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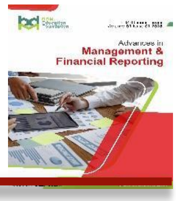

Analysis of Financial Reporting Errors and Their Impact on Stakeholder Trust

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Zakaria ✉

✉ *Universitas Yapis Papua, Jayapura, Papua, 99113, Indonesia*

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Corresponding author. Zakaria
✉ zakariahatta15@gmail.com

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The author(s) declares that the research was conducted in the absence of any commercial or financial relationships that could be construed as a potential conflict of interest.

ABSTRACT

Purpose: This study systematically examines the relationship between financial reporting errors and their impact on stakeholder trust. It will focus on the types and intensity of errors and explore strategies for trust recovery after identifying mistakes.

Research Design and Methodology: The research employs a Systematic Literature Review (SLR) method, analyzing existing studies on financial reporting errors, their effects on stakeholder trust, and the mechanisms for regaining trust post-error. The review encompasses both mature and emerging markets, providing a global perspective.

Findings and Discussion: The analysis reveals that intentional financial reporting errors, such as manipulation, cause significantly more significant damage to stakeholder trust than unintentional errors like technical mistakes. The severity of the errors also plays a crucial role in determining the level of trust erosion. Effective recovery strategies, including transparency, stakeholder engagement, and governance reforms, are essential for restoring trust. However, even with corrective actions, companies may not fully regain the same confidence level, especially following severe or high-profile errors.

Implications: This study offers practical insights for corporate governance by highlighting the need for robust internal controls and transparent communication to address financial reporting errors. Companies can use these findings to develop strategic approaches that minimize the long-term damage to stakeholder trust and ensure more effective recovery after identifying financial discrepancies.

Introduction

Financial reporting is crucial in maintaining company transparency and accountability, serving as a primary communication tool between the company and its stakeholders. Accurate financial statements provide a comprehensive view of a company's performance and financial condition, which forms the basis for strategic decision-making by investors, creditors, and regulators. However, errors in financial reporting, whether due to technical mistakes, human error, or deliberate manipulation, can have severe consequences for a company, particularly in undermining stakeholder trust. The loss of confidence resulting from inaccurate financial reporting can lead to declines in a company's value and reputation and, in extreme cases, financial crises (Hertati et al., 2020). This research systematically examines the impact of financial reporting errors on stakeholder trust. Several cases have demonstrated that financial reporting errors often result in a crisis of confidence, significantly harming a company's performance. For instance, the Enron and WorldCom scandals are extreme examples where financial reports manipulated led to the bankruptcy of major corporations and the loss of trust from stakeholders, including investors, creditors, and regulators (Prechel, 2022). These cases highlight the critical importance of stricter financial reporting standards to prevent the recurrence of similar events in the future.

In this study, agency theory is one of the primary frameworks for understanding the relationship between corporate management as agents and shareholders as principals. This theory suggests that corporate managers may have potential conflicts of interest with shareholders, especially when managers are incentivized to manipulate financial reports to meet short-term targets or enhance personal rewards (Jensen & Smith, 2000). Such manipulation is often conducted to present a more favorable financial performance than the actual situation, ultimately harming shareholders and eroding their trust in the company. Additionally, signaling theory explains how financial reports serve as signals to the market about a company's financial health (Connelly et al., 2011). Accurate and transparent reports send positive signals to stakeholders regarding the company's stability and prospects, while errors in these reports harm the company's reputation and stakeholder trust (Gomulya & Mishina, 2017). In this context, financial reporting errors can be perceived as a negative indicator, leading to distrust among stakeholders and affecting the company's long-term performance. In recent years, numerous studies have focused on the relationship between financial reporting and stakeholder trust and the role of environmental, social, and governance (ESG) factors in financial reporting. Permatasari & Tjahjadi (2024) examined the quality of integrated reporting using the International Integrated Reporting Council framework, emphasizing that high-quality reporting is essential in building trust among various stakeholders, including investors, regulators, and the public. High-quality reporting is necessary to create the transparency required for stakeholders to evaluate a company's overall performance comprehensively. In the context of the sharing economy, Song et al. (2023) highlighted the importance of building trust among diverse stakeholders, such as consumers, hosts, platforms, and governments. Transparency in reporting and accurate information are bridges to reduce distrust between stakeholders, especially in industries where trust is paramount, such as the sharing economy. Another relevant study focuses on the detection of fraud in financial reporting. Shahana et al. (2023) emphasized the importance of advanced data analytics tools for detecting fraud, focusing on challenges such as data imbalance and dimension reduction. Their research shows that advancements in fraud detection techniques can significantly improve the accuracy of financial reporting. Regarding ESG factors, Saini et al. (2023) found that companies with strong governance practices tend to have lower capital costs because stakeholders perceive them as lower risk. This underscores the importance of transparent and accurate financial reporting in ensuring stakeholders can assess a company's commitment to ESG. Additionally, Fragoso et al. (2020) explored the impact of financial restatements on a company's reputation and capital costs. They found that restating financial statements can erode investor trust, increase capital costs, and negatively affect a company's financial performance.

