CORPORATE GOVERNANCE

The Cost to Firms of Cooking the Books

Jonathan M. Karpoff, D. Scott Lee, and Gerald S. Martin
Journal of Financial and Quantitative Analysis
vol. 43, no. 3 (September 2008):581–612

Between 1978 and 2002, companies found guilty of financial misrepresentation as a result of a U.S. SEC enforcement action faced only modest penalties. In this study, however, the authors demonstrate that companies pay a much greater reputational penalty. In terms of the effect on company cash flow, the authors show a loss of approximately 7.5 times the formal penalties imposed. In terms of the effect on market value, for each dollar of market value gained through financial misrepresentation, the authors show a loss of almost four to one.

The authors examine the 585 enforcement actions brought by the U.S. SEC and the U.S. Department of Justice between 1978 and the end of 2002. Share value data come from the CRSP database. Financial data on the analyzed companies come from Compustat.

The authors conduct an event study to determine the effect on share value of a trigger event. Typically, the event is a company announcement that draws the SEC's attention. The results show the average one-day stock return for such companies to be a highly significant –25.24 percent. This approach is extended to determine the cumulative abnormal return (CAR) from inception to the final event resulting from an enforcement action. The study shows an average CAR of –50.86 percent with a mean dollar loss of $380 million. The total cumulative dollar loss resulting from all enforcement actions during the period studied is approximately $161 billion. Thus, although the monetary penalties imposed by regulatory agencies had

Jonathan M. Karpoff is at the Foster School of Business, University of Washington. D. Scott Lee is at Mayes Business School, Texas A&M University. Gerald S. Martin is at Kogod School of Business, American University. The summary was prepared by Daniel J. Larocco, CFA, CFA Institute.

a mean of almost $107 million per company, the effect on share price is many times greater.

This total loss of shareholder value can be disaggregated into a number of components. In addition to fines, companies are likely to face shareholder class action lawsuits. The average cost to the company of such suits is $25.5 million. In addition, companies engaging in financial misconduct may suffer losses from a readjustment effect. This effect is the loss in company value that occurs as investors recognize they have been basing their valuations on faulty data. The authors estimate this effect at an average of $97.4 million per company.

Companies may also suffer a reputation loss, which the authors define as the present value of the real effect that financial misconduct can have on a company's costs and operations. One such effect is a reduced willingness of the company's suppliers to extend trade credit on terms as favorable as previously offered, thereby affecting the company's cost of capital. According to the authors' analysis, approximately two-thirds of total losses are attributable to reputation loss.

An intriguing aspect of this study is the authors' attempt to estimate the probability of detecting the financial misconduct of a company. They note that as a rough approximation, enforcement actions equal 40.2 percent of company financial restatements. Thus, as a first approximation, 40.2 percent can be implied as the probability that financial misconduct will be detected. So, under an assumption that half of all restatements are for legitimate reasons, the authors propose that the likelihood of detection of financial misconduct rises to 80.4 percent.

In conclusion, the authors note two policy implications. First, the direct costs of financial misconduct are only a fraction of the total costs incurred by such companies. Second, these substantial additional costs predate the Sarbanes–Oxley Act of 2002.

Keywords: Corporate Governance; Financial Statement Analysis: accounting and financial reporting issues