# The Effects of Critical Audit Matter Paragraphs in the Audit Report on Commercial Loan Officers' Decision to Grant Credit

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*This study examines whether Critical Audit Matter paragraphs (CAMs) affect a lending decision. I use commercial lending officers (CLOs) to answer the call for additional research that examines the decision usefulness of CAMs by sophisticated users and the unintended consequences therein (Bédard et al., 2016). This study uses a 1 × 3 between-subjects experimental design. CLO participants are randomly assigned to one of three experimental conditions (1. CAM auditor provided, 2. CAM management provided, 3. NO CAM). Results suggest CAMs are decision-useful to CLOs. Evidence from this study suggests CAMs lowers the probability of a CLO to approve a loan.*

*Keywords: critical audit matter paragraph, critical audit matter, CAMs, commercial lending officers*

## INTRODUCTION

Do all financial statement users process information available with the issuance of financial statements similarly? The answer to this question is neither a simple yes or a resounding no. This study does not seek to answer that exhaustive question, but to evaluate in a specific context if a particular financial statement user group would process information the same way as others based on an examination of the decision usefulness of CAMs to a more sophisticated user group.

Given the sweeping changes to the audit report and the importance of this report to all financial statement constituent groups, it was noteworthy to find that the Public Company Accounting Oversight Board (PCAOB) (2017), specifically mentioned investors 208 times while the implications to any other financial statement user are assumed from the use of the phrase *financial statement user(s)* as a reference point to other stakeholders. References to these other financial statement users are found only 43 times nearly a 5:1 ratio. In their review, Bédard et al. (2016) reviewed studies of CAMs and summarized the results from studies using a variety of financial statement user groups. From this comprehensive review, none of the experimental studies examined used commercial lending officers. With no studies using commercial lending officers, we do not know the resultant decision usefulness of CAMs on this financial statement user group and specifically the decision usefulness of CAMs in a lending context. Thus far, the author of this study has not found existing studies specifically examining this financial statement user group. I add to the existing literature by explicitly examining how CAMs impact commercial lenders within a lending context as well as answering the call for the examination of the decision usefulness of CAMs by a more sophisticated user group (e.g., Bédard et al., 2016).

The goal of this study is to evaluate the resultant impact on a commercial lending officer's lending decision when a CAM disclosure is present. To examine this objective, I used three independent measures

(*1. CAM* $_{auditor\ provided}$, *2. CAM* $_{management\ provided}$, *3. NO CAM*). The first independent measure is the traditional audit report (NO CAM). This first measure serves as the control condition (i.e., status quo). The remaining two measures include a CAM paragraph. The second measure contains a CAM paragraph in the audit report (CAM $_{auditor\ provided}$). The third measure uses a traditional audit report with the CAM paragraph in the management footnote (CAM $_{management\ provided}$).

In the study, the hypothesized dependent variable is expressed in the following question: "What is the probability that you would extend a line of credit for a material amount to Gilead-Global Exports, Ltd. at a reasonable rate of interest as determined by your financial institution? (Assume that your financial institution does not restrict you on the size of the loan that you may grant and that your institution is not limited in the amount of funds that it has available to lend)." I measure participant responses using a scale ranging from 0%—100%.

In the study, I use a completely randomized design. Following the method used by Brown-Liburd and Zamora (2015) and Christensen et al. (2014), Qualtrics randomly assigns participants to one of three experimental conditions. The experimental conditions consist of (1) traditional audit report – No CAM; (2) CAM disclosure in the audit report; and (3) CAM disclosure in management footnote.

The study suggests that the commercial lending officer's decision is a result of an information effect and a source credibility effect. The information effect is evidenced when a commercial lending officer's decision is statistically different in the presence of a CAM disclosure versus the absence of a CAM disclosure. Evidence in this study supports the existence of an information effect whereby commercial lending officers have a lower propensity to lend when a CAM paragraph is present in the auditor's report compared to when a CAM disclosure is not present. A source credibility effect is evidenced when commercial lending officers have a lower propensity to lend when the source of a CAM disclosure is the independent auditor as compared to management. In this study, results support the existence of a source credibility effect whereby commercial lending officer respondents indicate a lower propensity to lend when the source of the CAM disclosure is the auditor compared to when the source of the CAM disclosure is management.

The findings of the study should be of interest to the Public Company Accounting Oversight Board as part of their subsequent review of any potential unintended consequences associated with the disclosure of CAMs. This study also adds to the existing literature regarding CAMs by examining their impact in a lending context, which thus far has not been examined. In addition, this study answers the call for research that examines the decision usefulness of critical audit matter disclosures using a more sophisticated financial statement user group.

The remainder of this paper proceeds as follows (1) Background and Literature Review, (2) Hypothesis Development, (3) Research Design, (4) Results, and (5) Conclusion.

## BACKGROUND AND LITERATURE REVIEW

Are the only financial statement users worthy of mention equity investors? In the US alone, debt markets are twice the size of equity markets, and yet the basic premise of the regulatory regime in developed capital markets is a continued focus on primarily informing the equity markets. Empirical evidence suggests that the source of the demand for financial reporting lies not in equity markets but debt markets (Ball et al., 2008). In contrast, Asare & Wright (2012) find that investors place greater weight on the audit report than bankers but also report a contradictory and unexplained finding, which suggests that investors place limited value on the audit report as evidence of the viability of an organization than bankers.

From its origins as a nonstandard document in the early 1900s to the current standard document with three paragraphs, the audit report has undergone significant changes. A consensus about what an audit report should contain does not exist (Public Company Accounting Oversight Board (PCAOB), 2010). The report has moved from a "free form" structure (Geiger, 1993; King & Case, 2003; PCAOB 2010) to a standardized format (Carmichael & Winters, 1982), to the current three-paragraph form (ASB 1988). Despite minor changes (PCAOB 2003, 2007), the audit report was virtually unmodified from the three-paragraph format (ASB 1988). The current change to the audit report represents the most significant change in over 40 years as a consequence of the inclusion of CAMs (PCAOB 2017).

Christensen et al. (2014) found evidence that suggests nonprofessional investors will not invest in a company when the audit report includes a separate section in the audit report addressing CAMs. They also found evidence, which suggests nonprofessional investors place more weight on information received from the auditor than information received from management in their investment decision. Specifically, their study found an adverse effect on the investment decision when auditors supplied the CAM language rather than management. This study complements the findings of Christensen et al. (2014) by using a more sophisticated financial statement user group, commercial lending officers. This study is the first study to use commercial lending officers as a user group to evaluate the impact of CAMs in a lending decision.

**Critical Audit Matters**

In its final rule, the Public Company Accountancy Oversight Board (PCAOB) (2017) made several changes to the standard audit report, which is now part of auditing standard 3101. The PCAOB conducted outreach over six years in arriving at this new standard. While receiving several comments that were intended to dissuade the decision to significantly modify the audit report, the PCAOB followed their mandate to protect the interests of the investing public, as an overwhelming majority of comments from investors, analysts, and other financial statement users voiced positive support for changes to the audit report that would increase its informative and communicative value.

While the audit report will continue using the historical pass/fail model, among the notable changes to the audit report is the communication of CAMs, disclosure of auditor tenure, and additional enhancements that should make the audit report easier to read. While each of the changes will have an impact on how financial statement users impound the information from the audit report, this research focuses exclusively on the communication of CAMs in the audit report. CAMs, which are reported for the current audit period only and tailored for each audit, are defined as follows (2017, p. 1)

> *"matters communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements; and (2) involved especially challenging, subjective, or complex auditor judgment."*

The inclusion of CAMs in the audit report does not diminish the importance of the auditor's opinion. The disclosure requirements for CAMs includes the following and is summarized in Figure 1 (PCAOB 2017, p. 12):

- *Identifying the critical audit matter;*
- *Describing the principal considerations that led the auditor to determine that the matter is a critical audit matter;*
- *Describing how the critical audit matter was addressed in the audit; and*
- *Referring to the relevant financial statement accounts or disclosures.*

The audit report has undergone little change since the 1940s, while the underlying financial information has become increasingly complex, especially given the movement towards increased use of fair value accounting and the consequent increase in the use of complex managerial estimates. The audit report did not communicate the complexities of the audit. Thus, financial statement users had to infer a lot from an audit report that did little to reduce the information asymmetry that exists between the auditor and the investor. By reducing the information asymmetry that exists between the auditor and the investor, it is believed that the information asymmetry between management and the investor will also be reduced.