While the recent studies offer valuable insights into financial reporting, stakeholder trust, and the role of ESG factors, they leave several gaps in both empirical and theoretical aspects that need further exploration. One notable gap lies in the insufficient examination of how financial reporting errors, specifically in smaller or emerging markets, differ in their impact compared to larger, more established markets. Much of the existing literature focuses on significant economies, leaving a void in understanding the implications of reporting errors in less regulated or less transparent environments. While many studies like those by Fragoso et al. (2020) and Saini et al. (2023) emphasize the financial outcomes of reporting inaccuracies, there is still a lack of comprehensive research examining how these errors affect long-term stakeholder trust across different sectors. Additionally, the role of digital financial tools and how they could mitigate or exacerbate financial reporting errors remains underexplored. Shahana et al. (2023) touched on this with their analysis of fraud detection tools. Still, more research is needed to understand the broader implications of technology-driven reporting systems on stakeholder trust and financial transparency. From a theoretical standpoint, while agency theory and signaling theory are widely accepted frameworks in this domain, there remains room to explore alternative theories, such as stakeholder theory and legitimacy theory, to offer a more holistic view of the interactions between financial reporting practices and stakeholder trust. Addressing these gaps will provide a more nuanced understanding of the systemic challenges in financial reporting and trust-building among stakeholders.

This study aims to bridge the existing gaps by conducting a Systematic Literature Review (SLR), which exclusively examines financial reporting errors and their impact on stakeholder trust. This research aims to understand how financial reporting errors affect the relationship between companies and their stakeholders. The study considers a range of markets, including established and emerging ones, to provide a global perspective on the impact of financial reporting errors on trust. The primary research questions guiding this study are: How do the intensity and type of financial reporting errors affect stakeholder trust? How can stakeholder trust be restored after financial reporting errors are identified? These questions are designed to explore the nuances of financial reporting errors and their implications for the trust between companies and various stakeholders. This research aims to comprehensively analyze existing literature, identify common patterns of financial reporting errors, and explain how these errors impact stakeholder trust. Additionally, this study offers practical recommendations for improving financial reporting practices to strengthen stakeholder trust across different industries. The novelty of this research lies in its exclusive focus on the relationship between financial reporting errors and stakeholder trust. The study seeks to deepen understanding of how financial reporting errors influence strategic decision-making by investors, creditors, and other stakeholders. Furthermore, the findings are expected to contribute to developing more robust theoretical frameworks and practical solutions to help companies minimize the adverse effects of financial reporting errors on trust by adopting more careful financial reporting practices.

Literature Review

The Importance of Accurate and Transparent Financial Reporting

Accurate and transparent financial reporting is critical in maintaining corporate transparency and accountability. As the primary communication tool between a company and its stakeholders, financial reports provide essential information that supports decision-making processes for investors, creditors, and regulators. High-quality financial reports offer a clear picture of a company's performance and financial position, which is crucial for assessing long-term sustainability and market stability (Gómez-Bezares et al., 2017). Therefore, financial reporting is not merely an accounting obligation but also a trust instrument influencing the relationship between the company and its stakeholders. The role of financial reporting as a foundation for strategic decision-making cannot be overlooked. Investors rely on financial reports to assess the risks and potential returns on their investments, while creditors use this information to determine a company's creditworthiness (Olayinka, 2022). Regulators, in turn, depend on financial reports to ensure that companies comply with applicable laws and accounting standards. Efunniyi et al. (2024) note that accurate financial reports build trust between companies and stakeholders, ultimately supporting market stability. Transparent reporting enables stakeholders to make informed decisions based on reliable risk analysis. This benefits the company and contributes to overall market stability by providing credible and dependable information. However, errors in financial reporting, whether intentional or unintentional, can have detrimental effects on a company. These errors may include manipulations to improve financial appearance or technical mistakes from improper application of accounting standards (Sabau et al., 2020). In both cases, the consequences are significant, disrupting stakeholders' decision-making processes and undermining trust between the company and its stakeholders. Trust can quickly erode when financial reports are inaccurate or misleading. Investors may lose confidence and withdraw their investments, while creditors might doubt the company's ability to meet its financial obligations. Research by Permatasari & Tjahjadi (2024) demonstrates that the quality of financial reporting directly correlates with stakeholder trust levels and the company's long-term performance. Manipulation or inaccuracies in financial reports can lead to diminished shareholder loyalty, customer distrust, and loss of creditor support. Over time, these impacts can affect the company's financial performance and viability.

