New study shows that when a whistle blows investors sound the alarm

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(PhysOrg.com) -- When a whistle-blower's allegations of financial misconduct gain the attention of mainstream media, the accused company's stock price takes an immediate hit, even if it's countered by outrage and denials.

New accounting research takes that thought a step further, measuring the effect such allegations have on a corporation's stock price long after the financial press have moved on.

The study, which appears in the July issue of The Accounting Review, found that whistle-blower allegations of financial wrongdoing had a measurable effect on a company's stock price for a period of two years, with some evidence showing that the damage persists beyond that.

"When whistle-blowers allege financial impropriety, investors react immediately," said Andrew C. Call, one of the study's authors and an assistant professor of accounting at the University of Georgia Terry College of Business. "Perhaps more interesting, however, is that these firms generally show weakened stock prices for a couple of years after the allegations surface, suggesting that whistle-blowers sound an important alarm about poor future performance."

Call co-wrote the study with Robert M. Bowen of the Foster School of Business at the University of Washington and Shiva Rajgopal of the Goizueta Business School at Emory University.

The study's most salient findings are based on an analysis of the stock performance of 81 companies that were the object of press reports alleging financial misconduct by a whistle-blower.

In the five days surrounding one or more such press reports, stock returns of accused companies were on average 2.84 percent lower than the returns for other firms during the same time period. The relative drop was even larger—7.3 percent on average—when the allegations concerned earnings management.

In addition, the accused companies were found to have weaker stock prices far past the press reports of whistle-blowing. The median stock performance of the accused companies was significantly lower than the performance of similar companies over the next two years, according to the research.

"There was even some evidence of continued weak stock performance for a third year," Call said. "And this was in comparison with companies we deliberately selected because they were similar to the whistle-blower firms in essential ways. These propensity-score matched controls, as we call them, allow us to attribute developments subsequent to whistle-blowing to the event itself."

The 81 firms in the study's media sample were exposed by whistle-blowers between 1989 and 2004 and included companies that became embroiled in massive scandals like Enron, Tyco, HealthSouth and Qwest Communications, as well as respected industry leaders such as General Electric, Intel and Medtronic.

"In spite of the growing prominence of whistle-blowers in the wake of Enron, WorldCom, and other corporate scandals, there has been very little academic research about whistle-blowing in the context of financial and accounting improprieties," Call said. "We wanted to learn whether these whistle-blower allegations tend to be credible or frivolous, and the long-term consequences that the targeted firms suffer suggest they are often quite credible."

Media reports of whistle-blower allegations also coincided with a higher frequency of shareholder lawsuits and financial restatements by the targeted companies, Call said. Within three years of whistle-blower reports appearing in the financial press, 26.9 percent of the "media sample" companies were sued for financial misconduct, compared with 11.9 percent of the study's control group. Similarly, 17.9 percent of the media sample had to restate their financial reports, compared with just 7.5 percent of the control group.

For further comparison, the study also looked at a second sampleof 137 companiesthat were the targets ofcomplaints involving financial misconduct that were registered with the Occupational Safety and Health Administration, the federal agency responsible for investigating cases of alleged discrimination against whistle-blowers. None of the OSHA cases attractedmedia coverage, and the authors found no connection to the same long-term effects on stock price as the media sample.

"Our findings that the companies involved in the OSHA cases were less likely to experience the same long-term consequences reinforces the impact of the media in identifying and publicizing whistle-blowers' allegations," Call said.

Another measure of the power of the press in these cases was the greater likelihood that companies would change their governance after media exposure. Corporations that were the objects of whistle-blower stories were more likely to replace their CEOs, reduce the size of their boards, lower the proportion of insiders on the board and reduce the proportion of directors serving on at least three other boards.

"Whistle-blowing targets that were exposed by the press seemed to change their leadership and governance on these four dimensions at levels that exceeded the market-wide changes that were taking place in the post-Sarbanes-Oxley era," Call said. "By contrast, companies that were targeted by whistle-blowers in the OSHA sample, which is a less public venue, did not exceed what was typical."

More information: aaahq.org/pubs/acctrev.htm

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