

## The Effect of Restatements on Commercial Lending Decisions

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### Abstract

This study examines whether restatement of financial statements for a commercial loan applicant affects loan officers' judgments. An experiment was conducted with 89 commercial lenders, who provided risk assessments and lending probabilities for a hypothetical loan applicant. One independent variable involved the manipulation of the type of restatement at two levels -- restatements due to errors versus restatements due to irregularities. Another manipulation involved the entity that prompted the restatement – company management versus outside auditors. A control group was informed that the company had not recently experienced any restatements. Findings indicate that restatements adversely impact lenders' judgments about the applicant company. Furthermore, restatements caused by irregularities more adversely impact lenders' judgments than restatements caused by errors. Additionally, restatements prompted by auditors more adversely impact lenders' judgments than restatements prompted by company management.

**Keywords:** Commercial lending, restatements

### Introduction

#### The Effect of Restatements on Commercial Lending Decisions

This study examines whether restatement of financial statements for a commercial loan applicant affects lending decisions. Companies seeking loans are generally required by banks to provide financial statements in support of loan applications. This information is used as an input to establish the appropriate loan yield and to determine features such as callability,

convertibility, repayment schedules, and collateral requirements (Shivakumar 2013).

Companies may be required to restate financial statements for a variety of reasons. Some result from normal operating practices such as mergers and acquisitions, discontinued operations, stock splits, currency issues, and changes in accounting principles (Flanagan, Muse, and O'Shaughnessy 2008). Others result from company errors (unintentional misstatements) or irregularities/fraud (intentional misstatements), both of which may reflect negatively on company management. In a study of restatements caused by errors and irregularities, Hennes, Leone, and Miller (2008) find that 24 percent are attributable to irregularities and 76 percent are due to errors. Another study by Fischer and Shumberger (2020) documents that fraud and clerical issues are not the usual causes of restatements.

The current study not only investigates whether restatements impact loan decisions, but also whether there may be differences for restatements due to errors versus restatements due to irregularities/fraud. This study also examines whether the entity that initiated the restatement, company management versus the outside auditor, makes a difference to lenders. A study by Hribar and Jenkins (2004) finds that in their sample, 38 percent of restatements were prompted by the company, 16 percent by the SEC, 7 percent by the outside auditor, and 36 percent are not attributable to any source. Restatements prompted by the company may send a signal that management is forthright and trustworthy, while restatements prompted by the outside auditor may send the opposite signal” (Kravet and Shevlin, 2010).

In this study, an experiment was conducted with 89 commercial lenders, who were given a scenario involving a hypothetical loan applicant. They assessed the level of risk associated with granting a line of credit as well as the probability that they would approve the line of credit. Five different questionnaire versions were created by varying information about the restatements. The study finds that restatements adversely impact lenders’ judgments about the applicant company. Furthermore, restatements caused by irregularities/fraud more adversely impact lenders’ judgments than restatements caused by errors. Additionally, restatements prompted by auditors more adversely impact lenders’ judgments than restatements prompted by company management.

### **Review of Literature on Restatements**

Previous studies have examined the impact of financial statement restatements on stock market prices of restating firms (Plumlee and Yohn 2015; Das, Gong, and Li 2022), turnover of executives and board members at restating firms (Collins, Reitenga, and Sanchez 2008; Azzali and Mazza

2020), management reputation (Dong and Wang 2023), shareholder voting for audit committee directors and auditor ratification (Liu, Raghunandan, and Rama 2009; Ye, Hermanson, and Krishnan 2013), earnings forecasts in post-restatement periods (Ettredge, Huang, and Zhang 2013; Wu, Kuang, Lee, and Zhai 2024), audit fees and audit opinions (Chi, Lisic, Myers, Pevzner, and Seidel 2022; Hu, Qian, and Hu 2024), and conservatism in financial reporting in post-restatement periods (Moore and Pfeiffer 2009).