CAMs represent those things that are material to the financial statements and that involve audit complexities that were previously undisclosed. More broadly, information specific to the audit was formerly known only by the auditor and, to a lesser degree, by management but at all times undisclosed to external constituent groups. Consequent to the final rule, these audit complexities are now being made available to the financial statement user (PCAOB 2017).

At the time, the PCAOB decided to issue its final standard (AS 1301), expanded auditor reporting had been adopted by its international counterparts. Overall, the belief is that expanded auditor reporting should facilitate more prudent capital allocation by investors. While other provisions of the PCAOB's final rule take effect for all SEC registrants for fiscal years ending on or after December 15, 2017, provisions of the final rule regarding CAMs take effect for audits of fiscal years ending on or after June 30, 2019, for large accelerated filers; and for fiscal years ending on or after December 15, 2020, for all other companies "to which the requirements apply" (PCAOB 2017, p. 4).

### Empirical Findings Related to Critical Audit Matters

A common concern about the inclusion of additional language in the auditor's report is that given the hopefully unstandardized nature of the communication of CAMs, it raises the potential for increased litigation (PCAOB 2017). While viewing the likelihood of increased litigation as minimal, the PCAOB stated that it intends to "monitor the standard after implementation for any unintended consequences" (2017, p. 44).

Key audit matters have been promulgated as the required additional audit disclosure by the International Auditing and Assurance Standards Board; I focus exclusively on CAMs, which are the required additional audit disclosure by the Public Company Accounting Oversight Board. Bédard et al. (2016), in their review article, specifically examined experimental and archival research related to CAM disclosure. The experimental evidence suggests that in the presence of a CAM disclosure, the perceived value of the audit is not significantly improved. Results of these studies also suggest some potential unintended consequences such as a reduced incentive to invest in a firm; the introduction of a disclaimer of effect whereby users believe that auditors disclaim responsibility within the area disclosed with a CAM and a perception that in a CAM disclosure environment the perceived value of the audit is less reliable.

Archival studies examining the presence of CAM paragraph disclosure in the United Kingdom have found conflicting results. Evidence suggests that CAM disclosure is not incrementally important to the market with contradictory results surrounding whether or not audit fees will increase or decrease in a regulatory regime with expanded auditor reporting. Conflicting results also were found concerning whether expanded auditor disclosure impacts audit quality measures. Bédard et al. 's (2016) review of studies examining financial reporting subsequent to the implementation of expanded auditor reporting suggests proxies for audit quality measures did not consistently improve or worsen.

I now proceed with hypothesis development.

## HYPOTHESIS DEVELOPMENT

### Source Credibility

Pornpitakpan (2004a) reviews five decades of research from the psychology literature focused on the main effects of source credibility, and it's interaction with other variables from the perspective of implications for marketers/advertisers. The primary dimensions of source credibility are *expertise* and *trustworthiness*. Further, if consumers believe a source has high credibility, it generates positive feelings towards the endorser and is more persuasive than an endorser with low credibility; a corollary to high source credibility is that respondents tend to make behavioral decisions that align with the messaging of the high credibility source. In the context of this study, auditors have higher source credibility (more persuasive) than management (less persuasive). Given that commercial lending officers are regularly exposed to differing levels of attestation services provided by auditors (e.g., review of financial statements vs. audit of financial statements), as sophisticated users of the financial statements they know that an audit of the financial statements provides the highest level of assurance and thus has the highest credibility (Wright & Davidson, 2000).

In a hypothetical investing context, Christensen et al.,(Christensen et al., 2014) find that nonprofessional investors attributed more source credibility to auditors than to managers. Given that commercial lending officers typically have more access to management than nonprofessional investors or various other financial statement users (Fulmer et al., 1991), *a priori,* it is possible that commercial lending officers would attribute higher source credibility to managers than would other financial statement constituent groups. However, despite the higher level of access attributable to commercial lending officers and managers, it is possible that since auditors act as an independent third-party validating the assertions of management, commercial lending officers will attribute higher source credibility to auditors than to management.

From a review of source credibility and its use in the psychology literature and the extant research examining the application of source credibility in an investment scenario using nonprofessional investors, I predict the following:

***H1:*** *Commercial loan officers who receive a CAM paragraph discussing the audit of significant uncertain fair value estimates in the audit report have a lower likelihood of approving a loan as commercial loan officers who receive the same information in management's fair value footnote disclosures.*

**Information Effect**

Similar to Christensen et al. (2014), this hypothesis tests an information effect, as footnote disclosure combined with a CAM paragraph in the audit report is compared to footnote disclosure alone. The combination of a CAM paragraph's less technical message and higher source credibility creates the information effect (Christensen et al., 2014). Consistent with the proposition of Christensen et al. (2014, p. 75), evidence suggests the influence of the CAM is derived from a source credibility effect. The CAM paragraph appears in the auditor's report (higher source credibility) rather than management footnotes (lower source credibility) (Christensen et al., 2014).

The extant psychology literature suggests that message persuasiveness is influenced by source credibility (e.g., Pornpitakpan, 2004b). This literature also suggests that source credibility is increased when the message is negative (Czapiński & Lewicka, 1979). Christensen et al. (2014) found that nonprofessional investors who receive an audit report with a CAM paragraph perceived this information as more credible if it appeared in the audit report (i.e., from the auditors) rather than in the footnotes (i.e., from management).

While there are no proposals that suggest management disclosure of CAMs is on the horizon, I seek to disentangle other consequent externalities that might affect commercial lending officers in a lending context. In the scenario where a CAM disclosure appears only in the audit report, there exist differences in the cognitive load exerted by commercial lending officer respondents. Commercial lending officer respondents will process more information when the CAM paragraph is present as compared to the case where the CAM paragraph is excluded. Given that CAM disclosure is required, it is worthwhile to specifically examine specific outcomes with a sophisticated financial statement user group by making a direct comparison between the new requirement for auditor disclosure versus the prior requirement.

By considering the negative effects of cognitive load (Malhotra, 1982), I specifically examine the effects of information processing by commercial lending officers. From an examination of the existing literature, I make the following prediction:

***H2:*** *Commercial loan officers who receive the standard fair value footnote and a CAM paragraph in the audit report, which discusses the audit of uncertain fair value measures, will have a lower likelihood of approving a loan as commercial loan officers who only receive the fair value footnote and a standard audit report which excludes a CAM paragraph.*

## RESEARCH DESIGN

### Participants

To obtain the information required for this study, I use commercial loan officers as participants. Commercial loan officers are often used in accounting research (Bamber & Stratton, 1997; Daniels & Booker, 2011; Guiral, 2012; e.g., Lavin, 1976; McKinley et al., 1985; Miller et al., 1993). Commercial lending officers are a sophisticated class of financial statement users. The existing CAM literature has not examined the impact of CAM disclosures in a specific lending context with commercial lending officers.

I use Qualtrics to recruit loan officer participants (Brandon et al., 2014a; Brown-Liburd & Zamora, 2015). Loan officer participants are automatically assigned to the experimental condition by Qualtrics (Brown-Liburd & Zamora, 2015; Christensen et al., 2014). This study uses three manipulations of the independent variable. In accordance with the central limit theorem and subsequent sensitivity analysis, I instruct Qualtrics to gather a target of 30 to 35 useable responses for each of my treatment groups.

### Experimental Task and Materials

The participants in this study view a cover letter and the experimental instrument via Qualtrics. The cover letter explained the purpose of the study and its importance to audit regulators, as well as a statement assuring respondents that their responses would be kept confidential and anonymized. Prior to dissemination to the Commercial Lending Officer respondents, this study was approved by the Institutional Review Board of Jackson State University.

Subsequent to reading the cover letter, respondents are provided with additional instructions necessary to complete the experiment. Similar experimental studies have used preliminary questions as a pre-screening technique (e.g., Christensen et al., 2014), but since commercial lending officers represent a sophisticated financial statement user group pre-screening questions were not utilized in this study.

