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The Importance of Being an Ethical Company

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Firms must fine-tune their corporate governance mechanisms to prevent unethical behaviour and take quick action once they are found, says Professor Cheng Qiang from the SMU School of Accountancy.

AsianScientist (Sep. 1, 2014) – By Dora Yip – When a company revises and restates its financial statements due to errors in accounting, it shakes investor confidence and has profound consequences on the company's stock price and future earnings. In some cases, these errors may be intentional, whether they involve outright fraud or managers wanting to report higher earnings to placate investors.

Professor Cheng Qiang, who is the Associate Dean (Research) at the Singapore Management University (SMU) School of Accountancy, studies the phenomenon of companies engaging in unethical behaviour.

> "Why do they do this? Why don't they realise the consequences of their behaviours and design better mechanisms to address such behaviours?" he asks.

His research focuses on governance issues as well as how to fine-tune corporate governance mechanisms, such as Chief Executive Officers' (CEOs) employment and severance pay agreements, to combat unethical and financially damaging behaviour.

Building up credibility takes years

In their research study that was published earlier this year in The Accounting Review, Professor Cheng and his co-authors found that firms which had issued material restatements experienced a significant decrease in credibility of earnings for up to three years following the announcement.

> "We found that there were severe consequences if a firm performed accounting tricks. It took almost three years for it to fully regain investors' confidence. Also, if investors didn't trust the company, they would be unwilling to fund its future projects," he says.

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Although many companies are aware of this, the problem often lies in delayed intervention. Professor Cheng's research showed that companies that did not take prompt action experienced a prolonged dip in investor confidence.

> "Companies need to see the outcome before they react. Some companies that have restated their numbers resorted to firing their CEOs, or replacing their auditors and board members. This is too late. Instead of reacting to the issues, what can they do to prevent it from happening in the first place?"

With his research receiving widespread media attention – it was featured in both The Wall Street Journal and The CPA Journal – Professor Cheng is optimistic that more people will recognise the need to design better mechanisms to prevent unethical corporate behaviour.

> "The tricky part is to design corporate governance in such a way that managers will not have the incentive to engage in unethical behaviour," he notes.

Dealing with manager 'short-termism'

Addressing managerial 'short-termism' (or an excessive focus on short-term results at the expense of long-term interests) has been an important issue for many companies, as unethical actions are often motivated by the urgency for short-term gains over long-term accountability.

Professor Cheng examines the impact of CEO contractual protection on managerial 'short-termism'. He found that firms with CEO contractual protection in the form of employment and severance pay agreements were less likely to engage in real earnings management. This signalled a deviation from optimal operation and investment strategies. Companies also tended to adopt a longer-term approach as the duration and monetary strength of CEO contractual protection increased.

> "In other words, if the CEOs cannot be fired for three to five years, they are likely to do their best in the longer term, and feel less pressed to engage in short-term, myopic behaviour to please shareholders and board members," he explains.

Influencing corporate action

Despite the compelling data, Professor Cheng says the real challenge is to convince his peers of his findings.

> "Much of this stems from their reluctance to accept research that attempts to change the existing paradigm. It takes very rigorous analyses to convince others that what we document is not driven by biases. If our results are different or inconsistent with other findings, people will ask why," he says.

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He is confident though, that his research on corporate governance and disclosure will continue to make an impact on the field. He hopes that managers will look at his findings and think about how to design better governance mechanisms that are in the best interests of stakeholders, not just themselves.

Professor Cheng hopes to collaborate with his colleagues from the School of Law and Lee Kong Kian School of Business to further explore the role of regulators, and how to engage them so that unethical behaviour in financial reporting is minimised. He is also looking at teaming up with colleagues from the School of Information Systems to find better ways of collecting information on corporate disclosure from the Internet.

> "It would really hearten me if my research can shed some light on the costs and benefits of governance mechanics, help researchers gain a better understanding, and enable companies to design better governance mechanisms," he says.

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