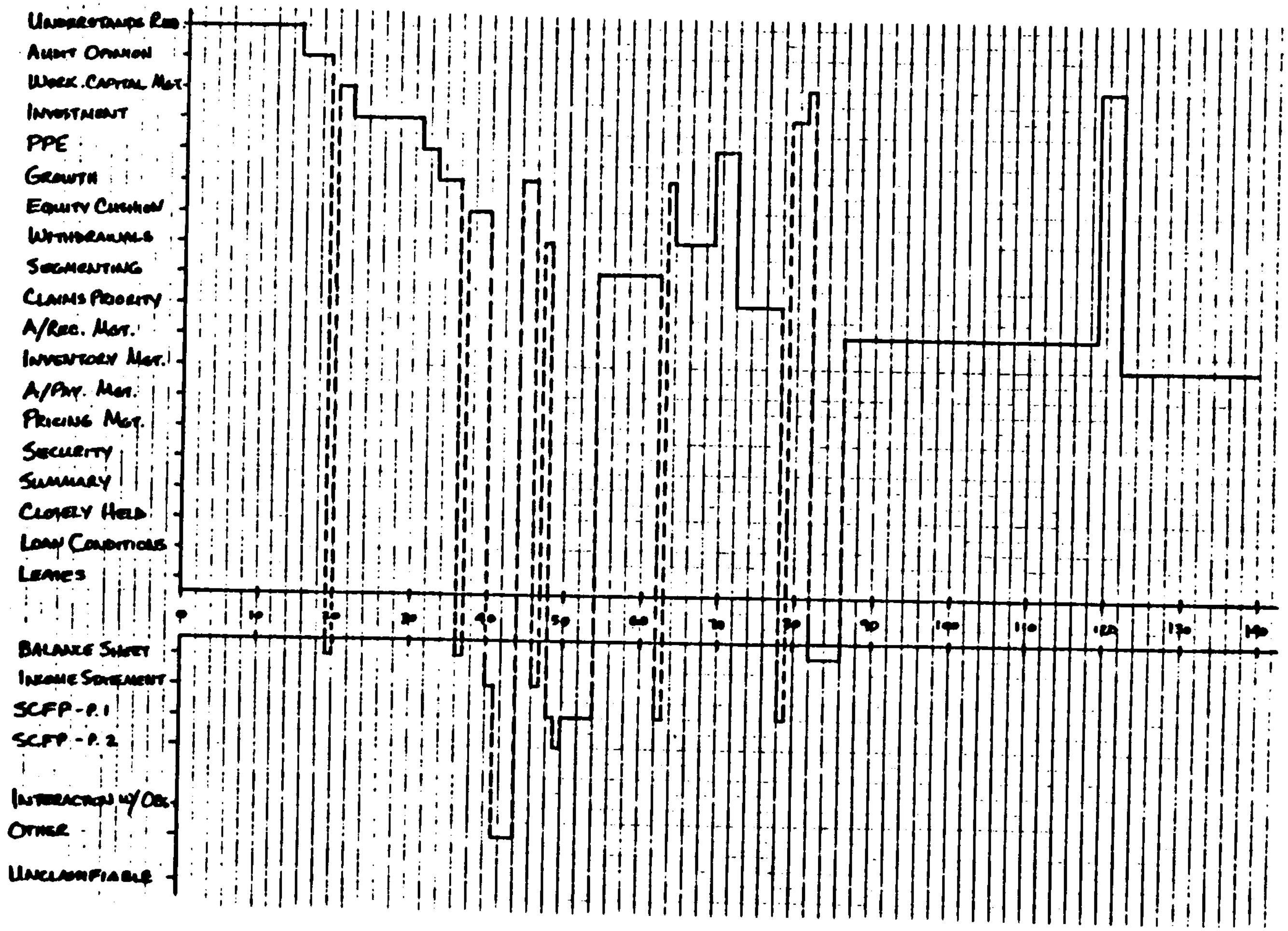

Figure 5. Loan Officer Y—Analysis by Components

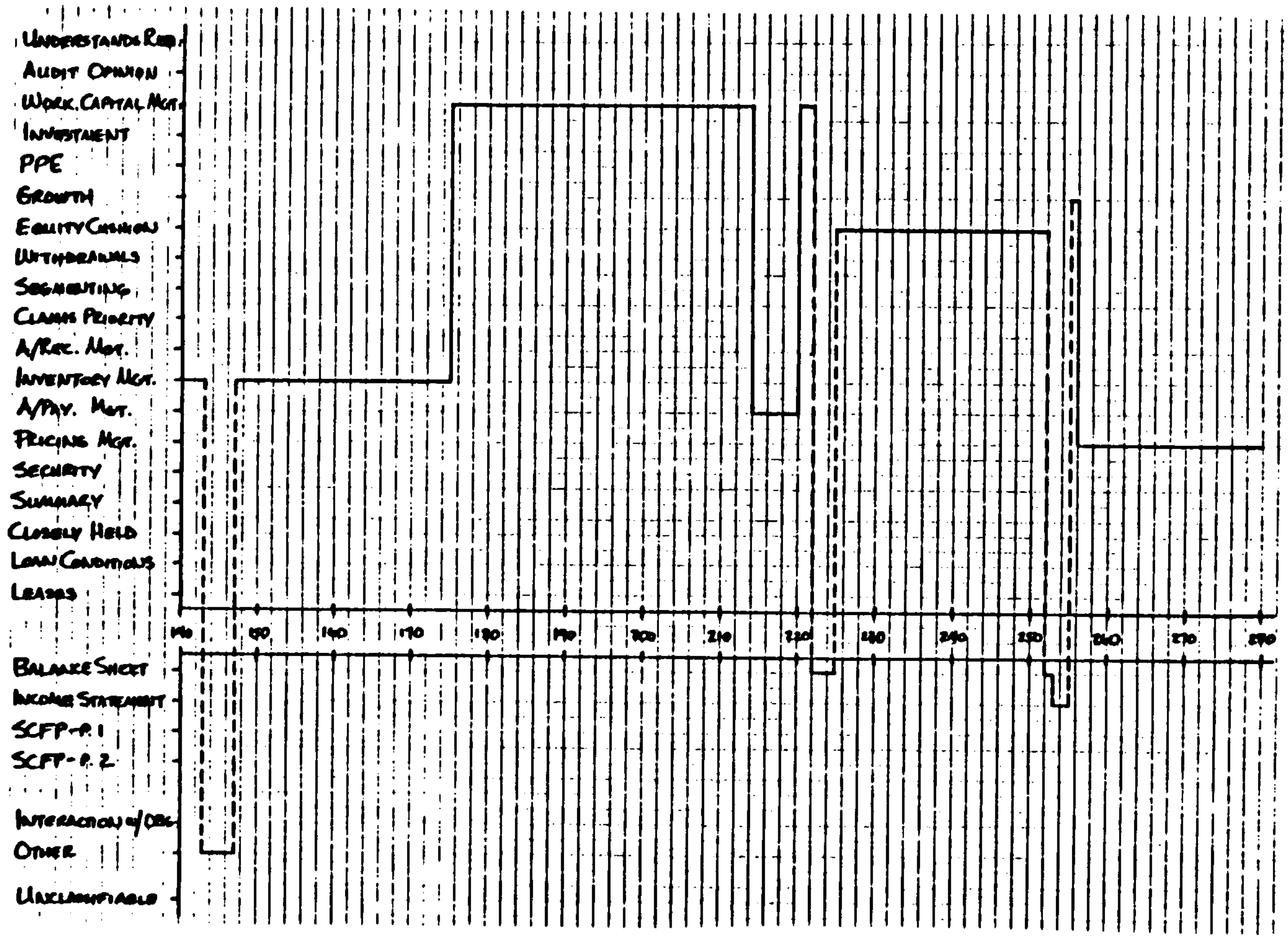

Figure 5. (Continued)