After reading the consent document and agreeing to participate in the study, participants are asked to complete the following question:

1. Do you have at least one year of commercial lending experience?

   ❍ **Yes**

   ❍ No

All respondents indicating that they have at least one year of commercial lending experience are provided with additional explicit instructions for completing the experiment. After reading these instructions, respondents are directed to a vignette about Gilead-Global Exports, which was adapted from Christensen et al. (2014) and Schneider and Church (2008) with permission. The case was primarily derived from Christensen et al. (2014), who used a similar case with nonprofessional investors.

I adapt the experimental instrument for use by commercial lending officers by providing financial ratio information to suggest that Gilead Global has the potential to pay back any amounts that would be owed in the future under a material revolving line of credit (Terry, 2000). The additional information added included a series of ratios that academic surveys have suggested have the highest priority in lending decisions. I give participants qualitative information about the ratios. This qualitative information indicates the named ratios are at or slightly above the industry average (Vishwanath, 2007).

The vignette utilized in this experimental case is based on a fictional company, Gilead-Global Exports, Ltd. Gilead-Global Exports, Ltd. is a specialty manufacturer of tools. Normal sales of the Company's products are to carpenters, contractors, production facilities, and fabricators across North and Central America. The Company also makes sales to certain distributors in certain high-demand markets. The Company is seeking a line of credit to finance an aggressive marketing campaign that will increase market share in these high-demand markets. This line of credit is secured by the Company's available for sale securities.

The use of fair value footnote disclosure has been consistently used in the accounting and audit decision making literature (e.g., Christensen et al., 2014). Given that fair value information is part of management's required disclosure, it is important as commercial lending officers seek to determine the loan applicant's financial position for purposes of evaluating the riskiness of a loan, whether to recommend a loan and the determination of an appropriate interest rate (Wright & Davidson, 2000).

Based on an examination of the extant literature related to CAMs, the current study is the first to examine their impact on commercial lending officers. A soft launch is used to validate the experiment instrument. This soft launch includes an evaluation of data integrity according to certain time constraints (Brandon et al., 2014a). The term soft launch and the associated implementation can be traditionally understood as a pilot study. After evaluating responses during this soft launch, I gave the okay to collect the remaining responses for this study.

### Treatments

In the study, all respondents receive the description of the Company, which includes qualitative information about certain financial ratios and a stated purpose for the loan proceeds, followed by an audit report, an income statement, and management's footnote disclosure. Across all treatments, the information was identical, with the exception of the appearance (nonappearance) of the CAM disclosure.

In the following paragraphs, I use the terminology of first, second, and final treatment related to the CAM disclosure. This does not imply an official ordering of the treatments but serves only as a means to adequately describe differences between each experimental manipulation. This description also does not imply nor suggest that responses were collected in a particular order. Using a native feature of Qualtrics referred to as survey flow, respondents were automatically assigned to each treatment upon accepting the invitation to participate in this study.

The first treatment in this study can be appropriately categorized as the status quo or control condition. In this treatment, there is no CAM disclosure. Commercial lending officer respondents read the vignette, the audit report, the income statement, and the management footnote disclosure.

In the second treatment, commercial lending officer participants receive all information as described in the first treatment, but I add a CAM disclosure to the audit report in this treatment. An appropriate label for the second treatment would be the CAM treatment.

In the third treatment, commercial lending officer participants receive all information as described in the first treatment, but contrasted from the second treatment, the CAM disclosure is added to the management footnote disclosure.

Similar to Christensen et al. (2014), I evaluate the existence of an *information effect* and a *source credibility effect* for commercial lending officers. To determine the existence of an information effect, I compare participant scores between the control condition and the CAM disclosure in the audit report treatment. For evaluation of the existence of a source credibility effect, I compare participant scores between the CAM disclosure in the audit report treatment and the CAM disclosure in the management footnote treatment.

Appearing in the APPENDIX is the entire experimental instrument. To explicitly examine the hypotheses in this study, I evaluate mean differences for the following question:

> What is the probability that you would extend a line of credit for a material amount to Gilead-Global Exports, Ltd. at a reasonable rate of interest as determined by your financial institution? (Assume that your financial institution does not restrict you on the size of the loan that you may grant and that your institution is not limited in the amount of funds that it has available to lend).
>
> |---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|
>
> 0% 10% 20% 30% 40% 50% 60% 70% 80% 90% 100%

### Manipulation Checks

I include a manipulation check in the experiment to directly measure whether or not the independent variable has the hypothesized effect on the commercial lending officers Inclusion of the manipulation check provides evidence of the successful operationalization of the conceptual variable by way of the independent variable. Considering that manipulation check questions might distract or give the participants undesired information about the purpose of the experiment, these questions appear after commercial lending officer participants have responded to the dependent variable question (Cozby & Bates, 2012). Similar to Christensen et al. (2014), I ask manipulation check questions using a Likert scale. The manipulation check questions appear as follows in this study:

**Did the portion of the audit report shown to you contain an entire paragraph explicitly discussing investment income's high estimation uncertainty?**

| | | | | |
|---|---|---|---|---|
| I am extremely confident the audit report **DID NOT** contain an entire paragraph discussing investment income's high estimation uncertainty | I am somewhat confident the audit report **DID NOT** contain an entire paragraph discussing investment income's high estimation uncertainty | I don't remember if the audit report contained an entire paragraph discussing investment income's high estimation uncertainty | I am somewhat confident the audit report **DID** contain an entire paragraph discussing investment income's high estimation uncertainty | I am extremely confident the audit report **DID** contain an entire paragraph discussing investment income's high estimation uncertainty |
| 1 | 2 | 3 | 4 | 5 |

**Was the final item in Footnote No. 9 a table that reconciled the Level 1 and Level 3 gains from the investment income account or a paragraph that discussed the investment income account and its uncertainty?**

| | | | | |
|---|---|---|---|---|
| I am extremely confident the final item in Footnote No. 9 **was a table** that reconciled the Level 1 and Level 3 gains from the investment income account **and NOT** a paragraph that discussed the investment income account and its uncertainty | I am somewhat confident the final item in Footnote No. 9 **was a table** that reconciled the Level 1 and Level 3 gains from the investment income account **and NOT** a paragraph that discussed the investment income account and its uncertainty | I don't remember if the final item in Footnote No. 9 **was a table** that reconciled the Level 1 and Level 3 gains from the investment income account or a paragraph that discussed the investment income account and its uncertainty | I am somewhat confident the final item in Footnote No. 9 **was NOT a table** that reconciled the Level 1 and Level 3 gains from the investment income account **but IT WAS** a paragraph that discussed the investment income account and its uncertainty | I am extremely confident the final item in Footnote No. 9 **was NOT a table** that reconciled the Level 1 and Level 3 gains from the investment income account **but IT WAS** a paragraph that discussed the investment income account and its uncertainty |
| 1 | 2 | 3 | 4 | 5 |

**Statistical Techniques**

This study uses a 1 × 3 between-subjects design. Participants were randomly assigned to one of the three experimental conditions using Qualtrics (Brandon et al., 2014a; Brown-Liburd & Zamora, 2015). The experimental conditions consist of (1) traditional audit report – No CAM; (2) CAM disclosure in audit report; and (3) CAM disclosure in management footnote. The primary statistical methods used for this research are (a) descriptive analysis, and (b) ANOVA.

**Descriptive Analysis**

This study uses descriptive statics for the following (1) level of uncertainty surrounding net income before tax that will affect the lending decision, (2) gender, (3) age, (4) frequency with which the audit report is relied upon in making the lending decision, (5) frequency with which the commercial lending officer reads the business press, (6) commercial lending experience, and (7) highest level of education. Performing descriptive statistics as an initial step guards against violating assumptions underlying the other statistical tests in this research (Pallant, 2010).

**One-Way Anova**

The independent variable in this study is the audit report. There are three levels of the independent variable in this study. The three levels consist of (1) traditional audit report – No CAM; (2) CAM disclosure in audit report; and (3) CAM disclosure in management footnote.

