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Key Governance Reforms May Not Cure Restatements: Study

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Of DOW JONES NEWSWIRES

NEW YORK -- Key corporate governance reforms aimed at bolstering the independence of corporate directors and auditors may have little effect on the accounting blowups they're meant to alleviate, a new academic study suggests.

At the same time, the study - believed to be the first to examine relationships between the current crop of reforms and its potential impact on financial restatements - finds that one probable outcome of the new rules can make a big difference: the presence of a financial expert on boards.

"It came as a surprise" that several of the governance reforms thrust on companies, courtesy of last summer's sweeping Sarbanes-Oxley Act and proposed stock market listing changes, have no discernible connection to the likelihood of restatements, said co-author **Anup Agrawal** , a finance professor at the University of Alabama's Culverhouse College of Commerce & Business Administration.

Agrawal, who described the results of the unpublished paper at a financial markets conference last week at Vanderbilt University's Owen Graduate School of Management in Nashville, is set to present the study Thursday to economists at the Securities and Exchange Commission's office of economic analysis.

The study's sample universe included 159 companies that restated earnings from January 2000 through December 2001 and a so-called matched sample of similarly sized companies operating in the same industries. Agrawal and his co-researcher, Alabama doctoral candidate Sahiba Chadha, reviewed governance characteristics that reflect the new and pending rules, such as having independent directors on the board or audit committee, or conversely, the presence of perceived governance weaknesses the rules seek to address, including auditor conflicts of interest, measured by the extent companies paid their accountants for nonaudit work.

When comparing the two sets of companies, the researchers found "none of the characteristics to be related to the probability of a restatement," Agrawal said.

Directors With Financial Expertise

Just as striking, perhaps, is the clear relationship between the existence of an independent director who has financial expertise on a board or audit panel and the probability of a restatement. Because of the way the study was designed, Agrawal cautioned that one can't say with certainty that appointing such directors to a board will necessarily reduce the risk of a restatement.

But the study does strongly suggest that companies with at least one independent director with financial expertise on the board or audit committee are significantly less likely to restate earnings than a company that doesn't have such directors in place. Companies with a financial expert on a board are about a third less likely to restate, while those with a financial expert on the audit panel are about 23% less likely to revise their books.

Lawmakers believed that pressing companies to include financial experts on their audit committees could make a difference in cleaning up accounting practices. The SEC, in carrying out the mandate of Sarbanes-Oxley, recently adopted a rule requiring companies to tell shareholders whether they have a financial expert on their audit panels, and if they don't, why not.

"These findings are consistent with the idea that the chances of a firm getting into a serious accounting problem are reduced by the presence of an independent director with a background in finance or accounting on the board or the audit committee," the study concludes. "Independent directors with financial expertise appear to be valuable in providing oversight of a firm's financial reporting practices."

By eliminating cases where restatements might have been the result of honest mistakes or technical errors, the authors sought to target the kind of accounting irregularities that have become a serious concern to investors in the wake of a slew of financial scandals.

Indeed, such financial restatements have grown significantly, according to a comprehensive study released in October by the U.S. General Accounting Office. The GAO report found that restatements jumped roughly 145% over the last five and a half years, with the number of yearly financial restatements rising to 225 in 2001 from 92 in 1997.

Despite the paper's mixed results, Agrawal isn't ready to write off the potential benefits of corporate governance reforms. For one thing, he said, previous studies have found positive relationships between corporate behavior and the presence of outside directors. Recent papers, for example, have found that outside representation on the board is related to lower levels of earnings management, for instance.

Also, as one of the first studies known to focus in on restatements, it's guaranteed not to be the last word.

"This is one study - there will be more studies," he said, adding that the GAO report included a large sample of restatements, ripe for further dissection. "As you have more studies done and people look at things in a variety of ways, they shed more light. This is a first step in this process."

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