Other studies have focused on the likelihood of restatements in contexts relating to auditor litigation (Mayberry, Park, and Zhang 2024), nonaudit fees (Biswas, Griffin, and Lont 2024), tax industry expertise (Goldman, Harris, and Omer 2022), internal controls (Habib, Bhuiyan, and Wu 2021), related party transactions (Otuya and Emiaso 2022), and corporate social responsibility (Wans 2020). Velte (2023) provides a review of studies dealing with whether auditors affect the likelihood of restatements.

### **Irregularities Versus Errors**

A number of studies have compared restatements caused by accounting errors versus those caused by irregularities/fraud. Findings from Palmrose, Richardson, and Scholz (2004) indicate that the market reaction to restatement announcements related to fraud is more negative than for non-fraud restatements. Hennes, Leone, and Miller (2008) also find that the market reaction to the restatement announcement for the companies that experienced irregularities is more negative than it is for the companies whose restatements were caused by errors. This study also reveals that CEO/CFO turnover rates are higher for companies having restatements due to irregularities than for companies having restatement due to errors.

Ettredge, Scholz, Smith, and Sun (2010) find that non-fraud restatement firms' balance sheet bloat (i.e., unusually high levels of working capital account balances) is higher than that of control firms for a two-year period preceding the initial misstated financial statements. These firms, however, have a lower amount of balance sheet bloat than firms with restatements that involved fraud. Badertscher and Burks (2011) show that when fraud is involved, companies usually take weeks or months to release restatement details. However, when fraud is not involved, companies generally disclose the restatement earnings impact within a day of the initial restatement announcement. Results from Huang and Scholz (2012) indicate that restating companies are more likely to experience auditor resignations than non-restating companies. In addition, the likelihood of resignation increases when a restatement is attributed to fraud or reverses a previously reported profit to a loss.

Amoah and Tang (2013) find that a restatement-induced lawsuit is more likely to be settled when the restatement is due to an accounting

irregularity and an SEC investigation occurs. Chen, Cheng, and Lo (2013) demonstrate that the likelihood of obtaining external financing decreases after restatements, primarily when the restatements are attributable to accounting irregularities. Also, restatement firms that obtain external financing after restatements tend to rely more on debt financing and less on equity financing than they did before.

Albring, Huang, Pereira, and Xu (2013) find that rates of sales growth, especially through external financing, decline following a restatement. Furthermore, the impact of restatements is more pronounced for companies that experienced fraudulent reporting than for companies with restatements due to accounting errors. Chen, Cheng, and Lo (2014) show that firms with restatements caused by accounting irregularities have a decline in information content of earnings for 11 quarters after restatement announcements. Firms having other causes of restatements, however, experience a decline only in the first quarter after restatement announcements.

### **Prompting by Auditors Versus Company Management**

Some studies have examined the impact of restatements by analyzing whether it differs according to which entity prompted the restatement. An analysis of abnormal returns after restatements by Desai, Hogan, and Wilkins (2006) suggests that the stock market imposes a significant penalty on firms committing GAAP violations. Furthermore, the average market reaction to the company-prompted restatements is -11.33%, while the average market reaction to the auditor-prompted restatements is more severe at -15.21%. Palmrose, Richardson, and Scholz (2004) include the SEC as well and find that more negative returns are associated with restatements attributed to auditors and the company, but not the SEC. Nguyen and Puri (2014) report that restatements initiated by auditors are associated with more negative returns than those initiated by the company or the SEC. Yet, Flanagan, Muse, and O'Shaughnessy (2008) find that restatements which are prompted by the SEC tend to be larger (in terms of reduced profits) than those that are prompted by other entities.

Results from Hribar and Jenkins (2004) reveal that restatements initiated by outside auditors are associated with the largest increases in the company's cost of capital. This finding is corroborated by Kravet and Shevlin (2010), who show that restatements result in increases in the estimated cost of equity capital. These increases are greater for restatements initiated by auditors and the SEC than for restatements initiated by company management.

## **Lending Studies**

Several studies have investigated the impact of restatements on commercial lending. Graham, Li, and Qiu (2008) show that compared with loans initiated before a restatement, loans that are initiated after a restatement have higher spreads, shorter maturities, a greater likelihood of being secured, and more covenant restrictions. Moreover, restatements related to fraud increase spreads more than restatements that are not related to fraud. However, the loan spread increase does not differ across the entities that prompted the restatement (company, auditor, SEC, others). Park and Wu (2009) analyze traded syndicated loans to see how the secondary loan market reacts to restatements and find an increased cost of syndicated bank loans after restatements. This negative loan market reaction is more severe when the restatement is prompted by either the SEC or outside auditors, and when the primary reason for restatement is related to revenue recognition issues. Baber, Gore, Rich, and Zhang (2013) demonstrate that restatements increase the cost of municipal debt financing and this increase is more substantial when municipal governance is poor. Following restatements, municipalities tend to reduce the use of debt financing and are more likely to issue secured rather than unsecured debt.

In a behavioral experiment with loan officers, Schneider (2023) finds an adverse impact on lending decisions when a borrower's audit firm has had past associations with borrowers who have defaulted, have experienced financial statement restatements, or have had regulatory enforcement actions. The current study also involves a behavioral experiment with loan officers, but it focuses on the impact of restatements themselves on lending decisions rather than how knowledge about an auditor's past associations with restatements might affect lending decisions.

## **Hypotheses Development**

Financial statement restatements would tend to reflect negatively on company management because the misstatement(s) that led to the need for restatement suggest financial reporting quality had been deficient. After restatements, the credibility of financial reporting is reduced and financial statement users are more suspicious of the information provided by management (Chen, Cheng, and Lo 2013). So, not only might lenders be wary of the company's financial reporting quality, but this deficiency may also tarnish their trust in the company management (Cao, Myers, and Omer 2012). Since lending judgments depend on the quality of financial information and the reputation of loan applicants, restatements would be expected to have an adverse impact on lending judgments. Hence, the following hypotheses are presented:

*H<sub>1a</sub>: Lenders' risk assessments will be higher for companies that have had a restatement as compared to companies that have not had a restatement.*

*H<sub>1b</sub>: Lenders' probabilities of granting lines of credit will be lower for companies that have had a restatement as compared to companies that have not had a restatement.*

Restatements caused by irregularities are viewed as more severe than those caused by errors because irregularities involve intentional misstatements, while errors are unintentional acts. Therefore, restatements caused by irregularities would be expected to produce a more adverse assessment of financial reporting quality and management reliability than restatements caused by errors. Hence, lending judgments should be more negatively impacted by restatements caused by irregularities than by restatements caused by errors. This leads to the following hypotheses:

*H<sub>2a</sub>: Lenders' risk assessments will be higher for companies that have had a restatement due to irregularities/fraud as compared to companies that have had a restatement due to errors.*

*H<sub>2b</sub>: Lenders' probabilities of granting lines of credit will be lower for companies that have had a restatement due to irregularities/fraud as compared to companies that have had a restatement due to errors.*

Restatements prompted by auditors signal that the company did not prevent, identify, and correct a misstatement. On the other hand, restatements initiated by the company indicate relatively stronger internal controls and oversight by management, boards, and audit committees, which should mitigate some of the uncertainty that restatements create about monitoring of the company as well as about management credibility (Palmrose, Richardson, and Scholz 2004). Hence, restatements prompted by auditors would appear to have more serious adverse effects on lending judgments than restatements prompted by company management. Consequently, the following hypotheses are proposed:

*H<sub>3a</sub>: Lenders' risk assessments will be higher for companies that have had a restatement prompted by outside auditors as compared to companies that have had a restatement prompted by company management.*

*H<sub>3b</sub>: Lenders' probabilities of granting lines of credit will be lower for companies that have had a restatement prompted by outside auditors as compared to companies that have had a restatement prompted by company management.*

## **Experimental Design**

The experimental design is 2 x 2 x 1 between-subjects, where the independent variables are the type of restatement (error vs. irregularity) and the party that prompted the restatement (auditor vs. company). For a control group, there is no restatement. As a result, five different questionnaire versions were created, and each loan officer received only one of the five versions. In the NR version (i.e., control group), there was no restatement. The Error/Company (EC) version portrayed a restatement resulting from an error and prompted by company management. An Error/Auditor (EA) version involved a restatement resulting from an error and prompted by the outside auditor. An Irregularity/Company (IC) version portrayed a restatement resulting from an irregularity and prompted by company management. A fifth version, Irregularity/Auditor (IA), presented a restatement resulting from an irregularity and prompted by the outside auditor.