The goal of this study is to compare the mean score of bankers' decision to approve a loan for different levels of the single independent variable. One way analysis of variance is the proper statistical technique when there is an independent variable with many levels and a single dependent variable (Pallant, 2010).

One-way ANOVA will compare the variance between the groups with the variance within the groups. The F-statistic is computed from the ratio of the between-group and within-group variance. The between-group variance is the variance due to the different levels of the independent variable. Within-group variance is the variance due to chance (i.e., "error"). In addition, if the F-statistic is large, indicating that scores on the dependent variable are due mainly to the different levels of the independent variable, post hoc tests will be used to identify the specific differences between different levels of the independent variable (Pallant, 2010). Post hoc tests are done when there is no *a priori* reason for expecting specific group differences. The post hoc tests will use all pairwise combinations to find these group differences (Field, 2013).

## RESULTS

**Summary of Response Rate**

Table 1 provides information about the response rate. Using Qualtrics panels, the total number of potential respondents that honor the invitation was 2,180, but after excluding participants in my sample that did not fit the criteria for the population under examination, the total number of qualified participants is 287. After further excluding respondents who failed the manipulation check questions and participants who successfully answered the manipulation check questions yet completed the entire experimental instrument in less than one minute, the usable sample was 105.

**TABLE 1**
**RESPONSE RATE SUMMARY FOR THE EXPERIMENT**

| | Respondents | Percentage |
|---|---|---|
| **Total number of qualified participants** | **287** | **100.0%** |
| | | |
| Less: Failed one or both manipulation checks | (178) | (62.0%) |
| Sped through survey | (4) | (1.4%) |
| **Complete and Usable Responses** | **105** | **36.6%** |

**Descriptive Analysis**

Table 2 provides demographic information on the respondents. The demographic information includes (1) level of uncertainty surrounding net income before tax that will affect the lending decision, (2) gender, (3) age, (4) frequency with which the audit report is relied upon in making the lending decision, (5) frequency with which the commercial lending officer reads the business press, (6) commercial lending experience, and (7) highest level of education. Among 105 respondents, 81.9% would consider inaccuracy around net income before tax (NIBT) ranging from 1% to 10% and still consider NIBT to be fairly stated, 55.2% are males, 80.0% are between 31 – 60 years old, 94.3% sometimes or always relied upon the audit report in making a lending decision, 85.7% read the business press at least monthly, 43.8% have over 5 years commercial lending experience, and 68.6% have an undergraduate or master's degree in accounting, finance, management, MBA or Ph.D.

For the analysis of demographic characteristics of respondents, I conducted a Chi-square analysis to analyze the differences in the frequency distribution for the categorical variables among these three treatment groups. Using the Chi-square tests for independence, I find no association between the nominal demographic characteristic and the three treatment groups.

**TABLE 2**
**DEMOGRAPHIC INFORMATION FOR THE EXPERIMENTAL GROUPS**

| | Traditional N = 35 | | CAM N = 35 | | Footnote N = 35 | | Total N = 105 | |
|---|---|---|---|---|---|---|---|---|
| | n | % | n | % | n | % | n | % |
| **Uncertainty Around Net Income before tax (NIBT)** [1] | | | | | | | | |
| ± 1% of NIBT | 3 | 8.6% | 5 | 14.3% | 3 | 8.6% | 11 | 10.5% |
| ± 5% of NIBT | 16 | 45.7% | 11 | 31.4% | 14 | 40.0% | 41 | 39.0% |
| ± 10% of NIBT | 12 | 34.3% | 11 | 31.4% | 11 | 31.4% | 34 | 32.4% |
| ± 15% of NIBT | 1 | 2.9% | 4 | 11.4% | 4 | 11.4% | 9 | 8.6% |
| ± 20% or greater | 3 | 8.6% | 4 | 11.4% | 3 | 8.6% | 10 | 9.5% |
| **Gender** | | | | | | | | |
| Male | 20 | 57.1% | 14 | 40.0% | 24 | 68.6% | 58 | 55.2% |
| Female | 15 | 42.9% | 21 | 60.0% | 11 | 31.4% | 47 | 44.8% |
| **Age** | | | | | | | | |
| < 30 years' old | 8 | 22.9% | 5 | 14.3% | 6 | 17.1% | 19 | 18.1% |
| 31 ↔ 40 yrs. old | 10 | 28.6% | 11 | 31.4% | 11 | 31.4% | 32 | 30.5% |
| 41 ↔ 50 yrs. old | 3 | 8.6% | 6 | 17.1% | 4 | 11.4% | 13 | 12.4% |
| 51 ↔ 60 yrs. old | 10 | 28.6% | 8 | 22.9% | 9 | 25.7% | 27 | 25.7% |
| 61 ↔ 70 yrs. old | 3 | 8.6% | 5 | 14.3% | 4 | 11.4% | 12 | 11.4% |
| > 70 years' old | 1 | 2.9% | 0 | 0.0% | 1 | 2.9% | 2 | 1.9% |
| **Frequency of referring to the auditor's opinion to inform lending decision** | | | | | | | | |
| Always | 19 | 54.3% | 19 | 54.3% | 22 | 62.9% | 60 | 57.1% |
| Sometimes | 15 | 42.9% | 13 | 37.1% | 11 | 31.4% | 39 | 37.1% |
| Never | 1 | 2.9% | 3 | 8.6% | 2 | 5.7% | 6 | 5.7% |
| **Frequency of reading the business press** | | | | | | | | |
| Never | 5 | 14.3% | 7 | 20.0% | 3 | 8.6% | 15 | 14.3% |
| Monthly | 11 | 31.4% | 9 | 25.7% | 6 | 17.1% | 26 | 24.8% |
| Weekly | 12 | 34.3% | 10 | 28.6% | 21 | 60.0% | 43 | 41.0% |
| Daily | 7 | 20.0% | 9 | 25.7% | 5 | 14.3% | 21 | 20.0% |
| **Commercial Lending Experience** | | | | | | | | |
| 1 ↔ 5 years | 21 | 60.0% | 21 | 60.0% | 17 | 48.6% | 59 | 56.2% |
| > 5 but < 10 | 10 | 28.6% | 11 | 31.4% | 10 | 28.6% | 31 | 29.5% |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| 10 years or more | 4 | 11.4% | 3 | 8.6% | 8 | 22.9% | 15 | 14.3% |
| **Education** | | | | | | | | |
| Under. →AFM [2] | 11 | 31.4% | 17 | 48.6% | 10 | 28.6% | 38 | 36.2% |
| Under. → Other [3] | 6 | 17.1% | 4 | 11.4% | 7 | 20.0% | 17 | 16.2% |
| Master →AFM [4] | 9 | 25.7% | 8 | 22.9% | 8 | 22.9% | 25 | 23.8% |
| Master →Other [5] | 5 | 14.3% | 5 | 14.3% | 6 | 17.1% | 16 | 15.2% |
| MBA. | 1 | 2.9% | 1 | 2.9% | 2 | 5.7% | 4 | 3.8% |
| Ph.D. | 3 | 8.6% | 0 | 0.0% | 2 | 5.7% | 5 | 4.8% |

All variables were evaluated for independence using $\chi^2$ test of independence ($\alpha = 0.05$). Results indicated no association between any of the demographic variables treated as dependent variables and the independent variable.

1 – When the respondent successfully answers the manipulation check question, the respondent first answered a question that assessed the level of uncertainty surrounding net income before tax, whereby the respondent would still consider the reported net income as fairly stated in all material respects. The baseline net income before tax was $100 million. Based on participant responses, 81.9% of the respondents believe that from 1% to 10% of measurement uncertainty may exist around stated net income before tax and the income statement is still fairly stated in all material respects.
2 – Undergraduate – Accounting/Finance/Management
3 – Undergraduate – Other
4 – Master's Degree – Accounting/Finance/Management
5 – Master's Degree – Other

## Manipulation Check Questions

I use two questions to conduct a manipulation check of my independent variable. I ask manipulation check questions using a five-point Likert scale. Similar to Christensen et al. (2014), I define a failure as participants at the wrong end of their treatment-related question. For both manipulation check questions, choice 3 (i.e., the midpoint) is always regarded as failure.

