Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

years, much longer than previously believed

Mar. 12, 2014

Corporate earnings restatements used to be an infrequent practice, but since the late 1990s, have become a much more common occurrence. While regulators and analysts have long cautioned about the potential for long-term damage to how corporate earnings statements are perceived in terms of their credibility, investors have doubted that such effects would last no more than a few quarters.

New research shows the regulators and analysts' fears were correct. The report, "Is the Decline in the Information Content of Earnings Restatements Short-Lived?," finds that *material restatements*, which involve correcting accounting irregularities and not just honest errors, occasion a loss in company credibility lasting substantially longer than previously documented. Investors, the new study reveals, have a diminished response to earnings reports of such companies for an average of close to three years. The study is in the current issue of *The Accounting Review,* a journal of the American Accounting Association.

"Material restatement firms experience a significant decline in earnings response coefficient [a measure of investors' response to earnings reports] for 11 quarters after restatement announcements," the report states. "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."

Lead resesarches Xia Chen and Qiang Cheng of Singapore Management University, and Alvis K. Lo of Boston College, found the magnitude of the drop in earnings response coefficient is quite considerable — "more than half the ERC in the pre-restatement period" — and is largely "driven by those firm quarters that are more likely to be subject to credibility concerns, such as those reporting good news and

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

27% of this group of companies dismissed both the CEO and CFO within a year of the announcement, while 30% replaced the chair of the audit committee and 15% dismissed the external auditor. Companies that took one or another of these measures to improve reporting credibility did not sustain a reduced ERC beyond the fourth or fifth quarter following their restatement announcements.

The paper analyzes investors' responses to 1,208 restatement announcements made by public companies during the period January 1997 through June 2006. Three hundred forty-three were classified as material on the basis of meeting one of three conditions – the firm explicitly used variants of "fraud" or "irregularity" in the restatement; there was a related investigation by the SEC or the U.S. Department of Justice; or there was a non-SEC independent investigation into the misstatement, such as a probe launched by a company's audit committee.

The professors found a sharp difference in investor response to material restatements compared to others. For the former, the announcement occasioned an immediate drop in stock price averaging 7.2% over the three days enveloping the restatement announcement, while the drop in the latter was only 1.8%. The difference in the duration of mistrust was equally dramatic: for material restatements, the decline in the ERC from what it was before the restatement announcement lasted for an average of 11 quarters while for non-material restatements the ERC was reduced for only one quarter.

In short, investors are relatively forgiving when it comes to honest errors but not when it comes to material irregularities.

Not only is the drop for material-restatement firms long-enduring but it is of considerable magnitude as well. The ERC dropped 56%, from a coefficient of about 3.3 during the five quarters preceding the restatement announcement day to an average of about 1.45 for the 11 quarters post-announcement. The professors found that "the reduction in the ERC shows a decreasing trend, being highest in the first

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

The American Accounting Association is a worldwide organization devoted to excellence in accounting education, research, and practice. Other journals published by the AAA and its specialty sections include *Accounting Horizons, Issues in Accounting Education, Behavioral Research in Accounting, Journal of Management Accounting Research, Auditing: A Journal of Practice & Theory,* and *The Journal of the American Taxation Association*.

Accounting • Auditing • Financial Reporting

CPA Practice Advisor is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing professional education on the National Registry of CPE Sponsors.

© 2024 Firmworks, LLC. All rights reserved