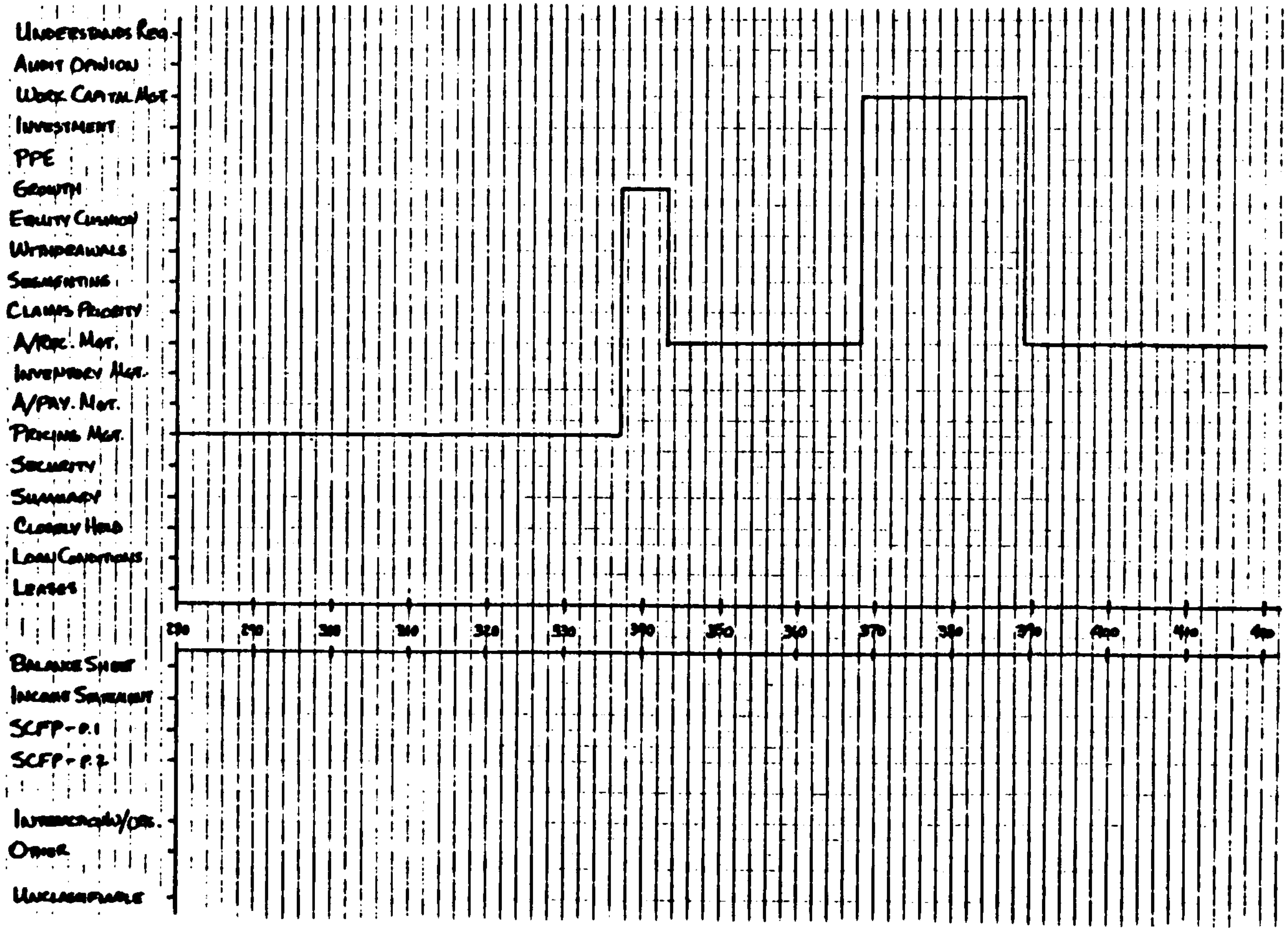

Figure 5. (Continued)

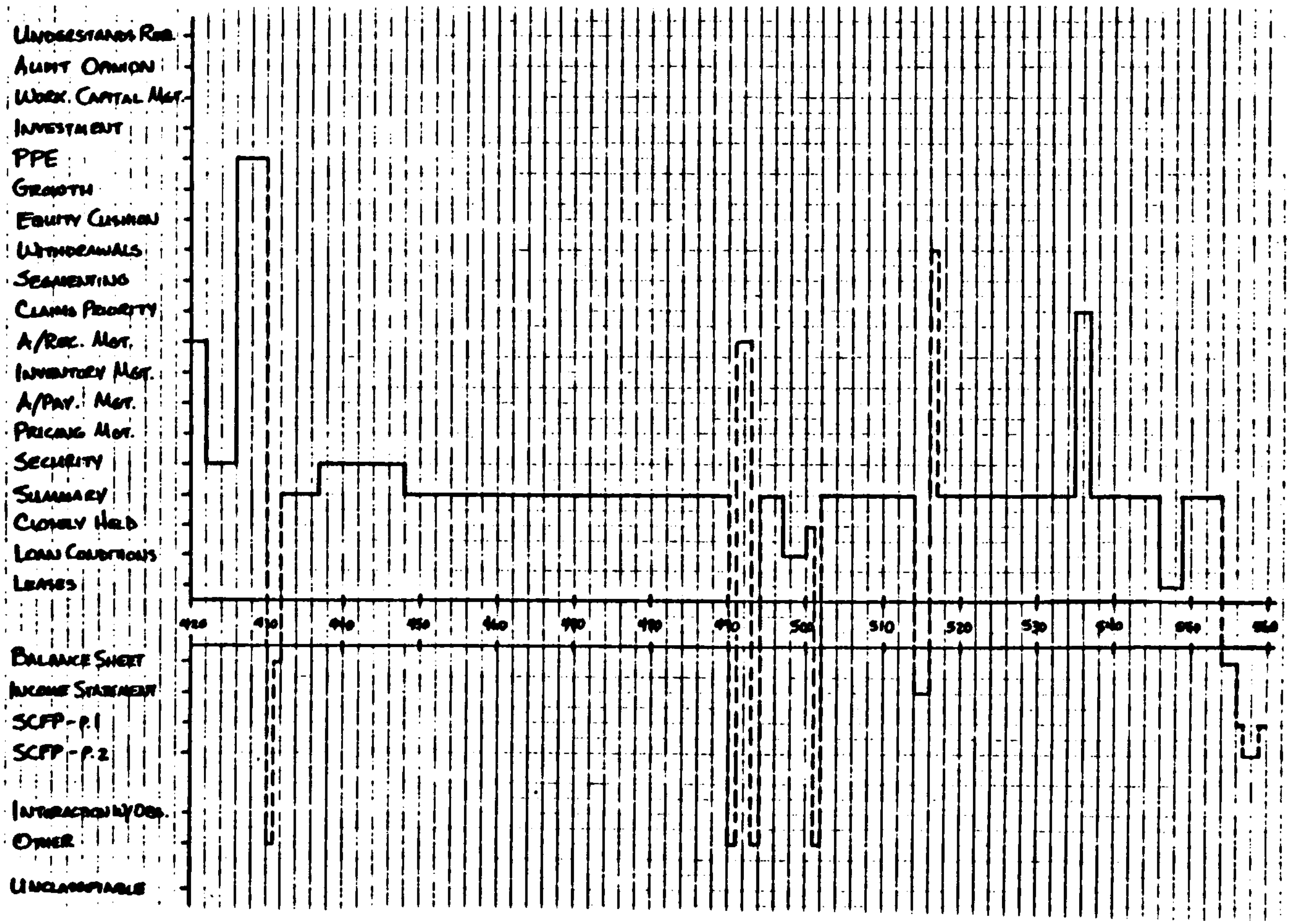

Figure 5. (Continued)

