DO FIRMS DO ‘WORSE’ BY DOING ‘BAD’?
FINANCIAL MISREPRESENTATION AND SUBSEQUENT FIRM PERFORMANCE

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ABSTRACT

This paper explores the relationship between business ethics and firm performance. The analysis finds strong support that firms ‘do worse by doing bad’; that is, financial misrepresentation leads to decreased legitimacy and impaired performance, and this detrimental impact is observable in the ongoing diminished operational profitability of the firm. Firms that decouple themselves from the misconduct – by increasing board independence or replacing their CEO – ameliorate this negative performance impact.

ETHICS AND FIRM PERFORMANCE

Many have suggested that corporate misconduct can hurt firms and their stakeholders. Margolis and Walsh (2003) suggest that research questions exploring this tension offer an important but neglected research opportunity for scholars of strategic management and organizational theory; the impact of this tension on firm performance is of particular interest to the research and practice of strategic management. This study focuses on quantifying the performance effects of corporate wrongdoing; specifically, I examine the impact of discovered financial misrepresentation – a particular type of firm misconduct that has surfaced with increasing frequency in recent years – on the operating profitability of the firms involved.

I argue that discovered financial misrepresentation damages the legitimacy of the offending firms, and that negative stakeholder response to this diminished legitimacy results in decreased firm performance. Specifically, in contrast to research studying the immediate but short-lived impairment to stock returns (e.g., Agrawal & Chadha, 2005), I show that the firm’s *operating* performance is impaired, and that this effect is much more persistent than a dip in stock price that rapidly dissipates.

HYPOTHESES

One specific way in which the discovery of corporate misconduct has adverse effects is through a loss of legitimacy. Organizational legitimacy has been broadly defined as “a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions” (Suchman, 1995: 574). Legitimacy is viewed as an economic asset that signals the attractiveness of a company’s offerings and initiatives, ultimately attracting more and better resources to the firm. Legitimacy is critical to the development of assured resources, and loss of legitimacy can disrupt these critical resource flows. Legitimate reputations can serve as mobility barriers for competitors, and can place a firm in an advantageous position due to such legitimacy being difficult to imitate. All of these factors support the idea that legitimacy can have an appreciable positive effect on organizational performance.

Conversely, legitimacy loss can diminish firm performance. In addition to the obvious direct costs firms may experience due to discovered misconduct (such as regulatory fines, civil or criminal penalties, restructuring charges, and class action shareholder lawsuits), legitimacy loss can decrease performance via its adverse impact among the firm's critical external stakeholders. Much like firms who experience high-profile mistakes, accidents, or other organization-level crises, firms caught in acts of financial misconduct experience a serious legitimacy threat. Stakeholder assessments of a firm's ethics are an increasingly important aspect of organizational legitimacy; specifically, financial restatements due to 'accounting irregularities' can be particularly damaging to firms experiencing such restatements, as they are considered both "ethics failures" (Staubus, 2005:5) and a type of business failure (Arthaud-Day et al., 2006) that is a "rare and serious event in the life of a company" (Agrawal & Chadha, 2005:373). Although not all of such restatements are criminally fraudulent, they are considered a proxy for fraud (O'Connor et al., 2006), and represent major accounting rules violations that the GAO characterizes as intentionally improper (U.S. General Accounting Office, 2002).

In addition to the adverse effect of misconduct on external stakeholders, legitimacy loss can also diminish firm performance due to consequences experienced within the organization itself. Whereas evidence demonstrates that sound organizational legitimacy has positive intra-firm effects, like the reduction of employee turnover, both theory and evidence indicate that legitimacy crises can increase dissonance and tension among organizational personnel, decreasing their cooperation (Dutton, Dukerich, & Harquail, 1994). This can decrease organizational effectiveness, illustrating another way in which a reputational crisis or loss of legitimacy can ultimately diminish firm performance. Through its effects both within the firm and on its external stakeholders, legitimacy loss due to misconduct can damage the firms involved.

These mechanisms for diminished performance – including both internal and external elements – lead to the same prediction: revelations of firm financial misrepresentation should negatively influence subsequent firm operating performance. Stated formally,

H1: Discovered financial misrepresentation negatively influences subsequent firm operating performance.

When threats to the organization's reputation occur, the organization must "engage in efforts to protect, repair, and enhance" that legitimacy (Ginzel, Kramer, & Sutton, 1992: 228). This can be especially true in the case of discovered financial misrepresentation, where the legitimacy crisis derives from organizational actions presumed to be intentional. Research suggests that firms with tarnished legitimacy need to *decouple* the organization from the legitimacy-threatening incident. Suchman (1995: 597) suggests that "organizations must construct a sort of 'firewall' between audience assessments of specific past *actions* and audience assessments of general ongoing *essences*." In other words, restoration of legitimacy rests on assuring stakeholders and organizational participants that past problems are not ongoing.

