A company's reputation is what gets fried when its books get cooked

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While fines imposed by regulators and courts on companies that falsify records may seem substantial, a new study finds the largest monetary penalties suffered by these companies are the result of a damaged reputation when news of their misconduct was reported.

The study, led by Jonathan Karpoff, a professor of finance at the University of Washington Business School, reveals than on average, companies that have cooked their books lose 41 percent of their market value after news spreads about their misdeeds.

"Cooking the books can be extremely costly," he said. "Firms lose real value when they are caught inflating their earnings, but the legal penalties turn out to be only a small part of the total losses experienced by these firms. The largest losses accrue because firms that cheat lose customers and face higher financing costs."

Karpoff and co-authors D. Scott Lee and Gerald Martin of Texas A&M University examined the penalties imposed on 585 companies that were disciplined by the Securities and Exchange Commission and the Department of Justice for financial misrepresentation from 1978 though 2002, and which were tracked through November 2005. They presented their findings, "The Cost to Firms of Cooking the Books" recently at a conference held at the University of Chicago's Center for Research in Security Prices.

The researchers found that while the penalties imposed on firms through

the legal system are relatively small, averaging $23.5 million per firm, the penalties imposed by the market in terms of damage to a firm's reputation are colossal.

According to Karpoff, damage done to a firm's reputation as a result of intentionally falsifying financial statements, commonly referred to as "cooking the books," is more than 7.5 times the amount of all penalties imposed on it through legal and regulatory systems. That is, for each dollar that a firm misleadingly inflates its market value, on average, it loses this dollar when its misconduct is revealed, plus an additional $3.08. Of this additional loss, $0.36 is due to expected legal penalties and $2.71 is due to lost reputation. Reputational penalty is defined as the expected loss in the present value of future cash flows due to lower sales and higher contracting costs.

Even before the implementation of the Sarbanes-Oxley Act in 2002, intended to improve corporate governance, penalties for cooking the books were substantial, Karpoff said. But the loss to a businesses' reputation is by far the biggest penalty it faces, he added.

Of the 585 companies studied, the researchers found:

• Ninety percent of the companies received non-monetary sanctions, including cease-and-desist orders or permanent injunctions -- actions that impose relatively small penalties

• Only 8 percent, or 47 companies, were fined directly by regulators

• 35 companies had 10-day trading suspensions imposed on their stocks

• 40 companies had their registrations revoked

• 231 companies were subject to class-action lawsuits; the average

settlement for these lawsuits was $37.7 million

There are two sections according to federal law under which charges of financial misrepresentation can be brought. The books-and-records provision requires companies subject to Exchange Act reporting requirements to keep books and records that accurately reflect corporate payments and transactions. The second -- the internal-controls provision -- requires firms to create and maintain an internal control that assures management's control over a company's assets. The researchers found most of the enforcement actions -- 464 of the 585 companies studied -- cite violations of both the books-and-records and the internal-controls provisions. Additionally, most of these violators also faced fraud and insider-trading charges.

And while other types of corporate misconduct such as false advertising and product recalls cause reputational losses, Karpoff and his colleagues contend that reputational losses for financial misrepresentation are unusually large.

"Financial misrepresentation is an especially costly activity because financial transparency is a particularly valuable asset," he said. "A company's sales and contracting costs are very sensitive to financial misrepresentation because it undermines the company's credibility with customers, suppliers and investors."

Companies may cook their books to lower their tax liabilities or prevent investors from pushing down its stock prices, Karpoff said. The practice is illegal under SEC, Internal Revenue Service and stock-exchange rules and violates the ethical code of the accounting profession. He noted that scandals involving Enron, WorldCom and other corporations have helped create a widespread presumption that penalties for financial misrepresentation are nominal at best.

The view that financial misconduct is punished lightly is held by many politicians and business leaders and has a large effect on public policy, Karpoff said. It has helped motivate new investigations into the investment banking and mutual fund industries, as well as potential changes in corporate voting rules and the regulation of hedge funds.

"Reputational costs, however, have been all but ignored in policy deliberations over penalties for financial misconduct. It is a mistake to consider only prospective legal penalties in making business decisions or setting public policy. This is because most of the financial penalty for cooking the books comes from lost reputation."

Source: University of Washington

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