This study finds that participants receiving a CAM paragraph in the audit report recognized that they had received it, as compared to those who did not (4.3429 versus 1.60000; $t = 27.064$, $p < 0.001$). This study finds that participants receiving CAM paragraph information in the footnote disclosure recognized that they had received it, as compared to those who did not (4.1143 versus 1.5714; $t = 31.476$, $p < 0.001$).

## One-Way ANOVA

The results of One-Way ANOVA (i.e., completely randomized design) are the focus of this study. Through One-Way ANOVA, this study obtains the results of the effects of CAM disclosure type and the lending decision. One-Way ANOVA (**Error! Reference source not found.**) suggests CAM disclosure type has a statistically significant effect on the lending decision of the commercial lending officer respondents. Thus, the following discussion evaluates (1) a source credibility effect → $H_1$, and (2) an information effect → $H_2$.

Using One-Way ANOVA, this study examines the impact of CAM disclosure through a source credibility effect ($H_1$), and an information effect ($H_2$) on a commercial lender's lending decision. The hypotheses are as follows:

***H1:*** *Commercial loan officers who receive a CAM paragraph discussing the audit of significant uncertain fair value estimates in the audit report have a lower likelihood of approving a loan as commercial loan officers who receive the same information in management's fair value footnote disclosures.*

***H2:*** *Commercial loan officers who receive the standard fair value footnote and a CAM paragraph in the audit report, which discusses the audit of uncertain fair value measures, will have a lower likelihood of* *approving a loan as commercial loan officers who only receive the fair value footnote and a standard audit report which excludes a CAM paragraph.*

Table 3 provides the results of One-Way ANOVA for the lending decision. These results suggest that CAM disclosure type has a statistically significant effect on the lending decision (Panel A, $F_{2, 102} = 5.706$, p= 0.004, two-tailed). The results of One-Way Anova is an omnibus test. The results indicate that I reject the null hypothesis of no difference in the lending decision for the three treatment groups. To specifically examine the hypotheses under examination in this study, I proceed with the Scheffe test of multiple comparison.

*Hypothesis 1: Source Credibility*

I reject the null hypothesis of no difference between the CAM treatment group and the FOOTNOTE treatment group. Specifically, the mean difference between the probability of approving a loan between the CAM and FOOTNOTE treatment groups is 13.4%. Scheffe post hoc test results show this difference is statistically significant (p = 0.034). Results of this test add support to the existence of a source credibility effect and the resultant impact on the commercial lending officers' decision regarding whether or not they would approve a line of credit at a reasonable rate of interest.

*Hypothesis 2: Information Effect*

I reject the null hypothesis of no difference between the CAM treatment group and the TRADITIONAL treatment group. Specifically, the mean difference between the probability of approving a loan between the CAM and TRADITIONAL treatment groups is 16.0%. Scheffe post hoc test results show this difference is statistically significant (p = 0.009). Evidence from this study suggests an information effect exists whereby the presence of a CAM in the audit report will cause the lending decision to differ. In the context of this study, the presence of a CAM disclosure in the audit report reduces the commercial lending officers' propensity to approve a loan at a reasonable rate of interest.

The above findings have the following implications. The results indicate that the CAM language presented in the audit report has a statistically significant effect on the commercial lender's lending decision. This finding is consistent with extant literature that has found that auditor provided CAM disclosures are decision useful.

**TABLE 3**
**EFFECTS OF CAM DISCLOSURE TYPE ON A LENDING DECISION[a]**

**Panel A: Analysis of Variance for Lending Decision**

| **Source[b]** | **Hypotheses** | **Sum of Squares** | **Df** | **Mean Square** | **F** | **Significance** |
|---|---|---|---|---|---|---|
| Test Variable | | | | | | |
| Report Type | H1, H2, (Panel C | 0.517 | 2 | 0.258 | 5.706 | 0.004 |
| Error | below) | 4.619 | 102 | 0.045 | | |
| $*R^2=0.101$ | | | | | | |

**Panel B: Descriptive Statistics {Mean, Standard Deviation(SD), and N}**

| | **Traditional** (1) | **CAM** (2) | **Footnote** (3) | **Total** |
|---|---|---|---|---|
| *Mean* | 0.680 | 0.520 | 0.654 | 0.618 |
| *SD* | 0.203 | 0.218 | 0.217 | 0.222 |
| *N* | 35 | 35 | 35 | 105 |

| Panel C: Post Hoc Tests (Scheffe) | | | | |
|---|---|---|---|---|
| **Mean Comparison** [c] | **Mean Difference** | **Sig.** | **Hypothesis** | **Result** |
| \|(2) – (1)\| | 0.160 | 0.009 | $H_2$ | Reject the null (supports the existence of and information affect) |
| \|(2) – (3)\| | 0.134 | 0.034 | $H_1$ | Reject the null (supports the existence of a source credibility affect) |
| \|(1) – (3)\| | 0.026 | 0.880 | None | Fail to reject the null hypothesis of no difference between the Traditional and the Footnote treatment group |

[a] The lending decision is measured on an 11-point Likert scale anchored at 0% (Will not grant a line of credit for a material amount) to 100% (Will grant a line of credit for a material amount). Possible responses are in increments of 10%.

[b] Variable coding:
*CAM Report Type* = 1 for Traditional (No CAM disclosure or control condition); 2 for CAM (CAM disclosure in audit report); 3 for Footnote (Standard audit report but CAM disclosure in management footnote)

[c] Mean Comparison evaluates the absolute difference between groups

**Supplemental Analysis**

In this study, I conduct a series of supplemental analysis to further understand the effects of CAM disclosure type on commercial lenders. The findings of the supplemental analysis are organized as follows: (1) Questionnaire on Investment Income, (2) Questionnaire on Company-Wide Characteristics, and (3) Sensitivity analysis

*Questionnaire on Investment Income*

Table 4 summarizes the responses of commercial lenders to questions regarding investment income. This summary presents the mean response and the corresponding standard deviation for each of the questions by CAM disclosure type. A One-Way ANOVA was conducted to evaluate if there were statistically significant differences for each treatment group. Results of this test suggest there are no statistically significant differences among respondents for questions one, two, four, and five.

A One-Way ANOVA of questions six {$F_{(2,102)} = 4.753$, $p = 0.011$}and seven {$F_{(2,102)} = 5.928$, $p = 0.006$} yields statistically significant results. Question six concerns whether respondents believe the unrealized gain will result in a real dollar gain [Not Likely (0) ↔ Highly Likely (10)]. The results suggest that respondents in the CAM group have a lower belief in the unrealized gain resulting in a real dollar gain. Question seven concerns whether respondents believe whether financial reporting is handled well regarding investment income [Not Well (0) ↔ Very Well (10)]. The results suggest that respondents in the CAM group have the least favorable view of how well financial reporting was handled around investment income.

**TABLE 4**
**QUESTIONNAIRE ON INVESTMENT INCOME**

| **Means (Standard Deviations)** <br> **One-Way ANOVA**$_{(df\frac{2}{102})}$ <br> **(Independent Variable:** ***Audit Report Type*****)** | | | | | | |
|---|---|---|---|---|---|---|
| Question | Traditional (1) | CAM (2) | Footnote (3) | Total | ANOVA | Post Hoc (Scheffe) |
| 1 | 7.60000 (1.76901) | 7.02857 (2.3071) | 7.48571 (1.73835) | 7.37143 (1.9526) | F {0.837} P {0.436} | 1 – 2 <br> 1 – 3 <br> 2 – 3 |
| 2 | 6.00000 (2.16930) | 5.91429 (1.91544) | 6.37143 (2.45052) | 6.09524 (2.17735) | F {0.431} P {0.651} | 1 – 2 <br> 1 – 3 <br> 2 – 3 |
| 4 § | 5.65714 (2.32560) | 5.62857 (2.26334) | 5.71429 (2.79255) | 5.66667 (2.44818) | F {0.011} P {0.989} | 1 – 2 <br> 1 – 3 <br> 2 – 3 |
| 5 | 6.40000 (2.10322) | 6.62857 (2.08758) | 6.91429 (2.16077) | 6.64762 (2.10759) | F {0.518} P {0.597} | 1 – 2 <br> 1 – 3 <br> 2 – 3 |
| 6 | 6.71429 (1.58247) | 5.54286 (2.45360) | 7.00000 (2.15570) | 6.41905 (2.16964) | F {4.753} P {0.011} | 1 – 2 * <br> 1 – 3 <br> 2 – 3 ** |
| 7 | 7.85714 (1.59305) | 6.54286 (2.42951) | 7.94286 (1.57074) | 7.44762 (1.99509) | F {5.928} P {0.006} | 1 – 2 ** <br> 1 – 3 <br> 2 – 3 ** |

*, **, **** Denote two-tailed significance at the 10 percent, 5 percent, and 1 percent levels, respectively.

