Lending Decision Making and Financial Information: The Usefulness of Corporate Annual Reports to Lenders in Botswana

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Abstract: This study sought to determine the usefulness of annual report information to lenders in Botswana with a view to establishing whether users of financial statement information derive any utility from information presented in the Corporate Annual Report (CAR). The findings on the basis of analysis of responses from seven lenders suggest that financial statement information is required by formal lenders in making the lending decision. The most recent Annual Report (AR) appears to be the most favoured. Formal lenders in Botswana make greater use of the income statement than other components of the annual report. Finally, formal lenders in Botswana regard the audit report as being important to their lending decisions. Notes to the financial statements are not particularly used by these institutions. Also not used is the report from the chairman or directors.

Key words: Audit reports, corporate annual report, financial statements, lenders

INTRODUCTION

Corporate Annual Reports and financial statements, in particular, are expected to be produced by all business entities in regular intervals. The statements are considered an important means not only for gauging the performance of the entity but also for understanding how money invested in the entities has been used and enabling those interested in the entities to make pertinent decisions. In practically all countries production of financial statements is required by law. In Botswana, the Laws of Botswana [Companies Act (Cap. 42:01)] require that with the exception of certain small companies, all other entities established under that Act must produce financial statements on an annual basis. The usefulness of annual reports has been extensively discussed in the past (Vergoossen, 1993; Chang *et al.*, 1983). Much earlier studies confirm that financial statements have information content (Brown and Kennelly, 1972) that has value to the users of the statements. This value includes the ability to use financial statements to predict performance of entities (Abdel-Khalik and Espejo, 1978; Coates, 1972; Reilly *et al.*, 1972). Information in the Corporate Annual Report (CAR) can be used to influence the shareholders' and other reader's impression of company performance (Beattie and Jones, 2000; Segars and Kohut, 2001).

Users of CAR information include investors, creditors and government. Many believe that this information is produced primarily for the benefit of shareholders. However, CAR information is also used by financial analysts and venture capitalists (Chang *et al.*, 1983; Vergoossen, 1993), creditors, banks and other lenders (McCaslin and Stanga, 1986; Danos *et al.*, 1989) and investment analysts (Arnold and Moizer, 1984; Day, 1986; Gniewosz, 1990; Vergoossen, 1993). CAR information is also useful in relation to the market valuation of firms (Wolk *et al.*, 2003). There are some arguments,

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nevertheless, that CAR and financial statement information may not be as useful as it is being suggested. Magness (2003), for example, questions the usefulness of financial statement information on the basis that corporate financial statements do not include environmental values and in the absence of effective reporting guidelines in that regard these statements do not provide useful information to users outside the entity. Likewise Chen and Hsu (2005) suggest that in Hong Kong, users prefer that CAR information is supplemented by additional, preferably non-financial information as it is inadequate on its own. Despite these dissenting views, CAR information is widely being used.

A consideration of all possible users of CAR information will indicate that they are not a homogeneous group. Although Troberg and Ekholm (1995) argue that the real economic interests among the user groups are not different, it is reasonable to expect that the specific kind of information these users require from financial statements and the CAR as a whole differs. For example, individual investors desire information that enables them to determine the current operating results and future prospects of enterprises (Baker and Haslem, 1973). The income statement was particularly singled out as most important for investment decision making by Anderson (1981), Abdelsalam (1990) and Anderson and Epstein (1995). A broad spectrum of CAR users in Kuwait were found to consider the income statement, the balance sheet and the cash flow statement as the most important and credible parts of the CAR (Naser *et al*., 2003). Similarly, Al-Razeen and Karbhari (2004) found that the balance sheet and the income statement were the most important CAR information to Saudi Arabian users.

Although banks and other lenders have been found to use CAR information, the specific information preferred and demanded has not been clearly determined. Larry (1992) underscored the importance of cash flow information to bankers, suggesting that cash flows and not profits, repay the loan. Hence, according to Larry (1992) operating cash flows is important CAR information for purposes of assessing the borrowers' creditworthiness. Jones *et al*. (1995) surveyed, among others, managers, investors and creditors in Australia to determine which information in the financial statements they considered most useful. The creditors in the study were found to use the cash flow statement substantially more than the others included in the study. Research by Billings and Morton (2002) confirmed the importance of operating cash flows in assessing credit risk. Kwok (2002) also found that cash flow information is the second most used information item by bank loan officers in Hong Kong, after Notes to the Financial Statements. Different results were obtained by Abu-Nassar and Rutherford (1996) who found that Jordanian bank loan officers read the income statement and the balance sheet more than other parts of the CAR. Nevertheless, these studies seem to suggest that the CAR information that will be preferred and demanded by lenders to business entities is information conveyed by the Cash Flow Statement.

It can be presumed that the information lenders require needs to be dependable. CAR information is particularly reliable if it is prepared according to prescribed criteria such as Generally Accepted Accounting Principles (GAAP). However Kent and Munro (1999) suggest that deviation from GAAP does not affect bankers' assessment of a borrower's ability to repay although in those cases where there is deviation from GAAP loan officers tend to request for more information than when GAAP is complied with. Wolk *et al*. (2003) argue that the credibility of financial statement information is enhanced if the statements are audited. An audit of financial statements enables the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. (IFAC, 2006:306). Kinney and Martin (1994) suggest that the independent year-end audit directly reduces bias in an entity's pre-audit net earnings and assets and improves the precision of measurement. This implies that the audit function and the resultant audit report should be useful CAR information to lenders. Research in the USA by Johnson *et al*. (1983) found that the impact of the level of audit attestation on commercial lending decisions was not significant. Lenders did not differentiate between financial statements with no attestation and those where a compilation, a review or an audit was done. However,