Decoupling can be accomplished by substantively restructuring certain aspects of the organization; this not only allows firms to attempt to directly address underlying structural antecedents of the misconduct, but also gives the firm something concrete to highlight in its rhetorical responses. In cases of repairing legitimacy loss due to misconduct or scandal, a key area of focus for substantive change is the firm's corporate governance structure.

One of the structural pillars of corporate governance that is strongly touted both in the business press and in academic research is the presence of ‘independent’ or ‘outside’ members of the board of directors. A focus on director independence undergirds recent regulatory reforms like the Sarbanes-Oxley Act of 2002 and the recent amendments to listing rules at the major U.S. securities markets. This suggests that many common stakeholders consider board independence important. Hence, stakeholders may see increased board independence in the wake of revealed financial misrepresentation as a key way to decouple the firm from the scandal and restore some of the firm’s lost legitimacy.

Ironically, Harris and Bromiley (2007) demonstrate that board independence has no dampening effect whatsoever on the likelihood of such misconduct happening in the first place. Yet regardless of whether or not independent boards *actually* provide good governance, outsiders’ presence on company boards may be *seen* as good governance. Therefore, to the extent that this perception is widely held, increasing board independence could have a symbolic effect in restoring legitimacy after the misrepresentation takes place, dependent upon positive stakeholder perceptions of the action. Given the pervasive conventional wisdom that board independence is ‘good governance,’ this structural change should be somewhat effective. Thus,

H2: Increasing board independence ameliorates (makes less negative) the negative relationship between revealed misrepresentation and subsequent firm operating performance.

Firms may also respond to legitimacy loss by replacing their chief executive. CEO replacement in the face of misconduct either directly punishes the CEO for the executive’s own unethical behavior, or symbolically shifts blame to an executive who may not be entirely blameworthy. Regardless, replacing the executive is, at the very least, a symbolic gesture that can serve as a restorative legitimacy signal.

As with increasing board independence, executive replacement strongly signals the firm’s commitment to decoupling itself from the scandal. Indeed, a recent study (Arthaud-Day et al., 2006) finds that firms with restatements replace their CEOs more than twice as often as other firms; changing leadership signals that the ‘current’ organization differs from the organization that caused the scandal. Symbolic actions that restore legitimacy or minimize its loss, if perceived favorably by the firm’s stakeholders, should reduce the negative relation between legitimacy loss and firm performance. Replacing the CEO may therefore reduce the reputational damage the firm suffers. Thus,

H3: Changing CEOs ameliorates (make less negative) the negative relationship between revealed misrepresentation and subsequent firm operating performance.

DATA AND METHODS

I started with a list compiled by the GAO of all firms with restatements due to accounting irregularities announced between January 1997 and June 2002. All the restatements reflect accounting ‘irregularities’, as previously discussed, and exclude restatements for stock splits, mergers, formal changes in accounting methods, or other proper business purposes. I used several data sources. Financial data came from Compustat. Governance data came from the ‘Directors’ dataset from the Investor Responsibility Research Center, supplemented with data from CompactDisclosure and firm proxy statements from the SEC's EDGAR database.

I matched each restating firm with a firm in the same four-digit SIC code industry with similar sales in the year prior to the restatement year. After dropping multiple-restatement firms and other anomalous observations, as well as firms for which data became unavailable, the final sample is 105 restating and 105 matching firms, for a total usable sample of 210. Year *t* is the year of restatement, with controls for prior performance and board composition coming from year *t-1*, the year prior to the initial restatement itself. This prior year data describes the 'initial condition' of the firms being studied. I then measure the performance effects and other variables in the year immediately following the year in which the restatement is made public.

I employ a methodology that includes fixed effects for each matched pair of firms, and the model estimation is a difference model, where the dependent variable, moderating variables, and controls are all measured as *changes* in the measured values from the initial condition to the year following the restatement announcement. This addresses some of the methodological problems associated with lagged variables, and also provides some level of control for firm-specific endogenous factors.

RESULTS

The parameter estimates strongly support Hypothesis 1 (see Table 1); discovered financial misrepresentation has a significant negative effect on change in operating performance. The coefficient indicates that firms experiencing restatements had a systematic change in ROA of –0.056 as compared to non-restating firms. Given that the mean value of ROA in the initial condition is 12%, a change of 5% or 6% on the same scale is a very large effect size – a drop in returns of 40 to 50 percent. Discovered misrepresentation is associated with a statistically significant and financially substantial impairment to operating performance.