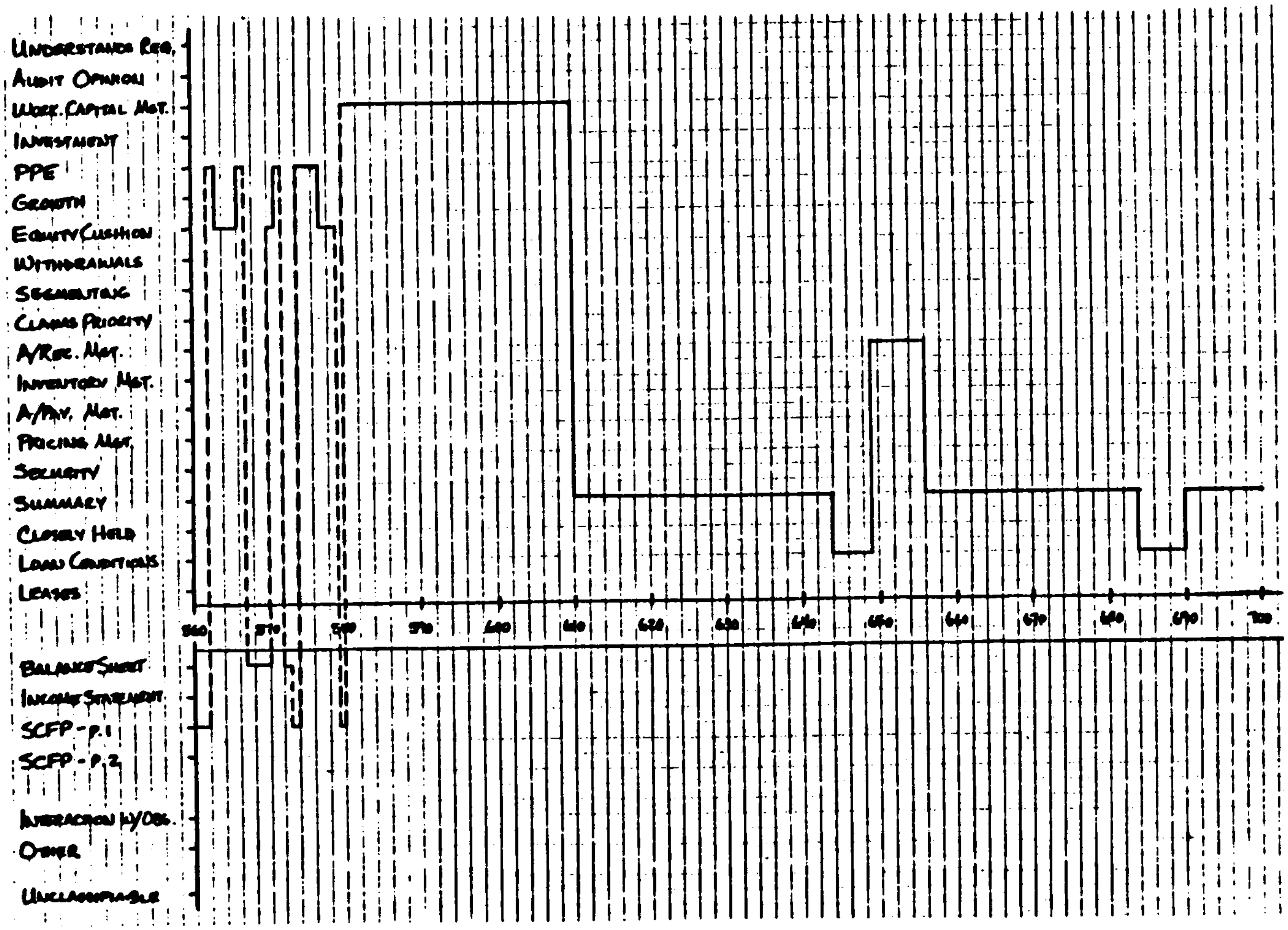

Figure 5. (Continued)

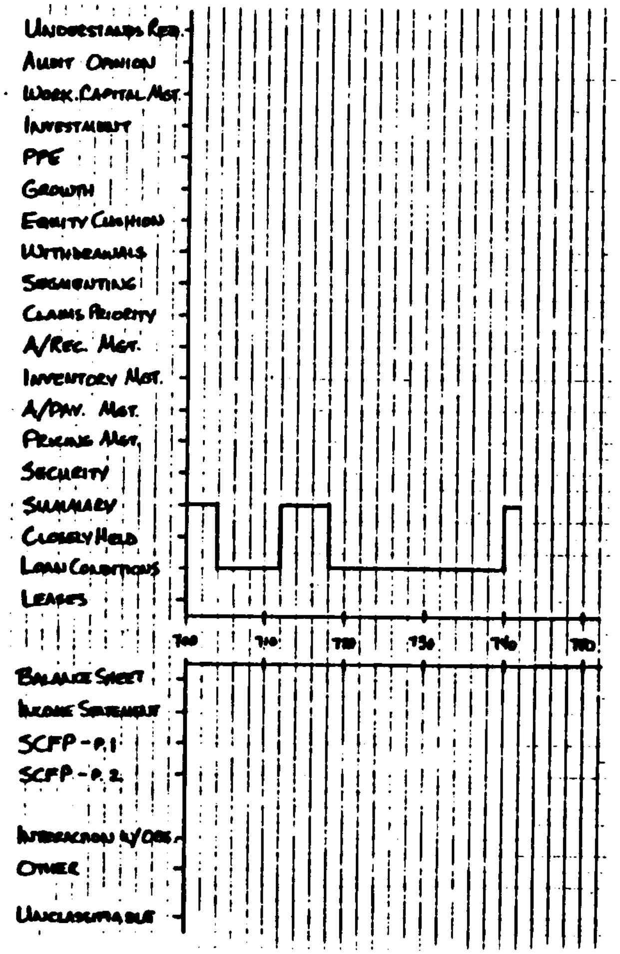

Figure 5. (Continued)