Financial reporting errors can also severely damage a company's reputation, as reputation heavily relies on public perceptions of the company's integrity and transparency. According to Freeman

(2010), transparency is critical to building solid relationships between organizations and the public. Transparent financial reports reflect management's honesty in presenting the company's financial condition, making stakeholders more likely to trust the company. Conversely, a lack of transparency can lead to scandals and tarnish the company's reputation, as seen in the cases of Enron and WorldCom, where financial manipulation led to the company's companies' downfall. A company's sustainability also depends on the accuracy and transparency of its financial reporting. Stakeholders who trust the integrity of a company's reporting are more likely to support its long-term strategies through investments or loans. DiPiazza Jr & Eccles (2002) assert that companies maintaining high reporting standards are better equipped to navigate economic and social challenges. Furthermore, transparency strengthens long-term relationships with stakeholders, ultimately supporting the company's sustainability and growth. In contrast, errors or manipulation in financial reporting can damage these relationships and negatively affect the company's performance.

Financial Reporting Errors: Types, Causes, and Impacts

Financial reporting errors are a critical issue in modern business, as accurate and transparent financial reports are essential for maintaining healthy relationships with stakeholders, including investors, creditors, and regulators (Pallissery, 2012). When financial reporting errors occur, their impact can be damaging both in the short and long term. Young (2020) categorizes financial reporting errors into two main types: intentional errors (fraud) and unintentional errors (mistakes). Each type of error has different causes and impacts on stakeholder trust, ultimately affecting the company's sustainability. Intentional errors, often committed to manipulating financial reports to meet specific targets or hide losses, are frequently driven by pressure from management or company owners to achieve short-term expectations (Lundelius, 2011; Simons & Dávila, 2021). For instance, a company may delay loss recognition or inflate asset values to make financial reports more appealing to investors. Although these manipulations might yield short-term benefits, the long-term consequences can be severe, including litigation, loss of investor trust, and even bankruptcy. High-profile scandals such as Enron and WorldCom demonstrate how financial report manipulation can lead to the collapse of entire companies. In contrast, unintentional errors often result from a lack of understanding of accounting standards or failure to adapt to regulatory changes (Ajekwe, 2021). These errors, such as misreporting assets or liabilities, are often caused by the complexity of accounting standards or inadequate knowledge among financial staff on implementing new regulations (Shahana et al., 2023). While these errors are not intended to deceive, their impact is still significant, as they diminish the quality of financial information provided to stakeholders. Even minor errors can erode trust, particularly among investors and creditors who rely heavily on accurate information to assess risks and make investment decisions. The primary causes of financial reporting errors can be traced to internal and external factors. Internal factors include management's inability to fully comprehend accounting standards, insufficient internal controls, and conflicts of interest. Pressure from shareholders or senior management to meet financial targets often leads to manipulation of financial reports (Permatasari & Tjahjadi, 2024). This situation is usually exacerbated by a lack of oversight from boards of directors or audit committees, ensuring financial reports' integrity. External factors such as regulation changes or accounting standards can lead to financial reporting errors. Regulatory changes, such as the adoption of IFRS, require quick adaptation from companies. Saini et al. (2023) emphasize that companies that fail to keep pace with these changes are at risk of making mistakes in their financial reporting. Market pressure and investor expectations for consistent growth can encourage management to present an overly optimistic financial picture. The impact of financial reporting errors on stakeholders is profound. When errors are discovered, they can trigger a loss of trust from investors and creditors, who may withdraw investments or increase lending costs. Declines in stock prices and rising capital costs are expected consequences of eroded trust (McDaniel, 1987). Coelho et al. (2023) argue that, in the long term, financial reporting errors can damage a company's reputation, hinder growth, and stifle innovation.

Financial reporting errors can also jeopardize the long-term relationships between a company and its stakeholders. Relationships with investors, customers, and creditors rely heavily on the trust established through transparent financial reporting (Karpoff, 2021). Once trust is broken, stakeholders may be reluctant to invest further or support the company's future projects. Shahana et al. (2023) highlights that companies that lose stakeholder trust often struggle to rebuild long-term relationships, ultimately undermining their sustainability in the market. To prevent financial reporting errors, companies must strengthen internal controls, enhance transparency, and ensure that all regulatory changes are correctly implemented (Wicaksana & Haryati, 2024). These measures can help companies maintain the integrity of their financial reports and build more vital trust with stakeholders. By doing so, companies can minimize the risk of errors and safeguard their reputation and operational sustainability.

