

How Does Financial Misreporting Impact Borrower Reputation?

» Authors

Sudheer Chava, Georgia Institute of Technology, sudheer.chava@scheller.gatech.edu

Kershen Huang, Nova Southeastern University, khuang@nova.edu

Shane A. Johnson, Texas A&M University, shane@tamu.edu

» Research Questions Addressed

How does deliberate financial misreporting impact a firm's reputation and its ability to secure low-cost loans?

How long does it take a firm to rebuild its reputation following an act of deliberate misreporting?

Does additional effort improve a firm's ability to restore its reputation after misreporting?

» Primary Findings

Firms that deliberately misreport financial information pay significantly higher interest rates than firms that truthfully report their finances.

Higher interest rates for misreporting firms are maintained for at least six years after the misreporting is identified. Furthermore, the interest rate premium paid by misreporting firms does not decrease over that same period.

Actions that misreporting firms take to restore their reputation do not result in a decrease in the interest rate premium.

» Relevant Sector

Finance

» Keywords

Bank loans

Cost of debt

Financial restatements

Fraud

Reputation





» Implications for Sustainable Business

Society is negatively impacted when corporations deliberately transact in a dishonest manner. These actions can result in externalities that include environmental damage, the destruction of financial wealth, and widespread job loss. Interest rates on loans are a mechanism by which financial institutions can encourage accurate and truthful reporting of financial information. When firms deliberately misrepresent financial information, the damage to their reputation is long-lasting and costly to repair. These firms face significantly higher interest rates on loans as a result. Borrowing firms are better off investing in systems to prevent misreporting than they are in planning to rebuild a damaged reputation following the discovery of misreported financial information.

» Link to Academic Paper

Chava, S., Huang, K., & Johnson, S. A. (2017). [The dynamics of borrower reputation following financial misreporting](#). *Management Science*, 64(10), 4775-4797.

» Related Links

Chava, S. (2014). [Environmental Externalities and Cost of Capital](#). *Management Science*, 60(9), 2223-2247.

Liang, Y., Marinovic, I., & Varas, F. (2018). [The credibility of financial reporting: A reputation-based approach](#). *The Accounting Review*, 93(1), 317-333.

» Highlights

Misreporting firms experience an increase of 20-86% in their interest rate spread in the first eight years after they restate previously inaccurate financial information.

A significantly greater proportion of misreporting firms undergo efforts to improve their reputation than non-misreporting firms. The proportion of misreporting firms that eliminate internal control weaknesses or replace potentially related parties such as a CFO is 22% and 16% higher, respectively, than non-misreporting firms.

Approximately 88% of misreporting firms undertake at least one action to improve their reputation after the inaccuracy is revealed.

Misreporting firms that attempt to improve their reputation continue to pay loan spreads that are 62-127% higher than loan spreads of firms that did not deliberately misreport their finances.

» Topic Overview

Publicly held corporations are required to report financial information for the protection of investors, lenders, and society. Accurate reporting allows firms to build a good reputation, thus allowing them to secure low-cost loans. Conversely, when firms deliberately misrepresent their finances, their credibility and truthfulness is questioned, and their reputation is diminished. This results in increased screening by lenders, fewer options for debt financing, and higher interest rates on loans.