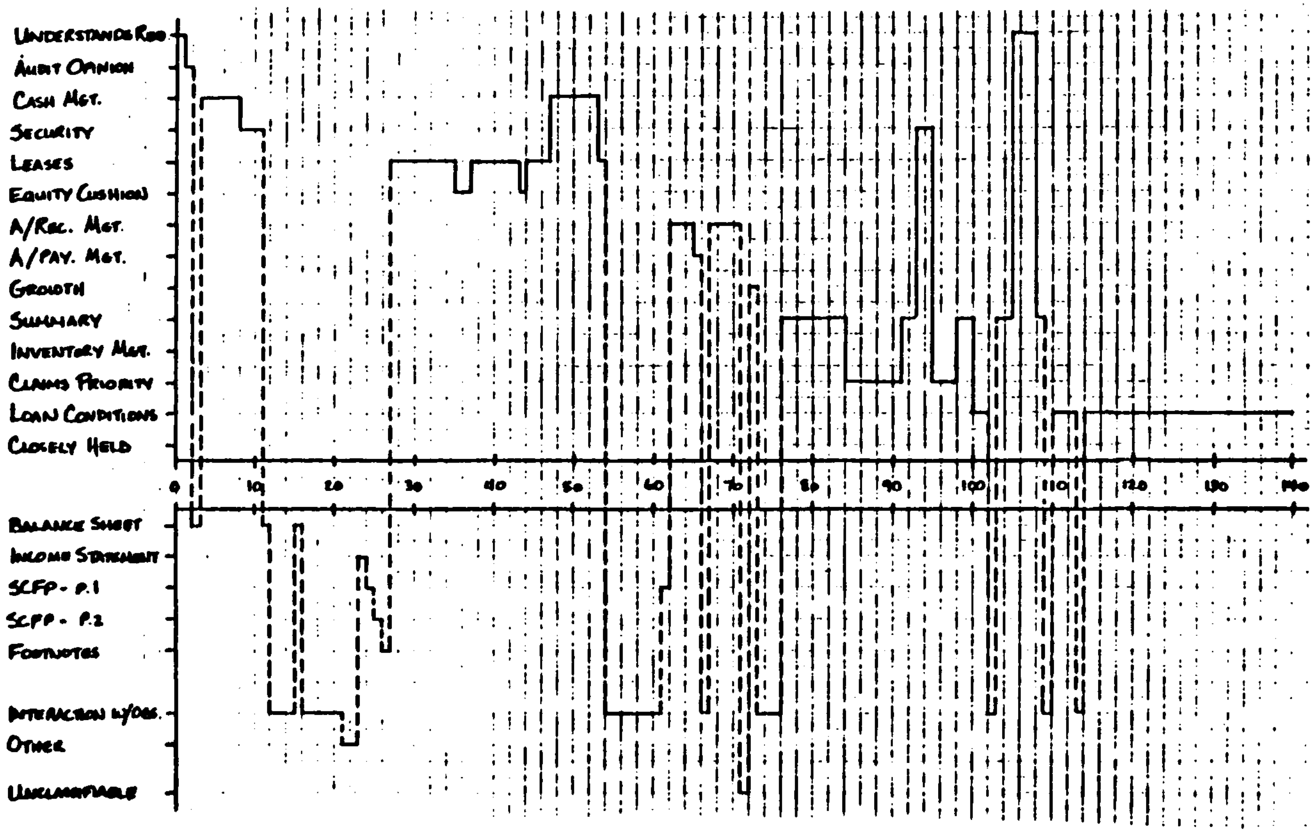

Figure 6. Loan Officer Z--Analysis by Components

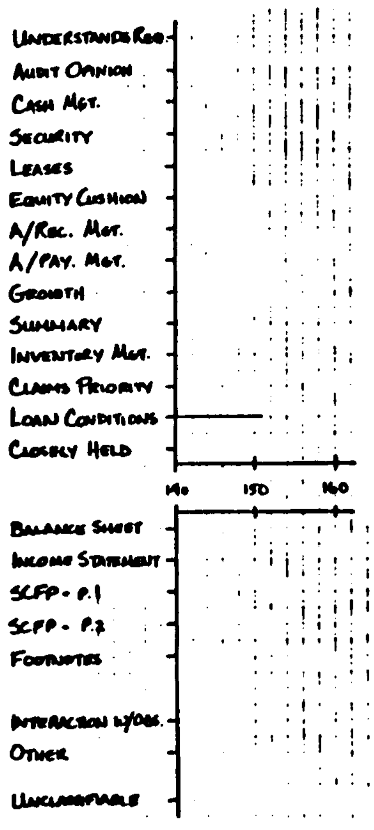

Figure 6. (Continued)

APPENDIX J

DISCUSSION OF THE CATEGORIES USED IN THE ANALYSIS BY PROCESSES

This appendix contains examples of the behaviors which fall into some of the categories used in the analysis by processes. In addition, there is some discussion about the decision rules used for the classification. The objective of the appendix is to make the analysis of processes performed in this study as explicit as possible in order to maximize the reproducability.

A. Read

Examples:

1. Reading
2. Verbalization of material exactly as read (i.e., reading aloud)

B. Intention

Examples:

1. I would like to know . . .
2. I would need to see . . .
3. I am going to calculate the ratio for 1978.

C. Query

Examples:

1. What is this?
2. I wonder why/what . . .

Comments:

Notice that there is a fine line between "query" and "intention" in some cases. For instance, in number two above, the sentence may continue: " . . . and I will ask them about that." The second part of the phrase expresses intention.

D. Estimate

Examples:

1. I assume that . . .

2. The current ratio of two to one is good.

3. The trend of the current ratio which I have calculated is increasing.

Comments:

This category probably contains the widest variety of behaviors. As described by Stephens, et. al., statements of assumption are included here. In addition, all evaluative comments by the subjects qualify also. The reasoning for this is that the subject does not know whether the company is a good credit risk, but assumes that various data, such as the current ratio, indicates that it is. The third example represents verbalizations about information generated by the "calculation" process. Even phrases where the subject merely summarizes data which were calculated are classified here. They cannot be classified as "paraphrase" because they are not the result of the "read" process.

E. Calculation

Examples:

1. Calculations using a pencil and paper or calculator
2. Mental calculations
3. Verbalizations of the results of calculations just performed
4. Writing down of results of calculations just performed

F. Flag

Comments:

This category was used only once (see Y214) because a good decision rule for its application could not be developed. It could have been stated that every time a subject changed the component being processed a flag had been encountered, but since those changes in processing could easily be seen already there was little information to be gained by doing so. Another possibility was to categorize a phrase as a flag when the subject apparently changed to a new component even though originally intending to continue processing the first component further. However, this decision rule was too subjective because it required the researcher to make assumptions about intentions of the subject which had not necessarily been expressed. In all but the one case where the "flag" category was used and the "unclassifiable" phrases, there seemed to be another category into which classification was appropriate.

F. Decision Review

Comments:

There was some difficulty associated with this category because typically the subjects summarized the information ("estimate" or "paraphrase") and mentioned items still needed ("intention") in the process of coming to a decision. Care had to be taken to make sure some sort of decision was also verbalized in order for the phrases to qualify for this category.