The data also strongly support Hypothesis 2; for restating firms, increasing board independence has a statistically significant positive effect on change in operating performance that can at least partially offset the negative main effect arising from the restatement. The practical impact of this effect can be large; for instance, the coefficient indicates that restating firms with no prior independent directors that reconstitute their board to include all independent directors – a unit change of 1.0 – experience a positive change in ROA of 12.3%. (The sample of restatement firms includes both of these extreme values.) Even less extreme changes that incrementally increase board independence can dramatically impact the change in operating performance; a 5% or 10% positive change in ROA provides a welcome offset to the overall performance loss associated with discovered financial misrepresentation, even when that loss is 40% or more. Restating firms that make their boards more independent can ameliorate the negative performance impact associated with the restatement.

Finally, the model estimation also provides moderate support for H3; for restating firms, CEO replacement also has a positive impact on operating performance that can potentially offset some of the negative main effect arising from the restatement. While we can only reject the hypothesis that the coefficient equals zero at $p<.07$, we can strongly reject the hypothesis that the coefficients for restating and non-restating firms are the same (switching CEOs in non-restating firms has a negative effect on performance; –0.085, $p=.001$). Since CEO replacement is a dummy variable, it makes more sense to assume that a normal amount of CEO turnover is represented by the non-restating firms, as opposed to thinking that the benchmark for CEO replacement is zero. If so, then the change in B would be represented by the difference in the two coefficients, resulting in a t statistic that is highly significant. Although such arguments should be interpreted cautiously, even a conservative interpretation of the estimation results – as reported – indicates at least moderate support for the idea that when financial misrepresentation is discovered, firms that switch CEOs ameliorate the subsequent negative performance impact associated with restatement.

DISCUSSION

Whereas the primary body of research exploring the interplay between business ethics and firm performance has comprised a largely inconclusive 30-year search for a positive connection between corporate social responsibility and firm financial performance, this paper focuses on the impact of firms' ethical or unethical behavior, rather than examining corporate charitable activity. This study provides insight into the relationship between financial misrepresentation and firm performance, by finding strong support for what is essentially the photographic negative of the shopworn axiom 'doing well by doing good'; the data confirm that firms 'do worse by doing bad'. Unethical firm actions lead to decreased legitimacy and impaired performance.

The sustained operating loss, discernible in the restating firms' diminished return on assets, offers strong support for the theoretical claim that legitimacy loss adversely impacts firm profitability. The data plainly show that firms whose financial misrepresentation is discovered, suffer. While this finding is certainly consistent with other work showing negative abnormal stock returns (Agrawal & Chadha, 2005; Arthaud-Day et al., 2006), this analysis goes one step further in identifying an accounting performance impairment that outlasts the dip in stock price.

For instance, Agrawal and Chadha (2005:386), in their study of financial restatements using the same GAO sample, find that restating firms experience negative abnormal stock returns in a three-day window surrounding the date of announcement; these cumulative abnormal returns continue for approximately three months, after which "they recover" and "hover around zero subsequently, as uncertainty is resolved and firms seem to put accounting problems behind them." Impaired stock returns associated with restatements, in other words, completely disappear over the course of a few months.

In contrast, I find that legitimacy loss prompted by misconduct, although certainly prompting a short-term negative stock market reaction, also has farther reaching effects; by either negatively impacting the behavior of the firm's direct stakeholders or the effectiveness of internal operations, the loss of legitimacy impairs operating performance beyond the year of announcement, throughout at least the following fiscal year. This has implications for strategic management, since sustained diminished financial performance is presumably of graver import than a one quarter dip and resurgence of the firm's stock price, which may simply be viewed as a public relations matter or an 'unrealized loss'.

Once misrepresentation occurs and is discovered, however, firms can take ameliorative actions. First, the results indicate that increasing board independence effectively softens the blow of legitimacy loss brought on by the restatement. Second, firms can moderate the negative impact of legitimacy loss by replacing their chief executive. In both cases, although the negative repercussions of financial misrepresentation cannot be completely offset, stakeholders appear to reward restating firms that decouple themselves from the scandal in a substantive way.

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Table 1: Fixed-effects Regression Results[1]

	Dependent Variable: Change in ROA	
	Coefficient	Standard Error
Restatement	-0.0562986 **	0.017836
Change Industry ROA	-0.2704279	0.3905711
Change Log Sales	0.0315376	0.0213759
Change Board Independence (R)	0.1233284 *	0.0511469
Replace CEO (R)	0.0444833 †	0.0240785
F (7,85)	5.79 (p<0.0000)	
R squared (within)	0.3228	
Rho	0.5336	
Fixed effects F (103,85)	1.31 (p=.0978)	

[1] † p< .10, * p< .05, ** p< .01, *** p< .001