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Headline: Investors punish material restatements, study says

Investors Punish Material Restatements, Study Says

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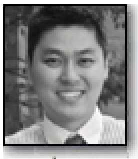
Recent academic research confirms that investors have low tolerance and a long memory for companies that issue material restatements to correct accounting irregularities.

Companies lose credibility with investors for as long as three years after material restatements for problems involving anything other than honest errors, says a paper out of Singapore University and Boston College. The American Accounting Association says the study provides the most extensive analysis of investor response to restatements ever undertaken. “Investors, the new study reveals, have a diminished response to earnings reports of such companies for an average of close to three years,” the AAA says in a statement.

The authors -- professors Xia Chen and Qiang Cheng in Singapore and Alvis Lo in Boston -- say companies experience a significant decline in investor response to earning statements for 11 quarters after a restatement is announced. “This is a considerably longer period than the three quarters reported in prior research, suggesting that the decline in credibility and information content of earnings after restatements is not short-lived,” the authors wrote. The latest data on restatements suggests the severity of restatements has begun to diminish, although the number of them has inched upward.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The study examined investor response to more than 1,200 restatements from 1997 through mid-2006, with 343 of those restatements regarded as material because they involved some kind of fraud or accounting irregularity. The study found a sharp difference in investor response to material misstatements compared with the rest of the restatement sample. Companies with material restatements saw their stock price drop an average of 7.2 percent and the decline in investor confidence persisted for 11 quarters; the rest of the restatements met only a 1.8-percent drop in stock price and a diminished investor response for only one quarter, the study found.

The study also finds that companies reporting material misstatements that took swift action with measures such as removing the CEO or CFO, the external auditor, or the audit committee chair regained investor confidence sooner, often within the fourth or fifth quarter following restatement. “In short, investors are relatively forgiving when it comes to honest errors but not when it comes to material irregularities,” AAA says.