Corporate Governance Ratings and Financial Restatements: Pre and Post Sarbanes-Oxley Act

Mohammad J. Abdolmohammadi
William J. Read*

Abstract

Using ratings of corporate governance developed by RiskMetrics Group (RMG), formerly Institutional Shareholder Services, we investigate whether relatively poor governance is associated with financial restatement, and whether restatement results in improved governance. We identify 150 firms that restated their 2003 financial statements to correct material error, and we use Compustat to generate a control sample matched on the basis of Global Industry Classification Standard (GICS), auditor type, year, and size. Compared to control firms, we find that restatement firms have significantly lower governance ratings in the restated year suggesting that poor governance results in financial impropriety. We also find that restatement firms improve their governance ratings in the year following the restated year, primarily by strengthening board independence, to the extent that significant differences with the control firms no longer exist. To test for the robustness of the results and provide insight into the likely direction of causation, we (1) match our test sample with other firms that did not restate in 2003, but had the same RMG corporate governance ratings (for evidence on post-SOX 2002), and (2) expand the examination period to pre-SOX (2002) and identify new test and control samples. The alternative empirical designs and related analyses support the finding that financial restatement results in board changes, which in turn improve governance ratings and reduction in chances of subsequent restatement.

Keywords: Financial restatements, corporate governance.

Data Availability: Performance and financial data are available from Compustat. Restatement and select audit committee and executive compensation data are from public sources identified in the manuscript. Corporate governance ratings were obtained from Institutional Shareholder Services.

* The authors are, respectively, John E. Rhodes Professor of Accounting, and Professor of Accounting, both at Bentley College.