Stakeholder Trust as a Key Asset

Stakeholder trust is one of a company's most valuable intangible assets. Maintaining trust in today's increasingly complex business environment is critical because it directly affects loyalty, reputation, and competitive advantage (Islam et al., 2021). Freeman (2010), a pioneer of stakeholder theory, emphasized that trust extends beyond the relationship between a company and its shareholders, encompassing relationships with various stakeholders, including customers, creditors, employees, suppliers, and the broader community. According to this theory, a company's long-term success depends on its financial performance and managing mutually beneficial relationships with its stakeholders. Trust plays a crucial role in ensuring business stability. Stakeholders who trust a company will likely remain engaged and support its long-term operations. Saini et al. (2023) found that companies with strong governance practices and transparent financial reporting are more valued by their stakeholders. This trust results in improved access to capital, increased customer loyalty, and excellent operational stability. Thus, trust is essential in strengthening a company's and its stakeholders' relationship, enabling sustainable growth. However, trust can be quickly eroded by financial reporting errors or intentional financial data manipulation. One of the primary causes of diminished stakeholder trust is financial reporting inaccuracies, mainly when these errors are intentional (Uwah et al., 2023). When financial misrepresentation occurs, the trust built over the years can be shattered almost instantly. The negative consequences of such breaches extend beyond short-term financial losses, such as stock price declines or loss of capital access. They also affect customer loyalty, damage relationships with business partners, and reduce employee morale. Coelho et al. (2023) highlighted that companies often struggle to regain stakeholder trust following major financial scandals, leading to a sharp decline in investor loyalty and market value (Lorsch et al., 2005). These consequences not only affect short-term performance but also impact a company's future growth potential. Restoring stakeholder trust after financial reporting errors is a challenging and time-consuming process. Trust is the foundation for long-term relationships between a company and its stakeholders. Companies that maintain strong trust-based relationships have a competitive advantage in dealing with market challenges, economic crises, and regulatory changes. However, research shows that after financial scandals, it often takes companies a long time to rebuild this trust. This recovery process requires increased transparency, governance reforms, and, in some cases, changes in company leadership Coelho et al. (2023). The restoration of trust depends on a company's ability to demonstrate a long-term commitment to integrity and transparency, underscoring the importance of accurate financial reporting.

Maintaining stakeholder trust is vital for business operations and a company's long-term competitiveness and sustainability. Stakeholder trust directly contributes to a company's ability to secure lower-cost capital, attract top talent, and retain loyal customers (Svendsen, 1998). Companies trusted by their stakeholders tend to enjoy lower borrowing costs, stable workforces, and strong long-term business relationships. In contrast, companies that lose stakeholder trust face significant challenges, such as higher capital costs, employee instability, and difficulties attracting customers and business partners. Trust is critical to company growth and sustainability in an increasingly competitive and uncertain business environment. Wibowo (2024) found that companies with strong governance, high transparency, and robust stakeholder trust tend to outperform in global markets. This finding emphasizes that maintaining stakeholder trust is not merely about avoiding mistakes or scandals but also building a solid foundation to face future changes and uncertainties. Additionally, stakeholder trust is a strategic asset that helps companies withstand external pressures and disruptions. Companies with high levels of stakeholder trust demonstrate stronger resilience during economic instability. Fung (2014) argued that companies with transparent financial practices and sound governance structures are better equipped to adapt to sudden market changes, as stakeholders remain committed to the company's long-term success. Transparency instills a sense of security among stakeholders, assuring them that their interests are managed responsibly, even during challenging times.

Restoring Trust after Financial Reporting Errors

Restoring stakeholder trust after financial reporting errors is a complex task that requires a strategic and well-planned approach. Trust is an asset for a company, and once lost due to errors, rebuilding it demands concrete and measured actions. As Mayer (2013) notes, restoring trust cannot be achieved through mere apologies or promises; it must be accompanied by actions demonstrating the company's commitment to transparency and integrity. This process often involves an independent audit to verify the accuracy of revised financial statements and improvements in internal control systems (Al-Mashhadi, 2021). Independent audits are a primary tool to ensure that past mistakes are not repeated and signal to stakeholders that the company is taking serious steps to address the issues. Also, management changes are often necessary when those involved in financial misconduct are replaced, indicating the company's commitment to maintaining integrity (Fauzan, 2024). Fragoso et al. (2020) highlight that these reform measures are crucial for restoring trust, demonstrating the company's seriousness in preventing future errors.

