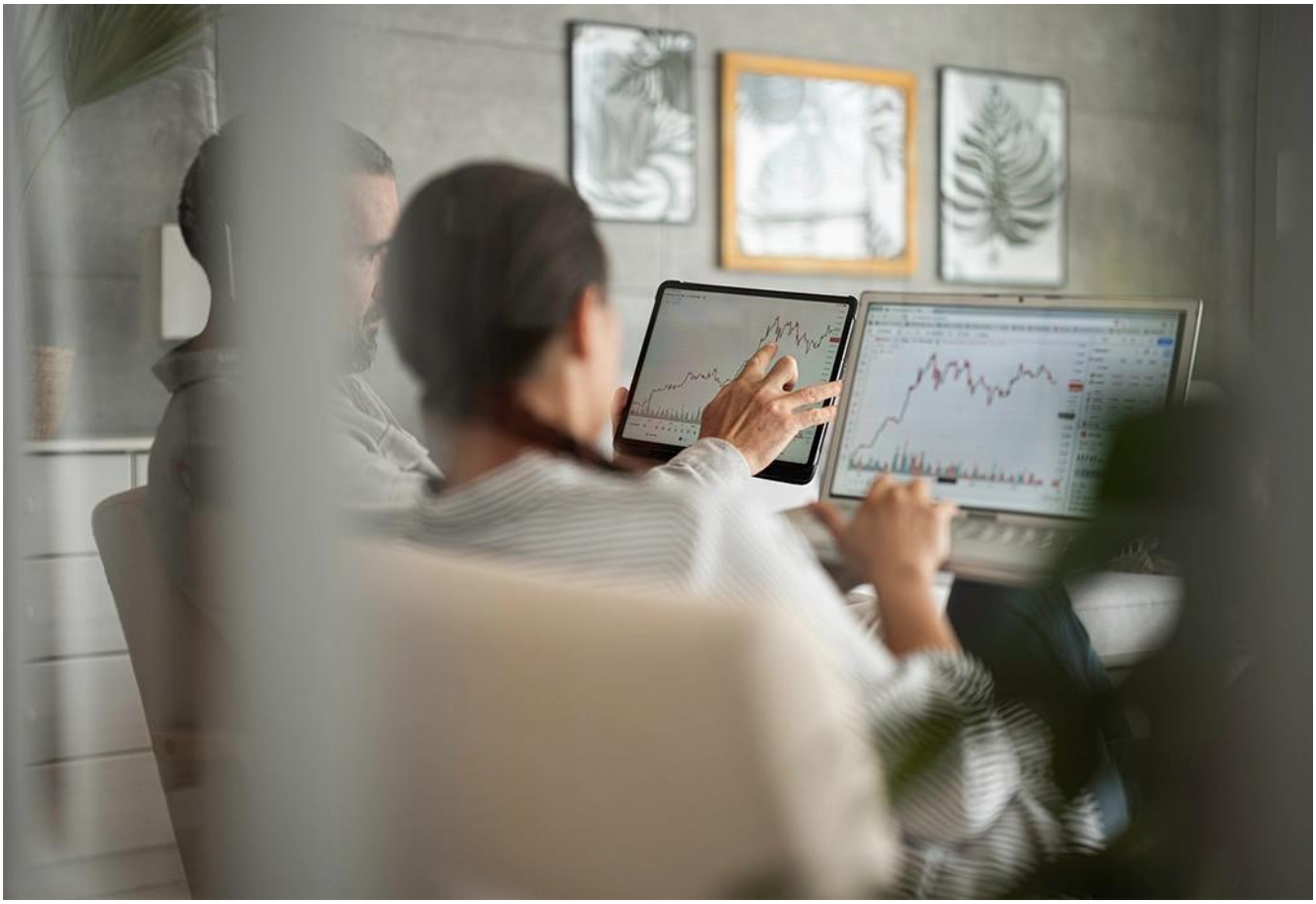
The cost of underreporting debt when applying for a loan

In tight times, reporting less debt on annual statements may seem a shortcut to securing more credit. But it comes at a cost.



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In 2011, Spanish seafood multinational Pescanova’s financial statements showed bank debt of approximately 393 million euros. The banks, however, had reported to the Bank of Spain’s

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Central Credit Register that Pescanova owed them more than 1.495 billion euros. Pescanova had concealed more than 1.1 billion euros that fiscal year. The fraud came to light in 2013, and the subsequent trial revealed that neither the auditing firm nor most of the affected banks had cross-checked the company's figures with the official register.

Was Pescanova an exception or an extreme case of a widespread practice?

A study by IESE professors Miguel Duro, Gaizka Ormazabal and German Lopez-Espinosa indicates that underreporting debt is neither rare nor a random occurrence. Analyzing the unaudited annual balance sheets of private companies in Spain with bank debt between 2008 and 2018, they identified the kinds of companies that did it, what motivated them and what happened after.

Reporting less debt when credit is needed urgently

The researchers compared the bank debt that companies reported in their annual financial statements through the Central Balance Sheet Data Office with the debt that banks reported to the Central Credit Register. Although the figures matched in most cases, in 24% of cases the reported debt differed from the recorded amount by more than 10% of total assets. In 13% of cases, the company reported less debt, while in 12%, the company reported more (percentages are rounded).

Human error or temporary imbalances are unlikely to fully explain these discrepancies. And they don't appear to be random: Companies with the greatest need for financing are more likely to underreport debt. In many cases, this may be a strategy to appear more solvent when financing is needed.

Which companies report less debt?

The study links four company characteristics with the practice:

1. **Financing pressure.** These companies tend to accumulate more short-term bank debt and incur higher financial expenses relative to their liabilities.
2. **Credit applications.** In years when the company applies for a loan from a bank, there's a greater incentive to present a favorable balance sheet.
3. **Seeking new banks.** When applying for credit, companies are more likely to seek

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financing from institutions with no prior credit relationship. A new bank is less familiar with the client's history and may rely more heavily on the financial statements the client submits. In contrast, the client's regular bank has more information about the client, which could make it easier to detect inconsistencies.

4. **Lower accounting sophistication.** This phenomenon occurs more frequently in companies with less developed accounting capabilities, as judged by three indicators: fewer financial instruments, fewer intangible assets and lower average salaries.

Why banks don't always check the public credit registry

With the Bank of Spain offering a centralized, reliable and up-to-date database, how and why do banks fall into the trap of granting loans to companies that report less debt? According to the research, it's because verification itself is a cost and an effort.

Banks don't pay to check the credit registry, except in employee time and availability. Even so, this leads them to conduct verification only selectively, prioritizing larger companies with more signs of risk, while those with more capital, liquidity and a longer track record are checked less frequently.

Professor Miguel Duro adds that, during periods of expansion or when under pressure to meet commercial lending targets, scrutiny is relaxed. And so some transactions slip through the cracks.

The boomerang effect

Reporting lower debt isn't without cost: Companies that do so receive, on average, less financing. The reduction is even greater among banks that grant a higher proportion of loans to companies exhibiting this behavior. It is also more pronounced at institutions with less capital, which are more risk-averse.

Moreover, getting away with underreporting debt tends to be temporary. The benefits rarely accrue for more than two fiscal years, especially when banks consult the credit registry.

The study shows that companies that report lower debt subsequently exhibit more signs of financial weakness. They tend to extend payment terms to suppliers and are more likely to

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have loans more than 90 days past due, non-performing loans and insolvency proceedings.



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