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Financial Statement Misreporting: Does Monitoring Matter?

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Abstract: I find a positive relation between the likelihood that a firm misreports its financial statements and its use of bank debt. I next test whether this result might obtain from the greater likelihood of the detection of misreporting, rather than misreporting per se, but my results suggest that this is not the case. Finally I find that the relations between bank debt and misreporting are stronger among larger firms, those with bond ratings, and those covered by Execu Comp. In sum, my results suggest that when firms are subjected to a greater extent of monitoring by outside agents, misreporting is more likely.

Key words: Financial Statement Misreporting, Bank Monitoring, Delegated Monitoring
JEL: G10, G21, G32, M41

1. Introduction

A substantial literature demonstrates theoretically and empirically that banks are effective monitors who add value to borrowing firms (Diamond, 1984; Sharpe, 1990; James, 1987; Lummer and McConnell, 1989; Slovin, Johnson and Glascock, 1992). Banks have clear incentives to monitor their borrowers because of their financial stakes in these firms, which make it in the best interests of banks to ensure that their borrowers do not take any actions that would reduce the value of their stakes, such as asset substitution or financial statement misreporting.[11] Banks' incentives to monitor their borrowers' financial statements in particular derive from covenants in the bank loan agreements, because they are written on information obtained from the borrowers' financial statements. A covenant violation helps

[11] I use the terms "misreporting" and "earnings management" interchangeably, and define them as in Healy and Wahlen (1999), "when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers."