Binghamton scholar advocates for additional corporate oversight

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Yan Zhang, an associate professor of accounting at Binghamton University, suggests that strengthening parts of the 2002 Sarbanes-Oxley Act would improve corporate performance and shareholder value. Credit: Jonathan Cohen

In the wake of the Enron and other corporate scandals, new research from Binghamton University suggests that strengthening parts of the 2002 Sarbanes-Oxley (SOX) Act would improve corporate performance and shareholder value.

It's particularly relevant as Republican presidential candidates have called for repealing some or all of SOX's provisions and even President Obama has mentioned easing its restrictions. Meanwhile, the Public Company Accounting Oversight Board, established to oversee compliance with the law, is considering ways to improve transparency requirements.

Yan Zhang, an associate professor of accounting at Binghamton University, has found:

- Companies with greater accounting transparency have greater cash value and less wasted spending.
- The independent and expert audit committees required by Sarbanes-Oxley — or SOX — are only as effective as the firm's chief executive is weak: The stronger the CEO, the less effective the audit committee.
- Measures meant to improve financial reporting quality have unintended costs.

"SOX is good, but it doesn't solve the problem entirely," Zhang says.

Before the passage of Sarbanes-Oxley, big accounting firms such as Arthur Anderson (Enron's auditor) lacked independence. A key provision of SOX is removing conflicts of interest for these firms. In fact, it's now unlawful for auditors to perform various non-audit services for their audit clients. The Public Company Accounting Oversight Board has been seeking public comment on how to further improve the independence of the outside auditing firms retained to examine companies.

One of the issues the oversight board faces is that while inspectors are able to trace an audit failure to a competence issue, such as in the design of the audit methodology or in its execution, on the whole, these firms are highly competent. Yet the failures continue to occur, in spite of firms' remediation efforts. The root of the problem could be a lack of auditor skepticism which is destroyed when there's a loss of independence. A possible solution? Zhang's research suggests that the board should consider limits to the influence a chief executive can have on the audit committee, in addition to the outside audit firms.

In the post-SOX era, stock exchanges prohibit CEOs from being directly involved with selecting members of the audit committee, but that doesn't guarantee the committee will be free of a CEO's informal influence. Zhang and her colleagues set up a metric to gauge how powerful a chief executive is, measuring prestige, expertise, corporate ownership and structural power.

The data showed that CEO power weakens the effectiveness of audit committee financial expertise in reducing earnings restatements — an indication that a supposedly independent and expert audit committee could still be influenced, even if informally, by a chief executive. A chief executive could refuse to provide necessary information or obfuscate details the audit committee requires. And a strong CEO can get away with it.

"The purely independent nominating committee doesn't solve the problem," Zhang says. "It merely mitigates the problem."

Zhang's study didn't consider the potential effects of limiting audit firm tenure, but her first suggestion in countering the effect of a powerful CEO is more direct: Re-balance the power other directors have to counter the chief executive, regulation that would require action by the Securities and Exchange Commission.

Although the oversight board is concerned about transparency, it was under pressure in late 2011 to ease disclosure regulations, even though Securities and Exchange Commission Chairwoman Mary Schapiro has called for increased transparency in the capital markets to protect investors. Zhang's research suggests they should stay the course, or even force increased transparency.

Zhang examined the cash on hand of a number of companies, and found that opaque (less transparent) companies had a perceived discount for

their cash levels: Investors valued cash on hand as low as 45 cents per $1. Transparent firms saw that value around $1.05 per $1.

"Taken together, our findings suggest that managers in firms with fewer disclosure activities are less subject to scrutiny of capital markets and thus are more likely to expropriate cash assets," said Zhang. And that can lead to empire building.

The logic is this: A CEO is looking to expand the company, because a larger company brings greater compensation. With little transparency and a large amount of excess cash, a CEO may be tempted to squander cash on weak acquisitions.

"A lot of firms are sitting on too much cash right now," Zhang says. "The empire-building motive is particularly severe when managers control cash levels in excess of those needed for operations and investment. Lending further credence to the monitoring effect of disclosure activity, we find evidence that the negative effect of major expansion on shareholder value is reversed when the firm has sufficient disclosure activities."

One section of Sarbanes-Oxley requires audit committees to include financial experts. Originally, SOX 407 narrowly defined a financial expert as an accountant. Later the SEC broadened this definition by allowing others with financial expertise, such as a chief executive, investment banker or venture capitalist, to serve in this capacity as well as accountants.

Zhang's research shows that the current broad definition comes at a price. She first found that audit committee financial experts outperform non-financial experts on audit committees in their trades of a firm's stocks. She further divided audit committee members into two groups, accountants and non-accountant financial experts, and found that these

"expertise rents" are driven by the non-accounting financial experts. Accountants, she says, made fewer trades and gained less value than the non-accountants, and the non-accountants were more likely to have abnormal returns.

That suggests one of the following options:

- Accountants and CPAs, governed by professional ethics that require them to place their fiduciary duty ahead of their own gain, forgo opportunities to earn expertise rents.
- Non-accountant committee members — venture capitalists, CEOs and others — may be more experienced in investing in the capital market and thus trade more aggressively than accounting financial experts.
- The non-accountant financial experts may be more likely to engage in inappropriate insider trading. (Zhang's research has not delved into this possibility.)

"This is the first study, to our knowledge, that demonstrates a negative aspect of mandating a financial expert on the audit committee," Zhang says.

Her solution? Require all financial experts on the audit committee to be accountants, supporting the law's original approach.

"Overall," she says, "the findings suggest that by restricting financial expertise on the audit committee to accounting financial experts, expertise rents earned by audit committee financial experts will be significantly reduced."

With SOX up for debate, Zhang's work suggests ways that additional reforms can rebuild investors' faith in the market. Her findings are

forthcoming in top-tier publications, including the *Accounting Review*.

"Is the reform good enough? Is it working?" she asks. "We do see financial improvements and an improvement in earnings quality, but regulators need to do more."

Provided by Binghamton University

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