Study explores impact of firms' restatements on loans

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When a company makes a mistake in its financial statements, it has to reissue them, which can have serious consequences including a loss in market value and investor confidence.

Dr. Rebecca Files and Dr. Umit Gurun, of the Naveen Jindal School of Management at The University of Texas at Dallas, investigated whether restatements by economically related firms also influence the terms of a loan, such as an increased interest rate, for borrowers. Their study was recently published in *Contemporary Accounting Research*.

Restatements are formal admissions that previously filed financial statements were inaccurate, and they can raise doubts about a firm's accounting practices and internal controls. The number of restatements increased from 41 in 1997 to more than 800 in 2014, according to the study.

"Restatements can vary in severity," said Files, associate professor of accounting. "Sometimes, you find a mistake in your financial reports that is very mundane, purely a typo. An error could also apply to a misapplication of complex accounting rules. Restatements also result from more severe issues, however, like fraud and intentional misrepresentation of the financial statements."

Using a sample of 29,519 bank loan initiations and 10,922 restatement announcements from 1998 to 2012, the researchers examined whether banks use restatements by peer firms and customer firms to reassess the risk of the borrower. Peer firms are those in the same industry as the borrower, and customer firms are those that do business with the borrower.

Restatements by related businesses may convey unfavorable information about the borrower's economic prospects and ability to repay the loan.

"We found that banks do, in fact, care about restatements announced by firms outside their lending portfolio," Files said. "Both peer restatements and customer restatements result in incremental loan spread increases to the borrowing firm, regardless of whether or not that borrowing firm has a restatement itself."

Loan spread is an indication of risk: the riskier the client, the higher the interest rate.

With peer firms, the researchers found that higher interest rates can occur regardless of restatement severity.

With customer firms, the loan spread increases only when the restatements are relatively severe or when the relationship between the two firms is extremely close. In these instances, the loan spread can increase dramatically.

For numerous reasons, businesses should think carefully about the companies with which they build close relationships, Files said.

"It's going to have a big impact on your firm," she said. "Beyond the obvious operational ties between customers and suppliers, we find that the implications of your customers' financial reporting can also trickle down to you."

Predicting Fraud, Restatements

The researchers found evidence that lenders are better able to predict fraud in the borrowing firm if peers and customers have had restatements in the past. Prior research has found that even the most sophisticated investors cannot predict fraud, Files said.

"This is one piece of information that banks are using to help them predict future restatements," she said. "Very few market participants can accurately predict restatements. Even when short sellers, or institutional investors, or analysts aren't able to do it, it appears that banks are."

Bank loans represent a sizable majority of external financing operations of businesses, so it's important for lenders, as well as firms, to understand how restatement information might help them.

Managers may be able to address the concerns upfront and bring down the loan's interest rate.

Gurun, a professor of accounting and finance and managerial economics, said the number of public companies has dropped 40 percent since 2008 because of a boom in mergers and acquisitions. In addition, startups can avoid public markets because they are funded by private equity and venture capital firms, which are flush with cash.

"In short, more and more firms do business with privately held companies, and we have limited information on these privately held firms' credibility," Gurun said. "We identified an important use of bank loan information in the public firm domain, which can help us develop a credit score index for privately held firms. Such an index can help determine which private firms will be a reliable business partner."

More information: Rebecca Files et al. Lenders' Response to Peer and Customer Restatements, *Contemporary Accounting Research* (2017). DOI: 10.1111/1911-3846.12374

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