Each of the five questionnaire versions contained the same case scenario involving a commercial lending decision pertaining to a hypothetical loan applicant. The case provided background information about the company and its financial statements for recent years. In addition, the case mentioned that the company's financial statements had been audited and that the auditor issued a clean (i.e., unqualified) opinion.

The loan officers first evaluated the level of risk, on a 10-point scale from very low risk to very high risk, associated with extending a four-million-dollar line of credit to the loan applicant. Next, the participants assessed the probability that they would grant the four-million-dollar line of credit to the loan applicant at a reasonable rate of interest as determined by their financial institution. Afterwards, the loan officers rated the importance of various factors in making these lines of credit decisions. Finally, they responded to several questions involving demographic and other issues. The questionnaires were pre-tested with nine commercial lending officers who had participated in a previous research study, but were not asked to take part in this study. No significant changes were made to the questionnaires based on their comments.

## **Loan Officer Participants**

Commercial bank loan officers located in several U.S. states were contacted by phone or by email and asked whether they were willing to complete a questionnaire for a research study dealing with financial reporting and commercial lending. Four hundred and eighty-five questionnaires were mailed or emailed, depending on their preference, to those who agreed to consider participation in the study. Many of these lenders were required to

receive approval from compliance officers or their superiors in order to participate in this study.

A total of 89 commercial loan officers from 51 different banks participated in the study, resulting in a response rate of 18.35 percent. Participants average 25.6 years serving as loan officers, have an average age of 53.5 years, 40.0 percent possess a master's degree or higher, and 93.3 percent are male. Almost half (47.2 percent) of the loan officers indicated that the financial institutions they work for have more than one billion dollars in assets. Most of the participants (70.8 percent) stated that they have sole loan approval authority up to a certain dollar limit, while 19.1 percent have joint authority with others, 1.1 percent have sole authority, and 9.0 percent have other arrangements (e.g., serve on a loan committee). Four of the five groups contained 18 lender participants, while one group had 17 lenders. Statistical tests reveal no significant differences in demographics among the five groups.

## Findings

The average responses to the two dependent variables for each questionnaire version are reported in Table 1. Overall, the average risk assessment (1=very low risk; 10=very high risk) is 5.50, with a range of 4.78 for the No Restatement group to 6.44 for the Irregularity/Auditor group. The average probability of extending the line of credit to the company is 0.59, ranging from 0.44 for the Irregularity/Auditor group to 0.68 for the No Restatement group.

**Table 1:** Means for Dependent Variables

<b>Group (Sample Size)</b>	<b>Mean Risk Assessment*</b>	<b>Mean Probability of Lending</b>
No Restatement [NR] (n=18)	4.78	0.68
Error/Auditor [EA] (n=18)	5.53	0.57
Error/Company [EC] (n=17)	5.06	0.66
Irregularity/Auditor [IA] (n=18)	6.44	0.44
Irregularity/Company [IC] (n=18)	5.67	0.63
<b>Combined Groups (Sample Size)</b>	<b>Mean Risk Assessment*</b>	<b>Mean Probability of Lending</b>
All five groups [NR,EA,EC,IA,IC] (n=89)	5.50	0.59
Four treatment groups [EA,EC,IA,IC] (n=71)	5.68	0.57
Two Error groups [EA,EC] (n=35)	5.30	0.61
Two Irregularity groups [IA,IC] (n=36)	6.06	0.53
Two Auditor groups [EA,IA] (n=36)	5.99	0.50
Two Company groups [EC,IC] (n=35)	5.37	0.64