APPENDIX K

GRAPHS OF ANALYSIS OF PROTOCOLS BY PROCESSES

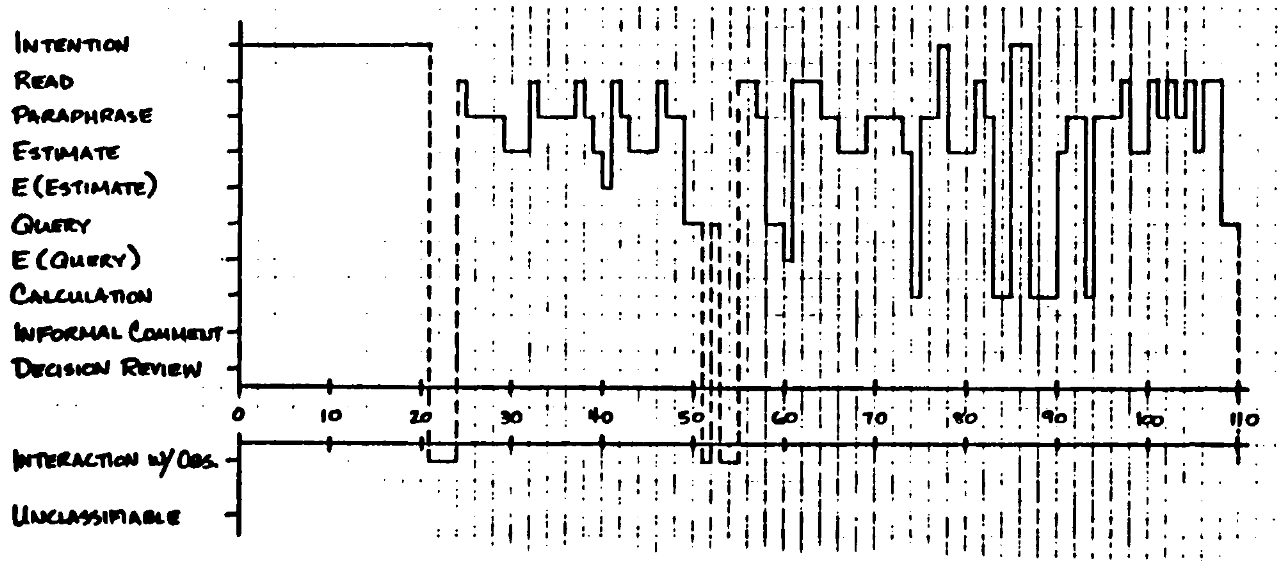

Figure 7. Loan Officer W--Analysis by Processes

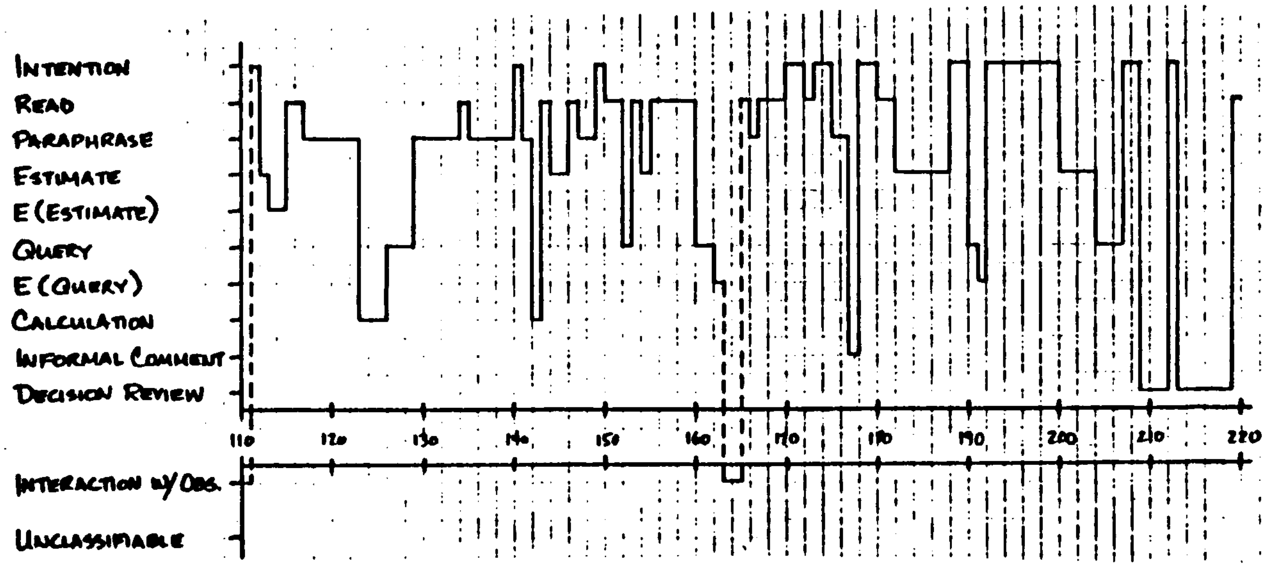

Figure 7. (Continued)

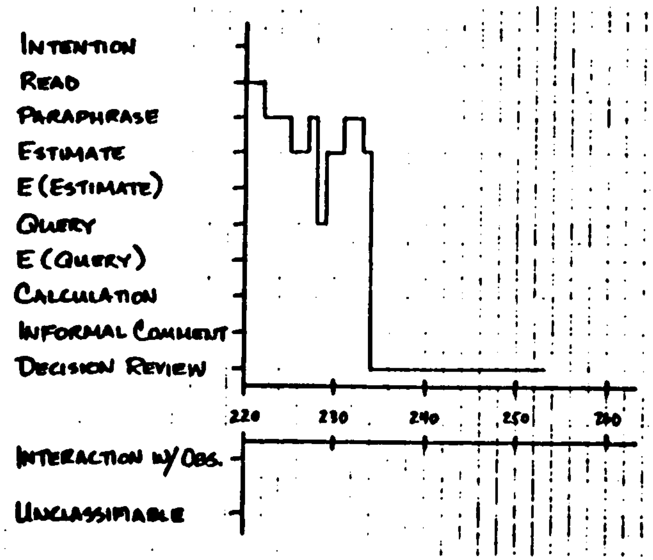

Figure 7. (Continued)

