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Forging new frontiers

New dean of SMU's School of Accountancy Cheng Qiang shares his latest research on CEO pay, independent directors and corporate site visits

SINGAPORE Management University's (SMU) Cheng Qiang may be teaching a subject – accountancy – 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 large 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 financial analysts, for example, spawned papers on the corporate site visit – a ritual where companies invite analysts covering their stock to their operating 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 accurate your forecast is relative to mine. 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 later 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 situation will be worse in the future," he says.

"People often associate employment agreements and severance pay with managerial power and entrenchment. 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 paint an overly positive view of their results through accounting techniques.

Theoretically, independent directors, who are people with no relationship to the company, will strengthen corporate governance such that it is less likely that financial statements will be fudged.

In reality, many independent directors are friends or social contacts of the CEO, and might not have an incentive to rock the boat.

Moreover, independent directors, who are supposed to represent the interests of shareholders, might not have much information to work with.

"The problem is if the CEO has something he does not want outsiders to know, he won't share it with independent directors either," he said.

In his research, Prof Cheng found that board independence alone is not enough to ensure financial reporting quality.

Rather, the independent directors need to be well informed – that is, they must be able to easily acquire information about the company.

Such an ideal information environment might be found in companies whose listed stocks are highly liquid, possess a low bid-ask spread, have high analyst coverage and little forecast error.

Prof Cheng found that in these companies, having a majority of directors who are independent will lead to less earnings manipulation.

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> **Professor Cheng Qiang (above), Dean of the School of Accountancy at SMU, on his research which addresses the role of contractual protection in influencing managerial myopia**

Common investor issues

At SMU, Prof Cheng's teaching interests include accounting theory, financial accounting, and financial statement analysis.

"I help students to understand why accounting rules are what they are. They all get the idea that accounting information is important, and the reason we have it is to reduce the information gap between managers and outsiders. So it is important that we design the system in the best way to reduce that information gap," he says.

However, Singapore's accounting rules, based on the International Financial Reporting Standards (IFRS), still contain grey areas.

"When you're a manager or a partner in an accounting firm, you're going to have to debate with managers what's the best way to account for a transaction," he says.

The most challenging accounting issues revolve around revenue recognition, Prof Cheng says.

"That's the first line in the income statement and the number most investors focus on. But to record revenue is quite tricky.

"Suppose you purchase an iPad and it comes with a three-year service contract. Do you record that at the time when you buy the iPad, or over time when you use the service," he says.

Revenue recognition issues usually crop up in hi-tech companies, telcos and Internet e-commerce companies or companies with many IT projects, he notes.

New challenges

Looking ahead, as the new dean of SMU's accounting school, Prof Cheng says one challenge is to make SMU relevant and attractive as a place to study accounting.

This is due to the multiple routes one can take now to become a professional accountant, he says.

"A lot of Singapore families are wealthier and starting to send their kids overseas. We are now competing with international universities," says Prof Cheng, who studied at Tsinghua University in Beijing and obtained his PhD in Accounting from the University of Wisconsin-Madison in the US.

He is working on changing the current four-year SMU programme, which follows an American model of education, to attract top students to the programme.

SMU takes in about 300 undergraduate accountancy students per cohort.

Other than improving the quality of the undergraduate education, another priority is to grow the size of the School of Accountancy's postgraduate programmes while maintaining quality, Prof Cheng says.

He hopes to expand the Master of Professional Accounting programme, which currently has 30 students per intake. This will be done through collaborating with other universities, notably from China. The programme can be completed in one year for full-time students or two years for part-time students.

Meanwhile, despite his experience analysing financial statements, Prof Cheng prefers to invest in low-cost index funds, saying he does not have time to follow stocks.

He did have some shares that benefited from the recent boom in the Chinese stock market – which he sold in May.

"I'm out of China at this point," he says with a laugh. "It's kind of dangerous when stocks keep going up but the real economy is not doing well," he says.

"I 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 wonder."

This is a monthly series brought to you by the Singapore Management University. Next month's feature will discuss ways to harness technology to develop urban solutions for a Smart Nation.