§ - *Question 3 is excluded as it is the dependent variable and similar information is available in Table 4*

**The specific questions and corresponding Likert scales appear as follows:**

1. How easily could you assess the importance of reported investment income for Gilead-Global Exports, Ltd.?
   **[Not Easily] 0 ↔ 10 [Very Easily]**
2. Based on the information provided, what is your assessment of the risk associated with extending a line of credit for a material amount to Gilead-Global Exports, Ltd.? **[Very Low Risk] 0 ↔ 10 [Very High Risk]**
4. If you had approved a line of credit for a material amount for Gilead-Global Exports, Ltd., to what extent would the risks from investment income cause you to worry? **[Not Worried] 0 ↔ 10 [Highly Worried]**
5. To what extent are the risks from investment income at Gilead-Global Exports, Ltd. controlled by the skill and diligence of management? **[Not At All] 0 ↔ 10 [Very Much]**
6. Will the unrealized gain from the investment income account eventually result in a real dollar gain for Gilead-Global Exports, Ltd.? **[Not Likely] 0 ↔ 10 [Highly Likely]**
7. How well did Gilead-Global Exports, Ltd. handle financial reporting in regards to the Investment Income account?
   **[Not Well] 0 ↔ 10 [Very Well]**

*Questionnaire on Company-Wide Characteristics*

Table 5 summarizes the responses of commercial lenders to the questions regarding company characteristics. This summary presents the mean response and the corresponding standard deviation for each of the questions by CAM disclosure type. A One-Way ANOVA was conducted to evaluate if there were statistically significant differences in responses to each question. The results of this test suggest there are no statistically significant differences among respondents for questions three, four, five, and six.

A One-Way ANOVA of questions one {$F_{(2,102)} = 4.115$, p = 0.019}and two {$F_{(2,102)} = 5.362$, p = 0.006} yields statistically significant results. Question one concerns the magnitude of trust respondents have in the Company [Small Amount (0) ↔ Large Amount (10)]. The results suggest that respondents in the CAM group have a lower amount of trust in the Company. Question two concerns the degree of integrity respondents believe existed at the Company [Low Integrity (0) ↔ High Integrity (10)]. The results suggest that respondents in the CAM group have the lowest assessment of the degree of integrity that exists at the Company.

**TABLE 5**
**QUESTIONNAIRE ON COMPANY-WIDE CHARACTERISTICS**

| **Means (Standard Deviations)** <br> **One-Way ANOVA**$_{(df\frac{2}{102})}$ <br> **(Independent Variable:** ***Audit Report Type*****)** | | | | | | |
|---|---|---|---|---|---|---|
| Question‡ | Traditional (1) | CAM (2) | Footnote (3) | Total | ANOVA | Post Hoc (Scheffe) |
| 1 | 7.28571 (1.63728) | 6.14286 (1.66527) | 7.05714 (1.96952) | 6.82857 (1.81583) | F {4.115} P {0.019} | 1 – 2 ** <br> 1 – 3 <br> 2 – 3 * |
| 2 | 7.51429 (1.77186) | 6.20000 (2.09762) | 7.31429 (1.51019) | 7.00952 (1.88361) | F {5.362} P {0.006} | 1 – 2 ** <br> 1 – 3 <br> 2 – 3 ** |
| 3 | 7.77143 (1.5163) | 6.94286 (1.78132) | 7.57143 (1.80336) | 7.42857 (1.72569) | F {2.250} P {0.111} | 1 – 2 <br> 1 – 3 <br> 2 – 3 |
| 4 | 5.97143 (2.09321) | 6.14286 (2.23795) | 6.05714 (2.67827) | 6.05714 (2.32804) | F {0.047} P {0.955} | 1 – 2 <br> 1 – 3 <br> 2 – 3 |
| 5 | 7.28571 (1.67282) | 6.42857 (1.97463) | 7.11429 (1.84345) | 6.94286 (1.85446) | F {2.140} P {0.123} | 1 – 2 <br> 1 – 3 <br> 2 – 3 |
| 6 | 5.60000 (2.71380) | 6.31429 (1.71106) | 5.91429 (2.48964) | 5.94286 (2.34040) | F {0.816} P {0.445} | 1 – 2 <br> 1 – 3 <br> 2 – 3 |

*, **, **** Denote two-tailed significance at the 10 percent, 5 percent, and 1 percent levels, respectively.

**The specific questions and corresponding Likert scales appear as follows:**

1. How much trust do you have in Gilead-Global Exports, Ltd. as a company?
   **[Small Amount] 0 ↔ 10 [Large Amount]**
2. How much integrity exists at Gilead-Global Exports, Ltd. as a company?
   **[Low Integrity] 0 ↔ 10 [High Integrity]**
3. How truthful is Gilead-Global Exports, Ltd. as a company?
   **[Not Truthful] 0 ↔ 10 [Highly Truthful]**

| | | |
|---|---|---|
| 4. | Overall, how risky is Gilead-Global Exports, Ltd. as a potential borrower?<br>**[Not Risky] 0 ↔ 10 [Highly Risky]** | |
| 5. | How confident are you in Gilead-Global Exports, Ltd. as a company?<br>**[Not Confident] 0 ↔ 10 [Very Confident]** | |
| 6. | What is the risk that Gilead-Global Exports, Ltd. financial statements contain a material misstatement?<br>**[Not Likely] 0 ↔ 10 [Highly Likely]** | |

*Sensitivity Analysis*

I examine if the results are sensitive to the respondent's failure to provide a correct response to the manipulation check questions. Specifically, I examine whether the inclusion of those respondents that fail the manipulation check will alter my results. Results indicate that if respondents fail to identify the presence of the CAM, I will fail to reject a null hypothesis of a differential impact of a CAM disclosure on the lending decision of commercial lending officers. To adequately assess the decision usefulness of CAM disclosures in the audit report, it is important that respondents paid attention to the appearance (i.e., or lack thereof) of the CAM disclosure.

Given that this experiment was administered online, I explore whether or not the inclusion of time spent on the instrument would affect my results. Treating time as a covariate, I use ANCOVA to examine the effects of time on the results. For all respondents, the aggregate time was a mean of 15.4 minutes. Results of ANCOVA show that time is not a statistically significant covariate.

## CONCLUSION

This study adds to the existing literature regarding the decision usefulness of CAM disclosures in the audit report. By evaluating the decision usefulness of CAMs with commercial lending officer respondents, this study specifically answers the call for the effect of CAM disclosures on a sophisticated financial statement user group. The findings of this study suggest the decision making of commercial lenders is affected by disclosure of CAMs in the audit report. The results of this study suggest that in a lending scenario, the disclosure of CAMs lowers the propensity of commercial lending officers to approve a loan at a reasonable rate of interest. Evidence from this study also suggests that when CAMs are disclosed in the audit report, commercial lending officer respondents are more critical of management's financial reporting; they reduce their trust in the firm, and they reduce their perceptions of management's integrity.

### Limitations

This study has several limitations. The first limitation is the incomprehensive information in the experimental instrument. To keep the experimental materials to a reasonable length, much of the information that would typically be available to the target group utilized in this study is excluded.

A second limitation of this study is that respondents did not receive a complete set of financial statements (1) balance sheet, (2) income statement, and (3) cash flow statement. Instead of providing respondents with a complete set of financial statements, the experimental instrument provided an income statement only and indicated the top 10 ratios that the extant literature has shown are used by commercial lenders (Vishwanath, 2007). Respondents were told the potential borrower was "in the range of slightly below average to slight above average" for these ratios. All respondents received this disclosure, but it is indeterminable that this introduced some bias (i.e. *positive or negative)* into the decision-making process.