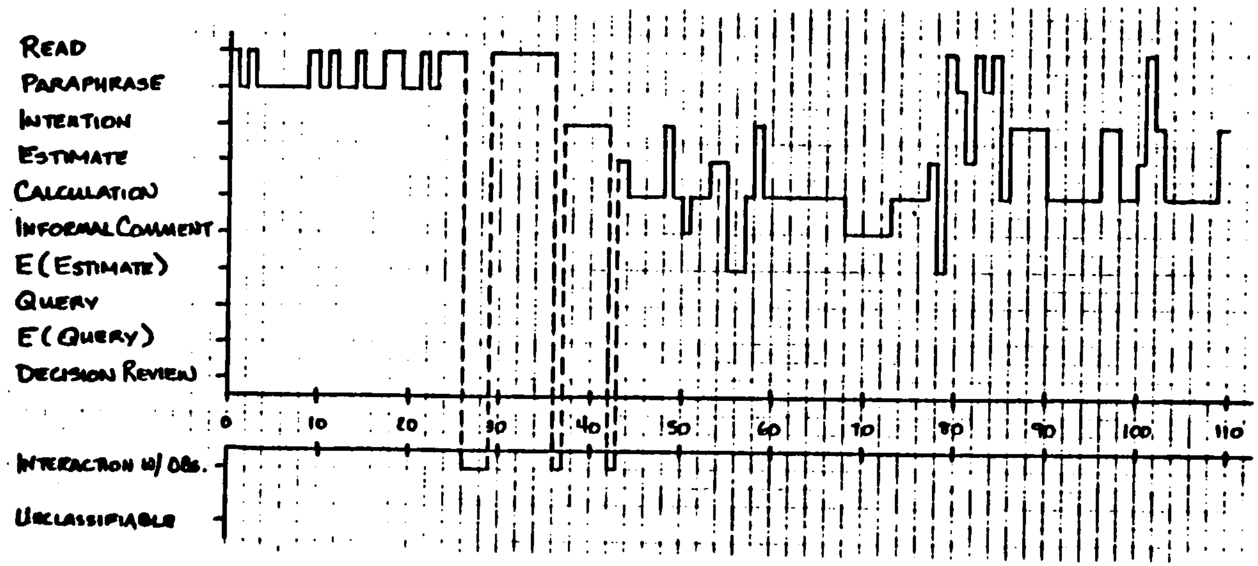

Figure 8. Loan Officer X--Analysis by Processes

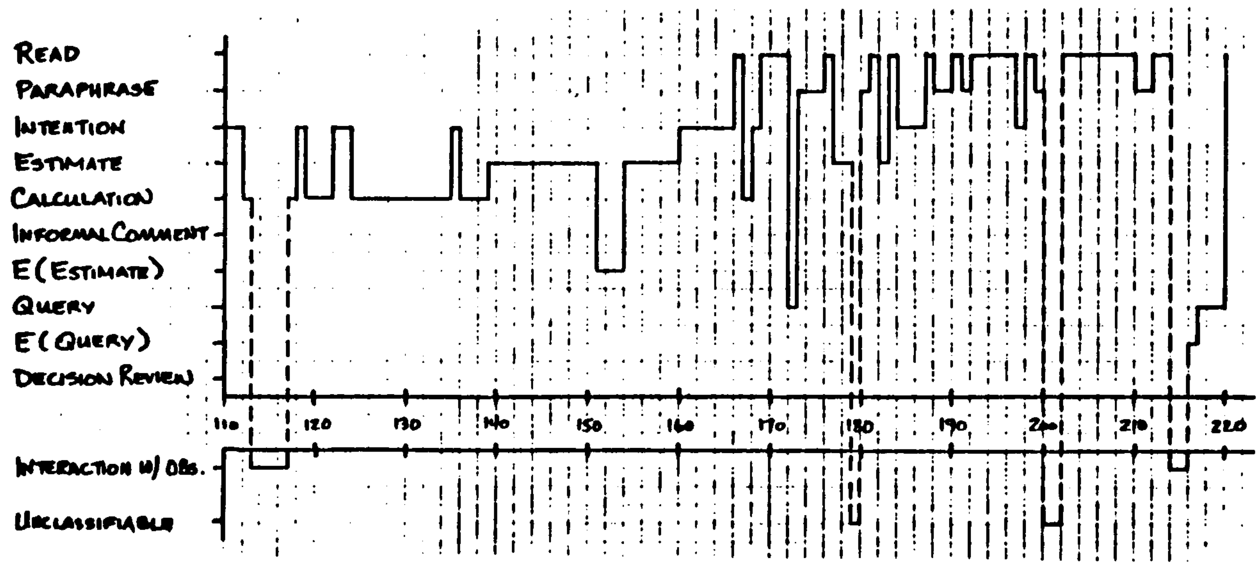

Figure 8. (Continued)

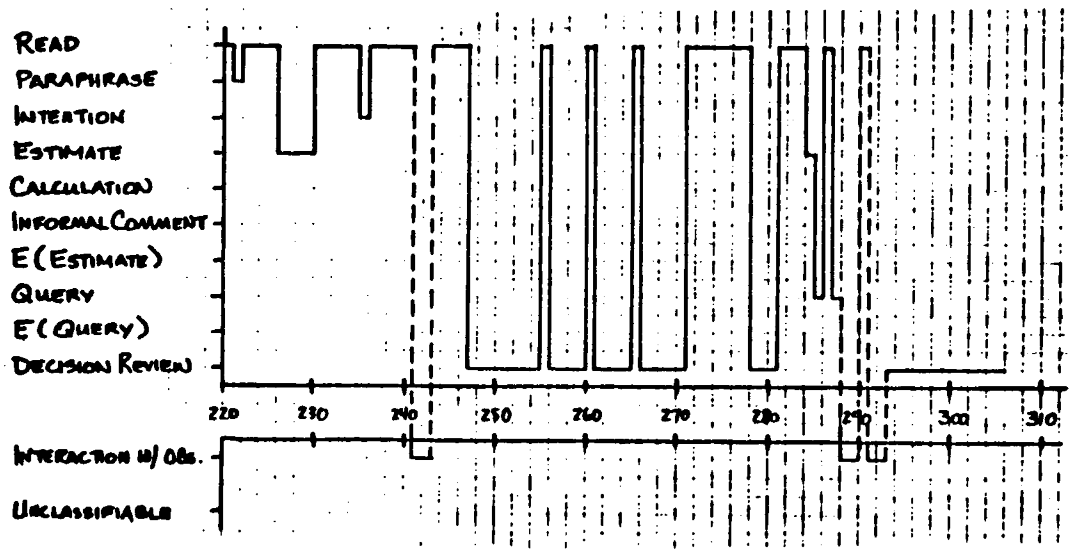

Figure 8. (Continued)

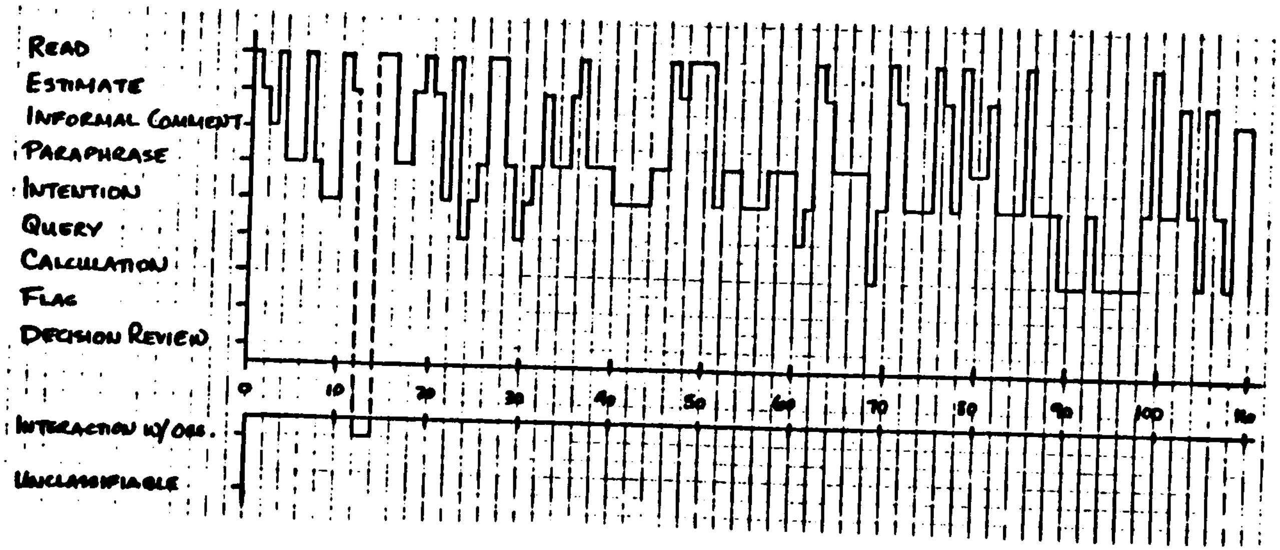

Figure 9. Loan Officer Y--Analysis by Processes

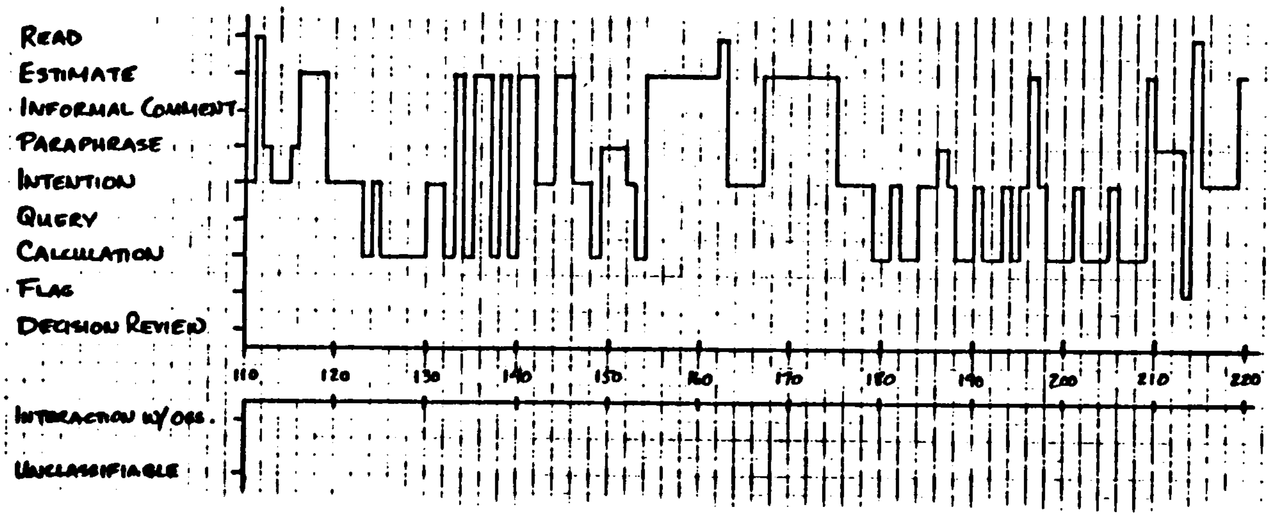

Figure 9. (Continued)