Besides tangible actions, actively involving stakeholders in the recovery process is essential for rebuilding trust. Song et al. (2023) found that transparent companies involving stakeholders in discussions about corrective measures are more likely to restore trust quickly. Transparency here refers to open communication about the root causes of the reporting errors and the steps the company is taking to rectify them. This process should be conducted consistently and transparently to minimize any doubts or skepticism among stakeholders. Active stakeholder participation is also critical for fostering a more profound sense of involvement with the company. For instance, establishing oversight forums or committees that involve independent third parties allows the company to demonstrate accountability. This creates an open line of communication between the company and its stakeholders, ultimately strengthening trust and relationships (Sjahruddin et al., 2023). By involving stakeholders directly in the corrective process, they are likelier to feel they play a role in ensuring the company's success. However, restoring trust is not always straightforward and often takes considerable time. Siegel (2021) suggests that even after appropriate recovery measures are implemented, access to capital markets or investor confidence may not return fully in the short term. Rebuilding trust requires a long-term commitment, where the company must consistently demonstrate transparency in its subsequent financial reports and across all aspects of its operations. In essence, companies must show that the changes they have made are not temporary fixes but comprehensive reforms that span all areas of corporate governance.

Hersel et al. (2019) also point out that negative perceptions of companies involved in significant scandals are often challenging to eliminate, even after corrective measures have been taken. This indicates that recovering a company's reputation can take longer, especially when the scandal involves severe ethical violations or financial crimes. In such cases, companies must focus on long-term efforts that restore stakeholder trust and rebuild their public reputation. Trust is a fundamental pillar for long-term relationships between companies and their stakeholders. According to research by Saini et al. (2023), companies with strong governance and high transparency tend to have better resilience against global market challenges. Therefore, restoring trust should not be viewed as a short-term goal but as a long-term strategy to ensure business sustainability. Companies that rebuild and maintain stakeholder trust will gain a competitive advantage in the long run. Moreover, transparency and integrity are critical for sustaining these long-term relationships. Mähönen (2020) emphasizes that transparency in financial reporting gives stakeholders a sense of security, assuring them that the company is responsibly managing their interests. Thus, companies that can restore trust and consistently maintain transparency will likely regain stakeholder confidence and foster more muscular, enduring relationships.

Research Design and Methodology

Study Design

This research uses a qualitative systematic literature review (SLR) approach to synthesize and critically evaluate existing studies on financial reporting errors and their impact on stakeholder trust. The SLR design follows a structured, transparent process to gather and analyze relevant literature. This method is chosen to provide a comprehensive overview of the topic, identify trends, and highlight gaps in the current research. Adhering to standard SLR guidelines, this approach ensures rigor, objectivity, and replicability in reviewing the available literature.

Sample Population or Subject of Research

The research focuses on peer-reviewed articles, book chapters, and academic papers published between 2013 and 2023, dealing with financial reporting errors, corporate governance, and stakeholder trust. Only studies addressing the relationship between financial reporting quality and stakeholder trust were included. Theoretical frameworks like agency and stakeholder theory are also incorporated to support the analysis. Non-empirical studies and those not aligned with the research questions were excluded to maintain relevance.

Data Collection Techniques and Instrument Development

Data collection involved a structured search in academic databases such as Scopus, Web of Science, Google Scholar, and ProQuest. Keywords such as “financial reporting errors,” “stakeholder trust,” and “corporate transparency” were used. After filtering results by title, abstract, and keywords, relevant studies were selected for full-text review. No specific instruments were developed, as the focus was on synthesizing secondary data from the existing literature.

Data Analysis Techniques

Data analysis was conducted using thematic synthesis, where recurring themes related to financial misreporting and stakeholder trust were identified and coded. Thematic coding allowed for pattern identification and the organization of findings into critical themes. The data were compared to highlight the literature's research gaps, strengths, and weaknesses. This process provides a clear understanding of the current knowledge on financial reporting errors and offers insights into areas for future research.

Findings and Discussion

Findings

Intensity and Type of Financial Reporting Error on Stakeholder Trust

This study highlights the significant relationship between the type and intensity of financial reporting errors and the level of trust stakeholders place in a company. A systematic literature analysis found that intentional mistakes, such as financial statement manipulation, have a far more damaging impact on stakeholder trust than unintentional errors, such as technical or clerical mistakes. Manipulating financial reports, which involves misrepresenting financial information to present a more favorable view of the company's performance, deeply erodes trust. This occurs because such manipulation signals a deliberate act of dishonesty by the management, thereby directly undermining the organization's integrity (Permatasari & Tjahjadi, 2024). Notable financial scandals, such as Enron and WorldCom, provide clear evidence of how intentional manipulation of financial data can obliterate years of built-up trust. In these cases, stakeholders—including investors, creditors, and regulators—reacted swiftly and negatively upon the disclosure of fraudulent reporting, leading to sharp declines in stock prices and loss of access to capital (Gómez-Bezares et al., 2017). These deliberate errors damage the relationships with stakeholders and threaten the company's long-term survival, as such misconduct often results in litigation, regulatory penalties, and, in extreme cases, bankruptcy (Fragoso et al., 2020).

