Forging new frontiers

SINGAPORE Management University’s (SMU) Cheng Qiang may be teaching a subject – accountability – which may make some eyes glaze over. However, he is conducting juicy research that will make most people sit up. Prof Cheng’s research spans issues of whether CEO pay is justified, whether having more independent directors helps improve financial reporting quality, and if corporate site visits are useful to analysts.

He is also currently working on a project – using data from social networking site LinkedIn – on whether US companies which employ more tax professionals save more tax.

“I’m interested in various issues. Whenever I read something, I get curious on the determinants and consequences,” says Prof Cheng, SMU’s new dean of its School of Accountancy, effective this month.

Conversations with friends who are financiers analysts, for example, spawned papers on the corporate site visit – a ritual where companies invite analysts covering their stock to their premises to examine manufacturing processes or talk to senior management.

Using data from the Shenzhen Stock Exchange, which requires companies to disclose site visit details, Prof Cheng examined whether analysts’ forecasts improved after the site visits.

He explains that site visits are now more important due to regulations barring the selective disclosure of sensitive information by managers to outsiders.

“If you’re doing the visit and I’m not doing it, we can compare how accurately your forecast is within three. In the old days, financial analysts could talk to managers to get some information. Now it’s not allowed, and this is strictly enforced everywhere,” he says.

Despite restrictions on the selective disclosure of material non-public information, site visits can still yield interesting insights. “Of course you can get information cues from the way they respond to your question,” he says.

One finding from the paper, which is under review, was that non-local analysts, who are usually at a disadvantage in the accuracy of their analyses, can overcome the information barrier through site visits.

Prof Cheng also found that site visits are more useful for analysts covering firms such as manufacturing companies, where one can see a lot of operations and assets.

“They are also important when companies’ disclosures are not very good, such that investors cannot get much from financial statements,” Prof Cheng says.

CEOs and independent directors

In another paper that will be published this year, Prof Cheng examined whether the nature of employment contracts can prevent CEOs from engaging in myopic behaviour.

“Myopic behaviour is defined as measures to boost a company’s short-term financial performance, at the expense of long-term value.”

To detect such myopic behaviour, Prof Cheng focused on whether firms cut their research and development (R&D) expenditures to boost profits, in a year when earnings would otherwise decline if funding cuts were not made.

He found that CEOs without contractual protections such as severance pay agreements and employment assurances tend to engage in more of such profit-boosting behaviour.

“But if you cut R&D this year, the firm’s market valuation will be worse in the future,” he says.

People often associate employment agreements and severance pay with managerial power and enforcement. Our evidence suggests that such contractual protections can expand managers’ horizons and address the problem of managerial short-termism.”

Separately, in a paper published earlier this year, Prof Cheng also examined whether companies whose boards have a majority of independent directors are less likely to engage in earnings manipulation.

“The problem is if the CEO has something he wants to hide, but he can’t say whether it’s a bubble or not but I sold all my shares. When prices double in a year you have to less earnings manipulation. Such an ideal information environment might be found, but in the future, it’s probably going to be much more difficult to do it. It’s a kind of dangerous when stocks keep going up but the real economy is not doing well. I couldn’t say whether it’s a bubble or not but I sold all my shares. When prices double in a year you have to wonder."