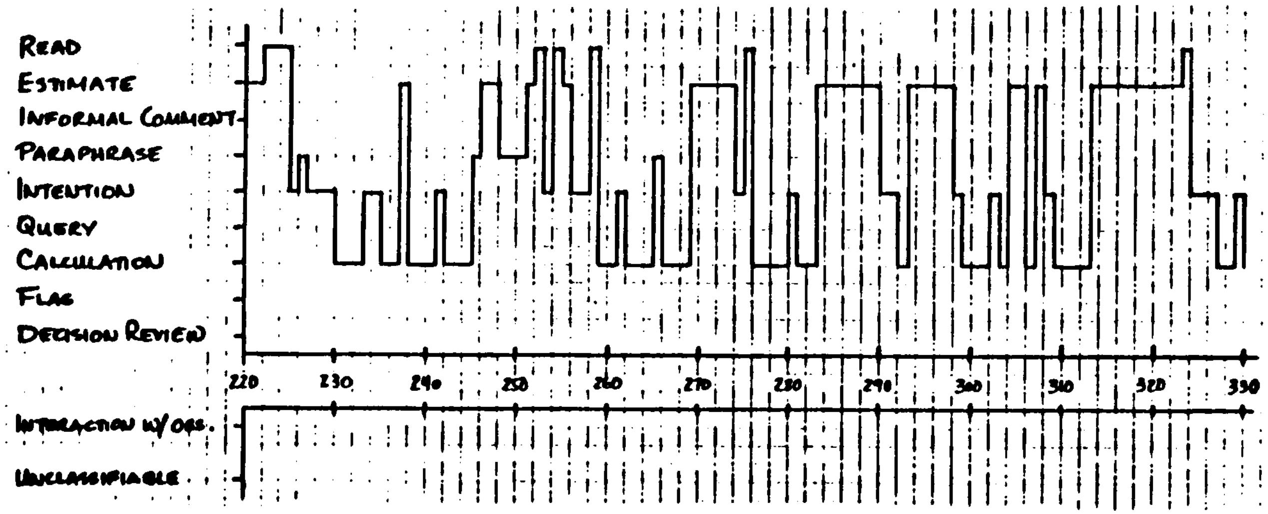

Figure 9. (Continued)

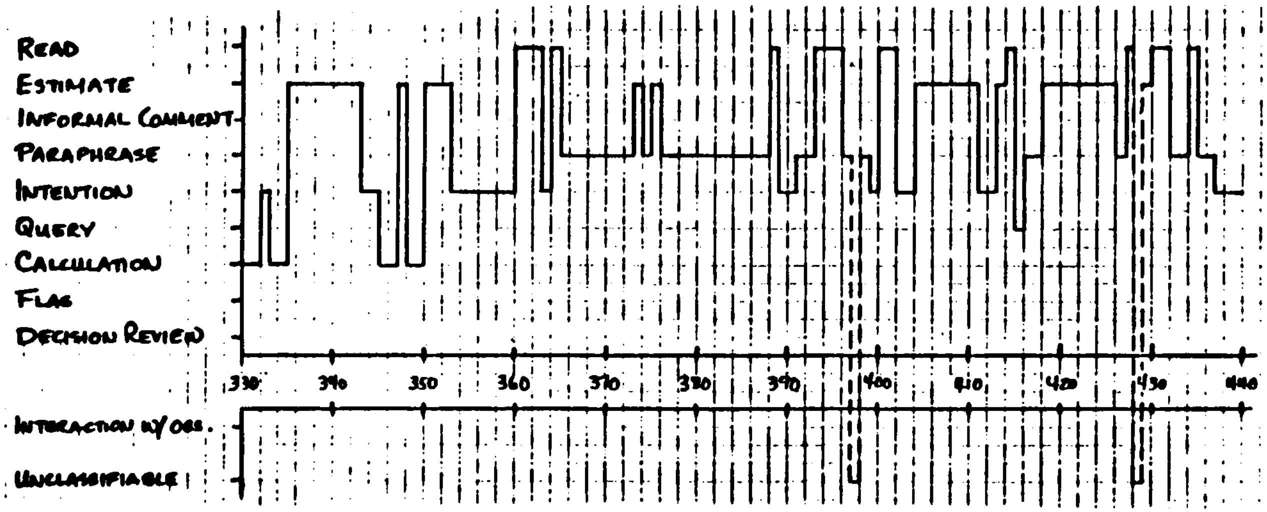

Figure 9. (Continued)

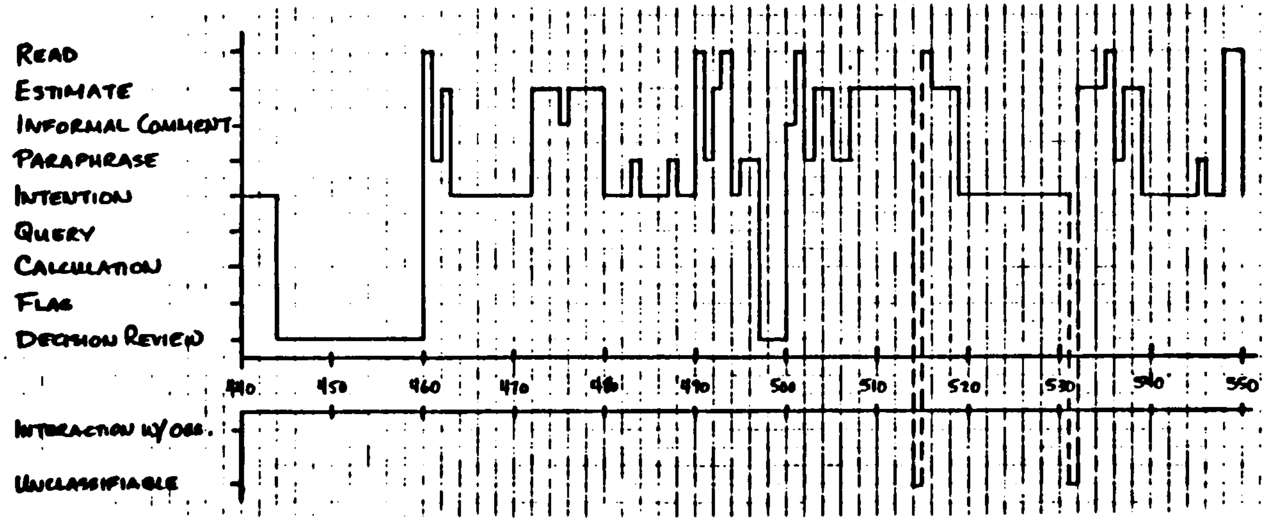

Figure 9. (Continued)