In contrast, unintentional reporting errors, such as technical or recording mistakes, though still damaging, typically do not result in the same level of trust erosion as intentional misstatements.

Unintentional errors often arise from a misunderstanding of complex accounting standards or insufficient financial expertise among the management. In these cases, stakeholders, including investors and creditors, tend to be more forgiving, especially if the company quickly acknowledges the error and takes corrective measures. Errors in recording assets or liabilities, while still risky, are generally viewed as more repairable, and stakeholders may be more understanding if the company immediately takes steps to rectify the mistake (Sabau et al., 2020). However, the intensity of the error also plays a crucial role in determining the degree of trust lost. When an unintentional mistake is significant or has a material impact on the financial statements, it can still raise doubts about the validity of other financial information. This is particularly true in established markets where regulatory oversight is stricter, and investor scrutiny is more intense (Olayinka, 2022). In these markets, even minor inaccuracies can trigger adverse reactions from stakeholders who expect higher financial transparency and accountability. On the other hand, in emerging markets, where regulatory frameworks are often less robust and economic uncertainties are more prevalent, stakeholders may be more accustomed to tolerating certain levels of financial reporting discrepancies (Saini et al., 2023).

The research further demonstrates that stakeholders are more likely to maintain trust when companies act quickly and transparently to correct intentional or unintentional errors. When errors are promptly acknowledged and corrective actions, such as independent audits or management changes, are taken, stakeholders tend to restore their trust in the company more readily (Shahana et al., 2023). This highlights the importance of transparency and accountability in maintaining stakeholder relationships, even in the face of reporting mistakes. The severity of the error also impacts how quickly and effectively trust can be restored. If the error is deemed material—meaning it significantly affects financial decisions, stakeholders may question the credibility of the company's overall financial reporting. Material faults can substantially harm trust even when unintentional, particularly in more regulated markets. Conversely, when immediately rectified, minor errors are less likely to lead to long-term damage Siegel (2021). In highly regulated markets such as the United States or Western Europe, the effects of financial reporting errors are more pronounced due to the higher expectations for transparency and rigorous compliance standards. In these markets, stakeholders react more severely to inaccuracies, driven by stricter regulatory requirements and heightened investor expectations (Gómez-Bezares et al., 2017). This is contrasted by emerging markets where economic instability and weaker regulatory frameworks often temper reactions to financial reporting errors (Olayinka, 2022).

Restoring Stakeholder Trust After Reporting Errors Are Identified

The recovery of stakeholder trust after identifying financial reporting errors is complex and time-consuming, often requiring a strategic and measured approach. Stakeholder trust, once lost, is difficult to regain, and the path to restoring it demands transparency, stakeholder engagement, and comprehensive system improvements. This section explores the findings related to organizations' strategies to rebuild trust after discovering financial reporting errors. One of the most critical initial steps in restoring stakeholder trust is the open acknowledgment of the error. Research suggests that stakeholders are more likely to regain confidence in honest and transparent companies about their mistakes (Permatasari & Tjahjadi, 2024). The admission of wrongdoing, particularly when paired with concrete actions such as conducting independent audits to verify the accuracy of revised financial statements, signals stakeholders that the company is taking the issue seriously. An audit conducted by an external, independent party provides a level of credibility to the corrective measures taken, reassuring stakeholders that the company is committed to rectifying the problem. Furthermore, replacing management responsible for errors sends a clear message that the company is dedicated to accountability and preventing similar issues in the future (Fragoso et al., 2020).

Stakeholder engagement is another crucial factor in the process of trust recovery. According to Song et al. (2023), trust will likely be restored more quickly when companies involve stakeholders in corrective action and plan discussions. Engaging stakeholders means providing them access to relevant information, soliciting their input, and creating transparent channels for ongoing dialogue. For example, companies can establish oversight committees that include independent third parties tasked with monitoring the implementation of governance reforms. This involvement fosters a sense of ownership and responsibility among stakeholders, reinforcing their trust in the company's commitment to change. Research indicates that transparency during this process is critical to reducing uncertainty and rebuilding relationships. When stakeholders feel informed and involved in the company's efforts to address the issue, they are likelier to extend the benefit of the doubt and give the company a second chance (Saini et al., 2023). Transparency, in this context, involves not only the communication of corrective actions but also a willingness to disclose the root causes of the error and how the company plans to mitigate similar risks in the future.