\*Responses were on a ten-point scale ranging from 1 = very low risk to 10 = very high risk

In testing the first set of hypotheses, which addresses whether restatements impact lending judgments, the responses to the NR (i.e., control) group are compared to those of the combined four treatment groups, all of which involve restatements. The mean risk assessment for the NR group is 4.78, while that of the combined treatment groups is 5.68. The mean probability of granting the line of credit for the NR group is 0.68, while the mean for the combined treatment groups is 0.57. The directions for both of these differences support the notion that restatements adversely impact lenders' judgments about the applicant company. A MANOVA test on the NR group versus the combined treatment groups indicates that the differences are significant (Wilks' Lambda=0.832;  $p=0.070$ )<sup>1</sup>. Furthermore, while an ANOVA reveals borderline significance for the risk assessment variable ( $F=1.484$ ;  $p=0.109$ ), it shows a significant difference for the probability of granting the line of credit ( $F=3.096$ ;  $p=0.011$ ). Therefore, the results appear to support the first set of hypotheses, indicating that restatements adversely impact lending judgments.

The second set of hypotheses investigates the effects of restatements due to irregularities/fraud versus restatements due to errors. The mean risk assessment for the combined Irregularity groups is 6.06, while that of the combined Error groups is 5.30. The mean probability of granting the line of credit for the combined Irregularity groups is 0.53, while the mean for the combined Error groups is 0.61. The directions for both of these differences support the notion that restatements caused by irregularities/fraud more adversely impact lenders' judgments than restatements caused by errors.

The third set of hypotheses examines the effects of restatements prompted by company management versus restatements prompted by outside auditors. The mean risk assessment for the combined Company groups is 5.37, while that of the combined Auditor groups is 5.99. The mean probability of granting the line of credit for the combined Company groups is 0.64, while the mean for the combined Auditor groups is 0.50. The directions for both of these differences support the notion that restatements prompted by auditors more adversely impact lenders' judgments than restatements prompted by company management.

To test the second and third sets of hypotheses, a 2 x 2 MANOVA is first conducted. The results are statistically significant for the type of restatement, i.e., restatements due to irregularities/fraud versus restatements due to errors (Wilks' Lambda=0.931;  $p=0.070$ ). However, the difference for company versus auditor prompting is not statistically significant (Wilks' Lambda=0.993;  $p=0.419$ ). Next, a 2x2 ANOVA is conducted with risk assessment as the dependent variable and the results are displayed in Panel A

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<sup>1</sup> Unless otherwise indicated, p-values from hereon are one-tailed.

of Table 2. The differences are statistically significant for the type of restatement ( $F=2.354$ ;  $p=0.065$ ) as well as for the source of the restatement prompting ( $F=1.939$ ;  $p=0.085$ ). Another 2x2 ANOVA is conducted with the probability of granting the line of credit as the dependent variable and the results are displayed in Panel B of Table 2. The differences are statistically significant for the type of restatement ( $F=1.813$ ;  $p=0.092$ ) as well as for the source of the restatement prompting ( $F=5.459$ ;  $p=0.012$ ).

**Table 2:** ANOVA Results

**Panel A:** ANOVA with Risk Assessment as the Dependent Variable (for Testing the Effects of Type of Restatement and Source of Restatement Prompting)

Effect	Mean Square	F-statistic	p-value
Type of restatement	8.887	2.354	0.065
Prompt	7.318	1.939	0.085
Interaction	2.691	0.402	0.201

**Panel B:** ANOVA with Probability of Lending as the Dependent Variable (for Testing the Effects of Type of Restatement and Source of Restatement Prompting)

Effect	Mean Square	F-statistic	p-value
Type of restatement	0.122	1.813	0.092
Prompt	0.367	5.459	0.012
Interaction	0.168	2.490	0.060

The MANOVA and both ANOVA tests support  $H_{2a}$  and  $H_{2b}$ , indicating that restatements caused by irregularities/fraud more adversely impact lenders' judgments than restatements caused by errors. Although the MANOVA test does not support  $H_{3a}$  and  $H_{3b}$ , both ANOVA tests do support those two hypotheses. So, there is some evidence, though not strong, that indicates restatements prompted by auditors more adversely impact lenders' judgments than restatements prompted by company management.