A third limitation is that commercial lenders are not the only sophisticated financial statement user group. Other types of users in the following non-exhaustive list include equity analysts, credit analysts, institutional investors, and hedge fund managers who may respond to the presence of CAMs in a different way than commercial lenders.

**Recommendations**

As per the identified limitations of this study, there are several avenues for future research. First, due to the limited information in the experimental instrument in this study, future study could provide respondents with more information that more closely approximates what would be available to commercial lenders in a real lending scenario. Second, similar to the first limitation, a future study should provide respondents with a complete set of financial statements, especially a statement of cash flows. Third, since other sophisticated financial statement user groups exist and impound information from auditor provided disclosure differently than commercial lending officers, a future study could evaluate how CAM disclosure would impact a contextually relevant decision.

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## APPENDIX

### Experimental Instrument
### General Instructions and Background

The case materials contain financial information about a fictitious company. Gilead-Global Exports, Ltd. After reading the materials, you will be asked to evaluate certain characteristics of the Company and its financial statements. Your responses will remain confidential.

The information included in the case is not intended to be comprehensive or representative of what would normally be available when you evaluate a company. Assume that all the information in the case materials are prepared in accordance with the prevailing auditing and accounting standards, which may differ from current auditing and accounting standards. Please base your judgments about Gilead-Global Exports, Ltd. only on the information provided in the case materials.

Terminology specific to auditing and financial reporting will be used in the case. Two terms used in the case are defined as follows:

Materiality: an amount is deemed to be material if an omission or misstatement to the financial statements by that amount would affect a reasonable commercial loan officer's judgment. Practically speaking, an amount is material if it is greater than or equal to 5% of pre-tax income.

Material Misstatement: a misstatement, or error, in the financial statements of such a dollar amount that it would affect a commercial loan officer's judgment. Practically speaking, an individual misstatement or aggregation of misstatements that exceed 5% of pre-tax income would be considered a material misstatement.

Thank you again for participating in the study and please continue to the next page.

**<u>Pre-Screen Question</u>**

Do you have at least one year of commercial lending experience?

- ❍ **Yes**
- ❍ No

**Company Description and Background Information**

Gilead-Global Exports, Ltd. is a specialty manufacturer of tools. The Company ships first-rate tools to carpenters, contractors, production facilities, and fabricators across North and Central America. The Company's products are largely sold directly to the end users, but the Company also sells to select distributors in certain high-demand markets. Some historical financial ratios are below:

| Gilead-Global Exports, Ltd. | | | |
|---|---|---|---|
| | 2012 | 2013 | 2014 |
| Return on Assets | 7.23% | 8.05% | 7.56% |
| Return on Sales | 6.85% | 7.03% | 6.69% |

The Company is seeking to obtain a line of credit for a material amount for the next year from your financial institution because it is planning an aggressive marketing campaign to select distributors in certain high-demand markets that will increase market share in these high-demand markets. The line of credit would be secured by the Company's available for sale securities. The Company does not currently have a business relationship with your financial institution.

**SUPPLEMENTARY FINANCIAL INFORMATION**

The following additional ratio information is provided to help you assess the creditworthiness of Gilead-Global Exports, Ltd.:

| | | | |
|---|---|---|---|
| **Financial Ratios**: *in the range of slightly below average to slightly above average* | $\frac{\text{Debt}}{\text{Equity}}$ | $\frac{\text{Cash flow}}{\text{Current maturities of debt}}$ | Current ratio |
| | Fixed charged coverage | Net profit margin after tax | Net interest earned |
| | Accounts receivable turnover | Degree of financial leverage | Inventory turnover |

## Treatment 1: Traditional Audit Report

**Auditors are responsible for providing reasonable assurance that the financial statements are fairly stated in all material respects. Although the responsibility to accurately present financial statement information lies with the Company's management, public company auditors provide an important service by providing an independent assessment as to the accuracy of the financial statements.**

**Independent Auditor's Report** (final paragraph only)

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2014, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on criteria established in a widely-accepted internal control framework.

ABC Auditor
February 15, 2015

**The Income Statement presents the financial performance of the Company during the fiscal year presented.**

Income Statement

| | Dec 31, 2014 ('000's) |
|---|---|
| Net Sales | $2,716,256 |
| Cost of goods sold | 1,831,250 |
| Gross profit | 885,006 |
| Selling, general & administrative expenses | 402,500 |
| Income from operations | 482,506 |
| Investment income | 60,400 |
| | 542,906 |
| Interest expense | 252,378 |
| Income before income taxes | 290,528 |
| Income tax | 108,571 |
| Net income | $181,957 |
| | |
| Earnings per share (EPS) | $1.82 |

**The Footnotes to the Financial Statements provide additional information to support the amounts recognized in financial statements such as the Income Statement**

**Selected Footnote Information**

**Note 9. Investments Measured at Fair Value**

The Company uses fair value accounting for its investments. Fair value is measured based on observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's assumptions. These two types of inputs create the following fair value hierarchy:

- Level 1 — Quoted prices for identical instruments in active markets.
- Level 2 — Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; an model-derived valuations whose inputs are observable.
- Level 3 — Model-derived valuations that reflect the Company's own assumptions and projections.

Level 1 fair values contain low estimation uncertainty. Level 2 and Level 3 fair values contain moderate or high estimation uncertainty, depending on the nature of the model inputs and the value of the instrument. Estimation uncertainty is the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

The following table presents, for each level of the fair value hierarchy, the Company's trading securities and available-for-sale securities at fair value as of December 31, 2014 **(numbers in thousands):**

| | | Fair Value Measurements Using | | |
|---|---|---|---|---|
| Description | Fair Value at 12/31/2014 | Level 1 | Level 2 | Level 3 |
| Security Assets | | | | |
| Trading Securities | $ 147,624 | | | $ 147,624 |
| Available for sale | $ 63,576 | $ 63,576 | | |
| Total Security Assets | $ 211,200 | $ 63,576 | | $ 147,624 |

The following table provides a reconciliation of the beginning and ending balances for security assets **(numbers in thousands)**.

| | Level 1 | Level 3 | |
|---|---|---|---|
| Beginning Balance at December 31, 2013 | $63,576 | $87,224 | |
| Realized and unrealized gains and losses included in the income statement | 0 | 60,400 | * |
| Ending balance at December 31, 2014 | 63,576 | 147,624 | |
| Total Effect on Earnings | 0 | 60,400 | * |
| Total Effect on Earnings per Share (EPS) | $0.00 | $0.60 | |

**Unrealized Level 3 Gains*

**Treatment 2: CAM Paragraph**

**Auditors are responsible for providing reasonable assurance that the financial statements are fairly stated in all material respects. Although the responsibility to accurately present financial statement information lies with the Company's management, public company auditors provide an important service by providing an independent assessment as to the accuracy of the financial statements.**

**Independent Auditor's Report** (final two paragraphs only)

**Investment income in the Company's financial statements is composed of unrealized investment gains based on the application of estimates and assumptions, some of which were highly uncertain at the time of estimation due to estimation uncertainty of valuation inputs. Estimation uncertainty is the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement on the reporting date. As a result, the investment account and affected subtotals in the financial statement, including but not limited to net income, contain high estimation uncertainty, which suggests that the reasonable range of possible values for investment income as of the reporting date exceeds materiality, potentially by multiples of materiality. (See Note 9 to the financial statements.)**

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2014, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on criteria established in a widely-accepted internal control framework.

ABC Auditor
February 15, 2015

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**The Footnotes to the Financial Statements provide additional information to support the amounts recognized in financial statements such as the Income Statement**

**Selected Footnote Information**

**Note 9. Investments Measured at Fair Value**

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| Total Effect on Earnings per Share (EPS) | $0.00 | $0.60 | |

**Unrealized Level 3 Gains*

## Treatment 3: Footnote

**Auditors are responsible for providing reasonable assurance that the financial statements are fairly stated in all material respects. Although the responsibility to accurately present financial statement information lies with the Company's management, public company auditors provide an important service by providing an independent assessment as to the accuracy of the financial statements.**

**Independent Auditor's Report** (final paragraph only)

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2014, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on criteria established in a widely-accepted internal control framework.