Despite these efforts, however, studies show that trust is not always fully restored, especially in cases where the financial reporting error was significant or involved a major scandal. Fragoso et al. (2020) highlight that some companies struggle to regain access to capital markets under the same favorable terms as before the error occurred. The long-term impact of these errors may persist, as stakeholders—particularly investors—may continue to doubt the reliability of the company's financial disclosures. This indicates trust recovery is not an overnight process but requires sustained efforts and consistent transparency. The extent to which trust can be recovered often depends on the severity of the financial reporting error and the company's track record of transparency. If the error in question was minor or unintentional, and the company had a history of solid governance, stakeholders may be more inclined to forgive the mistake. However, stakeholders may be far less forgiving if the error was material—meaning it significantly impacted financial statements—and resulted from intentional misconduct or gross negligence (Shahana et al., 2023).

The long-term restoration of trust also hinges on the company's ability to demonstrate consistency in its reform efforts. Stakeholders need assurance that the company is not merely addressing the immediate issue but is also committed to maintaining high financial reporting and governance standards in the future. According to Siegel (2021), this often involves broad governance reforms to prevent similar errors from occurring again. For example, companies might need to overhaul their internal controls, implement more rigorous compliance measures, or adopt new technologies for more accurate financial reporting. Companies must also exercise patience during the trust recovery process. Even when a company takes all the proper steps, acknowledges the error, engages stakeholders, and implements reforms, it may take years to rebuild trust fully, especially if the mistake caused significant damage to the company's reputation. Research by Coelho et al. (2023) emphasizes that trust recovery is not linear; it can be derailed if the company is perceived as backsliding on its commitment to transparency and governance.

Discussion

The discussion of this research delves deeply into the significant impact of financial reporting errors on stakeholder trust. The systematic analysis of the literature reveals that the type and intensity of financial reporting errors play a crucial role in determining the level of confidence stakeholders place in a company. Specifically, intentional errors, such as financial statement manipulation, have far more damaging effects than unintentional errors. Deliberate errors, which involve altering or concealing financial information to present a better-than-actual company performance, directly undermine trust because they signify a breach of integrity by management. One of the clearest examples of this is the well-known scandals involving Enron and WorldCom, where financial statement manipulation resulted in the swift and dramatic loss of stakeholder trust, leading to plummeting stock prices and a severe loss of access to capital. These intentional errors not only damaged relationships with key stakeholders like investors and creditors but also threatened the very survival of the companies, as they led to lawsuits, heavy fines, and even bankruptcy. The fallout from such deliberate financial misrepresentation highlights how deeply it can harm a company's reputation and destroy the trust built over the years.

While still damaging, unintentional errors, such as technical or recording errors, tend to have less severe consequences than intentional errors. Stakeholders generally show more tolerance toward these mistakes, primarily when the company swiftly corrects them and is transparent about the cause. For example, minor misstatements of assets or liabilities can be quickly corrected, and when companies are open and responsive, stakeholders are likely to retain trust. In these cases, quick corrective action and transparency often mitigate the damage, especially when stakeholders believe the errors stem from complex accounting standards or technical knowledge gaps rather than deliberate deception. However, the intensity of the error also plays a significant role in determining how much trust is lost. Material errors—significantly impacting investment decisions—can cause stakeholders to question the validity of other financial reports, even if the errors are unintentional. Material errors often provoke stronger reactions in more developed markets, where regulatory oversight and stakeholder scrutiny are more robust. Conversely, in emerging markets, other factors, such as economic instability and weaker regulatory frameworks, might influence how stakeholders react to financial reporting errors, sometimes leading to more leniency. The second significant finding of this study focuses on the recovery of trust after financial reporting errors are identified. Restoring trust after such mistakes is not easy and often takes considerable time. Based on the literature analyzed, effective trust recovery requires strategic and measured steps involving transparency, stakeholder engagement, and comprehensive system reforms. One of the first and most essential steps in trust recovery is the open acknowledgment of the error. Stakeholders are generally more inclined to restore trust when a company is honest and transparent about the mistake. Public acknowledgment should be followed by concrete actions, such as commissioning an independent audit to verify the accuracy of the revised financial statements and replacing management responsible for the errors. These steps signal to stakeholders that the company is serious about addressing the problem and is committed to preventing similar mistakes in the future. The research also highlights the importance of actively involving stakeholders in recovery. Song et al. (2023) found that trust tends to be restored more quickly when companies engage stakeholders in discussions about corrective actions. Involving stakeholders means giving them access to relevant information, inviting feedback, and fostering open and transparent dialogue. For example, companies can establish oversight committees that involve third-party independent participants to monitor governance reforms. Such involvement fosters a sense of participation and accountability for stakeholders in the recovery process, making them feel that their concerns are being addressed.