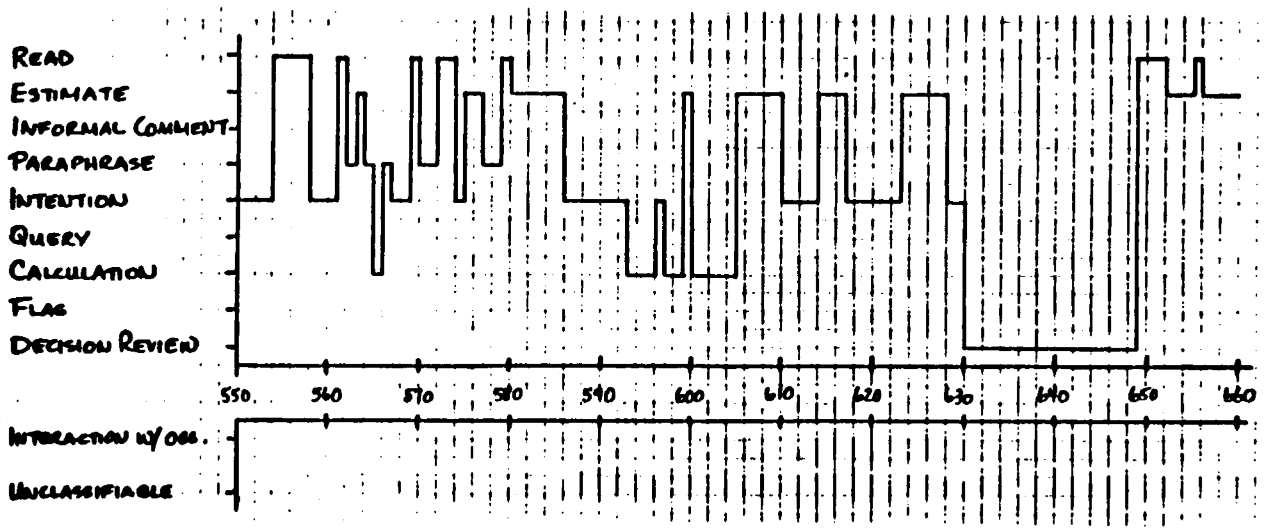

Figure 9. (Continued)

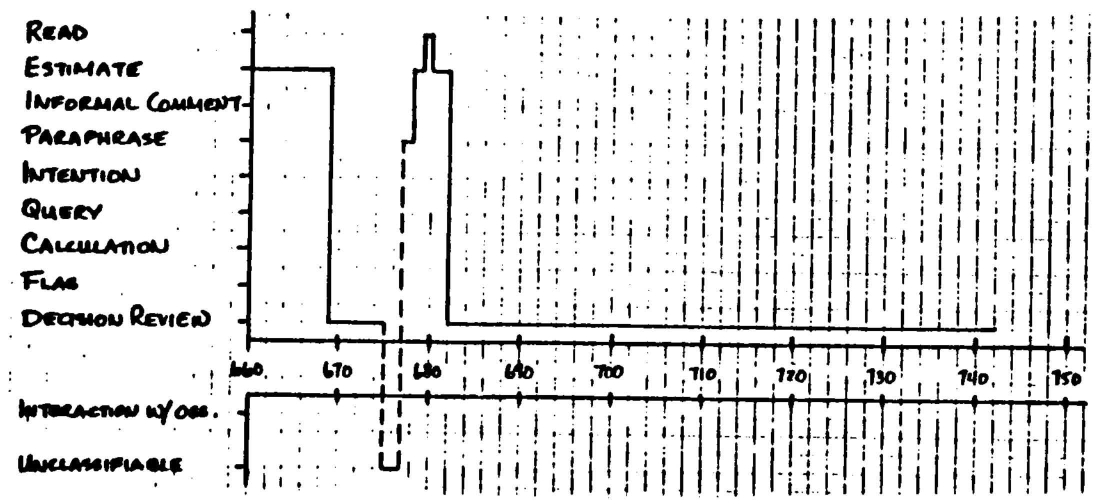

Figure 9. (Continued)

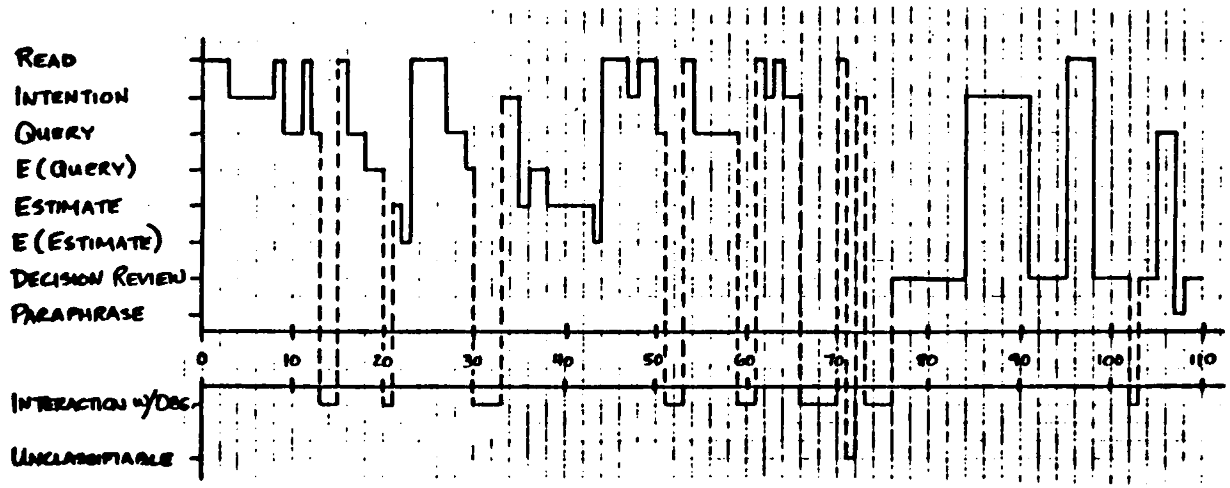

Figure 10. Loan Officer Z--Analysis by Processes

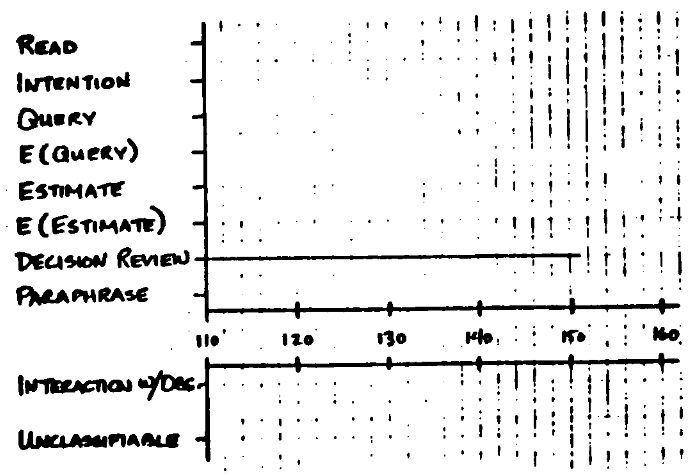

Figure 10. (Continued)

APPENDIX L

DESCRIPTIVE STATISTICS

TABLE 11

ITEM COUNT OF PHRASES CLASSIFIED BY TYPE OF BEHAVIOR

Loan Officer	Phrases			
	Verbal	Nonverbal	Observer	Total
W	202	47	4	253
X	161	136	9	306
Y	553	185	4	742
Z	114	22	15	151

TABLE 12

RELATIVE PERCENTAGES OF PHRASES BY TYPE OF BEHAVIOR

Loan Officer	Phrases			
	Verbal	Nonverbal	Observer	Total
W	80.0	18.5	1.5	100
X	53.0	44.0	3.0	100
Y	74.5	25.0	0.5	100
Z	75.5	14.5	10.0	100

VITA

Jane Ellen Campbell was born in Nashville, Tennessee on October 12, 1954. She attended Julia Green Elementary School and Hillsboro High School in that city and graduated in June of 1972. The following September she entered The University of Tennessee as a National Merit Scholar. In March, 1976, she graduated with high honors, receiving a Bachelor of Arts with a major in Psychology.

She entered the Graduate School of Business at The University of Tennessee that March, and received a teaching assistantship beginning in the fall. She was awarded a Master of Business Administration degree in August, 1980, and a Doctor of Business Administration degree in August, 1981, both with a major in Accounting.

Ms. Campbell is currently employed as an Assistant Professor of Accounting at The Ohio State University. She is a member of Phi Beta Kappa, Phi Kappa Phi, Beta Gamma Sigma, Beta Alpha Psi, American Accounting Association, and National Association of Accountants.