It all hinges on the bottom line

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Determining the financial health of a company is no easy task. But new research from Concordia University's John Molson School of Business, recently published in the *Journal of Corporate Finance*, demonstrates that a company that revises its previous financial statements is more likely to have been poorly governed.

"These restatements can result from a number of factors including accounting errors or omissions or fraud," explains the study's co-author, Lawrence Kryzanowski, professor and Ned Goodman Chair in Investment Finance in Concordia's Department of Finance. "If a negative statement affects the future expectations about a firm, its management and its corporate governance, it can cause the stock's price to decline, and can in some cases eventually result in the demise of the firm."

Kryzanowski's study, co-authored with Ying Zhang from the University of Manitoba, has implications not only for investors, but also for other stakeholders because efficient company operations are dependent on good corporate governance. That includes the performance of overseers like managers, directors and auditors. The protection and maximization of the interests of shareholders and other claimants, such as pensioners and employees, relies equally on good corporate governance.

To perform the research, Kryzanowski and Zhang compared governance practices of 127 Canadian firms that announced financial restatements with an equal number of carefully matched firms that did not submit restatements over a nine-year period. Says Kryzanowski, "We discovered

that these two groups of companies differed in their growth, their ownership, their proportion of unrelated directors, and the prestige of their auditors.

Kryzanowski and Zhang demonstrated that those firms that restated were more likely to have sustained higher growth. They were also subject to agency problems and had less independent oversight and hired fewer prestigious auditors.

The researchers also looked at how companies adapted post-restatement, to see whether corporate governance would change. They found that restated companies were more likely to replace their presidents, CEOs, CFOs and/or external auditors, and to increase the number and proportion of unrelated directors and audit committee members.

"When these firms make changes to pre-restatement management and external auditors, that signals that they are dealing with their internal agency problems. They are trying to mimic the governance practices of non-restating firms in what's likely an attempt to improve their public image," says Kryzanowski.

More information: www.sciencedirect.com/science/ … ii/S0929119913000084

Provided by Concordia University

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