After responding to the two dependent variables, loan officers also rated the importance of seven factors in making their risk assessments and lending decisions (1 = no importance; 10 = very important). These ratings are reported in Table 3. All of them are significantly different, at the 0.10 level, from the scale midpoint of 5.5. The most important factors were "balance sheet", "income statement", and "statement of cash flows". "Whether financial statements have been restated" was ranked number six out of seven, suggesting that although this is an important consideration when making judgments about granting lines of credit, it is not as important as most of the other factors.

**Table 3:** Factor Importance

Factor	Mean Rating	t-Statistic
Balance sheet	9.28	31.34*
Income statement	9.26	33.85*
Statement of cash flows	9.10	23.86*
Securing loan with fixed assets	8.36	16.33*
Company description	7.64	9.14*
Whether financial statements restated	7.60	7.36*
Company growth	7.39	8.24*

Rating scale: 1 = no importance; 10 = very important

\*Indicates significance at the 0.10 level for a two-tailed test of the difference between the mean rating and the scale midpoint of 5.5.

Finally, to examine whether lenders' beliefs about restatements were consistent with their responses in the experiment, they were asked to rate the credibility of loan applicant for each of the five scenarios used in this study's experiment. The ratings, which are significantly different across all five scenarios ( $F=48.07$ ;  $p<0.01$ ), are shown in Table 4. Consistent with this study's results, the credibility rating for the NR scenario is highest. The ratings for the two scenarios involving errors are higher than those for the two scenarios involving irregularities, which aligns with the findings in the experiment. Finally, the ratings for the two scenarios involving prompting of restatements by company management are higher than those for the corresponding two scenarios involving prompting of restatements by outside auditors. This also dovetails with the experimental findings.

**Table 4:** Loan Applicant Credibility Ratings for Each of the Five Scenarios

Group	Mean Credibility Rating*
No Restatement [NR]	7.81
Error/Company [EC]	6.91
Error/Auditor [EA]	5.99
Irregularity/Company [IC]	4.55
Irregularity/Auditor [IA]	2.82

\*Responses were on a Ten-Point Scale Ranging from 1 = No Credibility To 10 = High Level of Credibility.

## Summary and Conclusions

This research finds that lenders assess higher risk and assign lower probabilities of granting credit to loan applicants who have had financial statement restatements than to applicants who have not recently had restatements. Moreover, restatements caused by irregularities/fraud more adversely impact lenders' judgments than restatements caused by errors. Another finding is that restatements prompted by auditors more adversely

impact lenders' judgments than restatements prompted by company management.

The results of this study suggest that companies that may wish to borrow money from financial institutions need to be concerned about presenting restated financial statements to prospective lenders. Obviously, if errors or irregularities that warrant restatement occur, then financial statements must be restated. However, if there is any gray area about whether to restate financial statements, then companies may want to factor into their decision the possible impact on future borrowing. Another implication of this study's results is that when a restatement is warranted, companies should not wait until their outside auditors initiate a restatement. Rather, the negative impact of a restatement on future borrowing would appear to be lessened if the company initiates the restatement instead of the auditor.

Several issues may limit the results of this study. One limitation is that loan officers generally have more information about a loan applicant than they received in this study's questionnaire. Also, this research involved a single company scenario and therefore, is not necessarily generalizable to other types of company settings. Future research should therefore investigate the impact of restatements on bank lending with loan applicants having different characteristics relating to industry, competitive environment, risk, and financial strength. Another limitation of this research is that financial incentives, such as suffering losses from poor lending decisions, were not present in this study's experiment. Participants did not have any money or reputation at risk in this study. Rather than eliciting loan officers' intentions, future studies may wish to examine lending decisions in the context of experimental markets where compensation paid to lenders would be influenced by the quality of their lending decisions.

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**Data Availability:** All of the data are included in the content of the paper.

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