Despite the necessary measures being taken, some research suggests that trust lost through financial reporting errors may never be fully restored, particularly when significant errors or scandals are involved. Fragoso et al. (2020) reveal that some companies struggle to regain access to capital markets under the same favorable conditions as before the errors occurred. This indicates that, in some instances, the long-term damage from financial reporting errors cannot be completely reversed, and companies must demonstrate consistent governance reforms over time to restore trust sustainably. Furthermore, this research underscores the importance of consistency and patience in recovery. Stakeholders need assurance that a company is correcting its financial reporting at a given time and is committed to maintaining high standards in the long term. Companies must implement broader governance reforms to reassure stakeholders that errors will not recur. The recovery process can take years, depending on the extent of the damage and how well the company handles the recovery process.

From a theoretical perspective, the findings align with agency theory, which posits that conflicts of interest between management and shareholders can trigger manipulative actions in financial reporting. This theory explains how management, acting as agents for shareholders, often has incentives to manipulate financial reports to meet short-term performance targets or market expectations. The findings of this research support the idea that these incentives usually drive financial statement manipulation at the expense of long-term stakeholder trust and company integrity. The separation between ownership and control within companies creates conditions where management may prioritize personal or short-term gains over the company's long-term interests and those of its stakeholders. The research also supports the signaling theory, in which financial reports signal stakeholders about a company's financial health. Errors or manipulation in financial reports send negative signals to the market, eroding a company's reputation and stakeholder trust. Companies that consistently provide transparent and accurate financial reports are more likely to gain greater stakeholder trust than those involved in financial reporting scandals.

When comparing these findings with prior studies, the results align with the research by Coelho et al. (2023), which demonstrated that financial statement manipulation severely damages stakeholder trust. The study showed that intentional manipulation leads to significant declines in investor loyalty, increased capital costs, and even bankruptcy. Additionally, this research supports the findings of Permatasari & Tjahjadi (2024), who highlighted the direct correlation between financial reporting quality, stakeholder trust, and long-term company performance. Both studies emphasize that financial reporting errors, especially intentional ones, can damage trust and corporate reputation. Moreover, this study corroborates the research by Ball & Brown (2019), which found that unintentional errors, while risky, may be tolerated by stakeholders if companies act transparently and take swift corrective actions. This research confirms that transparency and responsiveness to errors are critical to maintaining stakeholder trust, even when mistakes occur. The practical implications of these findings emphasize the need for companies to strengthen their governance systems and internal controls to prevent financial reporting errors. Companies must ensure that internal solid mechanisms are in place to minimize the risk of intentional and unintentional errors. Additionally, actively involving stakeholders in oversight and governance reforms is crucial to maintaining stakeholder trust. By engaging stakeholders in the decision-making processes related to financial reporting and governance, companies can build a shared sense of responsibility, fostering long-term, healthy relationships with their stakeholders.

Conclusion

This study aimed to systematically analyze the impact of financial reporting errors on stakeholder trust, focusing on the type and intensity of errors and their influence on trust recovery processes. The findings revealed that intentional mistakes, such as financial statement manipulation, significantly affect stakeholder trust more than unintentional errors. Furthermore, the intensity of the mistake plays a crucial role in determining the level of trust erosion. In addition, effective trust recovery strategies, including transparency, stakeholder engagement, and comprehensive governance reforms, were essential for regaining lost trust after identifying financial reporting errors. The value of this research lies in its contribution to theoretical understanding and practical applications. It highlights the crucial role of financial reporting in maintaining stakeholder trust and underscores the long-term damage caused by intentional reporting errors. The study also emphasizes the importance of swift corrective actions and transparency in managing unintentional errors, offering practical insights for corporate governance and management. Companies can apply these findings to strengthen their internal controls and governance systems, ensuring trust is maintained or quickly restored when financial errors occur. The study's originality lies in its focused examination of how different types and intensities of reporting errors uniquely impact trust and the critical role that recovery strategies play in the post-error context. However, this study has certain limitations. The research relied heavily on secondary data from previous studies, which may limit the generalizability of the findings across different industries and market conditions. Additionally, the scope of this research did not explore the role of emerging factors such as digitalization or Environmental, Social, and Governance (ESG) considerations, which could influence financial reporting and stakeholder trust in contemporary settings. Future research could expand on these aspects by conducting empirical studies across various industries, regions, and market conditions and exploring the influence of technological and ESG developments on financial reporting accuracy and trust recovery. This would provide a more holistic understanding of how modern financial reporting dynamics affect stakeholder trust.

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