ABC Auditor
February 15, 2015

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**Selected Footnote Information**

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**Unrealized Level 3 Gains*

**Investment income in the Company's financial statements is composed of unrealized investment gains based on the application of estimates and assumptions, some of which were highly uncertain at the time of estimation due to estimation uncertainty of valuation inputs. Estimation uncertainty is the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement on the reporting date. As a result, the investment income account and affected subtotals in the financial statements, including but not limited to net income, contain high estimation uncertainty, which suggests that the reasonable range of possible values for investment income as of the reporting date exceeds materiality, potentially by multiples of materiality.**

**Section 1 Questions**

| |
|---|
| Please answer the following seven questions regarding investment income at Gilead-Global Exports, Ltd. (the case firm). You may review the case material above while answering these questions. To answer a question, click on the section of the scale that corresponds to your desired response. If you do not click on a portion of the scale, your response for that question will not be recorded. |

1. How easily could you assess the importance of reported investment income for Gilead-Global Exports, Ltd.?

| Not Easily | | | | | | Very Easily | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |

2. Based on the information provided, what is your assessment of the risk associated with extending a line of credit for a material amount to Gilead-Global Exports, Ltd.?

| Very Low Risk | | | | | | Very High Risk | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |

3. What is the probability that you would extend a line of credit for a material amount to Gilead-Global Exports, Ltd. at a reasonable rate of interest as determined by your financial institution? (Assume that your financial institution does not restrict you on the size of the loan that you may grant and that your institution is not limited in the amount of funds that it has available to lend).

|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|
0% 10% 20% 30% 40% 50% 60% 70% 80% 90% 100%

4. If you had approved a line of credit for a material amount for Gilead-Global Exports, Ltd., to what extent would the risks from investment income cause you to worry?

| Not Worried | | | | | | | | | | Highly Worried |
|---|---|---|---|---|---|---|---|---|---|---|
| 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |

5. To what extent are the risks from investment income at Gilead-Global Exports, Ltd. controlled by the skill and diligence of management?

| Not At All | | | | | | | | | | Very Much |
|---|---|---|---|---|---|---|---|---|---|---|
| 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |

6. Will the unrealized gain from the investment income account eventually result in a real dollar gain for Gilead-Global Exports, Ltd.?

| Not Likely | | | | | | | | | | Highly Likely |
|---|---|---|---|---|---|---|---|---|---|---|
| 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |

7. How well did Gilead-Global Exports, Ltd. handle financial reporting in regards to the Investment Income account?

| Not Well | | | | | | | | | | Very Well |
|---|---|---|---|---|---|---|---|---|---|---|
| 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |

Please answer the following six questions regarding company-wide characteristics of Gilead-Global Exports.

1. How much trust do you have in Gilead-Global Exports, Ltd. as a company?

| Small Amount | | | | | | | | | | Large Amount |
|---|---|---|---|---|---|---|---|---|---|---|
| 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |

2. How much integrity exists at Gilead-Global Exports, Ltd. as a company?

| Low Integrity | | | | | | | | | | High Integrity |
|---|---|---|---|---|---|---|---|---|---|---|
| 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |

3. How truthful is Gilead-Global Exports, Ltd. as a company?

| Not Truthful | | | | | | | | | | Highly Truthful |
|---|---|---|---|---|---|---|---|---|---|---|
| 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |

4. Overall, how risky is Gilead-Global Exports, Ltd. as a potential borrower?

| Not Risky | | | | | | | | | | Highly Risky |
|---|---|---|---|---|---|---|---|---|---|---|
| 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |

5. How confident are you in Gilead-Global Exports, Ltd. as a company?

| Not Confident | | | | | | | | | | Very Confident |
|---|---|---|---|---|---|---|---|---|---|---|
| 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |

6. What is the risk that Gilead-Global Exports, Ltd. financial statements contain a material misstatement?

| Not Likely | | | | | | | | | | Highly Likely |
|---|---|---|---|---|---|---|---|---|---|---|
| 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |

This marks the end of Section 1. After you have carefully reviewed the case information and your responses, please continue to Section 2. Please ensure that you have responded to all questions. You will not be able to return to these questions or review the case information while answering questions in Section 2.

**Section 2: Manipulation Check Questions**

Did the portion of the audit report shown to you contain an entire paragraph explicitly discussing investment income's high estimation uncertainty?

| I am extremely confident the audit report **DID NOT** contain an entire paragraph discussing investment income's high estimation uncertainty | I am somewhat confident the audit report **DID NOT** contain an entire paragraph discussing investment income's high estimation uncertainty | I don't remember if the audit report contained an entire paragraph discussing investment income's high estimation uncertainty | I am somewhat confident the audit report **DID** contain an entire paragraph discussing investment income's high estimation uncertainty | I am extremely confident the audit report **DID** contain an entire paragraph discussing investment income's high estimation uncertainty |
|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 |

Was the final item in Footnote No. 9 a table that reconciled the Level 1 and Level 3 gains from the investment income account or a paragraph that discussed the investment income account and its uncertainty?

| I am extremely confident the final item in Footnote No. 9 **was a table** that reconciled the Level 1 and Level 3 gains from the investment income account **and NOT** a paragraph that discussed the investment income account and its uncertainty | I am somewhat confident the final item in Footnote No. 9 **was a table** that reconciled the Level 1 and Level 3 gains from the investment income account **and NOT** a paragraph that discussed the investment income account and its uncertainty | I don't remember if the final item in Footnote No. 9 **was a table** that reconciled the Level 1 and Level 3 gains from the investment income account or a paragraph that discussed the investment income account and its uncertainty | I am somewhat confident the final item in Footnote No. 9 **was NOT a table** that reconciled the Level 1 and Level 3 gains from the investment income account **but IT WAS** a paragraph that discussed the investment income account and its uncertainty | I am extremely confident the final item in Footnote No. 9 **was NOT a table** that reconciled the Level 1 and Level 3 gains from the investment income account **but IT WAS** a paragraph that discussed the investment income account and its uncertainty |
|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 |

**Post-Experimental Questions:**
*BELOW IDENTICAL ACROSS ALL TREATMENTS*

As illustrated in this case study, Level 2 and Level 3 fair values included in companies' financial statements are subject to managements' estimates and judgments on inherently uncertain valuation inputs. Assume you approve a line of credit for a company that reports net income before tax (NIBT) of $100 million. Recognizing that uncertainty exists for all companies, as a [lender], what level of uncertainty around NIBT are YOU willing to accept and still consider the reported income of $100 M to be fairly stated in all material respects.

- ❍ $99M to $101M (± 1% of NIBT)
- ❍ $95M to $105M (± 5% of NIBT)
- ❍ $90M to $110M (± 10% of NIBT)
- ❍ $85M to $115M (± 15% of NIBT)
- ❍ ± 20% of NIBT or greater

Almost done! Please answer the following six demographic questions. No individual responses will be reported.

What is your gender?

- ❍ Male
- ❍ Female

What is your age?

- ❍ < 30 years old
- ❍ 31 – 40 years old
- ❍ 41 – 50 years old
- ❍ 51 – 60 years old
- ❍ 61 – 70 years old
- ❍ > 70 years old

How often do you refer to the auditor's opinion in the Company's financial statements to inform your lending decisions?

- ❍ Always
- ❍ Sometimes
- ❍ Never

How frequently do you read the business press (e.g. The Wall Street Journal, Bloomberg, etc.)?

- ❍ Never
- ❍ Monthly
- ❍ Weekly
- ❍ Daily

How many total years of commercial lending experience do you have?

- ❍ 1 – 5 years
- ❍ Over 5 years but less than 10 years
- ❍ 10 years or more

What is the highest level of education you have completed?

- ❍ Undergraduate – Accounting/Finance/Management
- ❍ Undergraduate – Other
- ❍ Master's Degree – Accounting/Finance/Management
- ❍ Master's Degree – Other
- ❍ MBA.
- ❍ Ph.D.

Thank you for your participation! Please continue to the next page to complete the study and save your responses.