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STRATEGIES

The Bad News on Certification Was Old News to the Market

By MARK HULBERT

The stock market didn't much care whether chief executives started certifying the accuracy of their companies' financial statements last Aug. 14, the deadline set by the Securities and Exchange Commission.

That finding, from a new study, is not what many investors would have expected. To them, the stocks of companies whose C.E.O.'s did not certify statements should have suffered because the companies, in effect, were acknowledging that there was something wrong.

The S.E.C. contributed to those expectations by arguing that certification would "provide greater assurance" that firms "have not violated, or are not currently violating, federal securities laws."

But on Aug. 15, the market, on average, did not punish the stocks of companies that failed to meet the previous day's deadline. Instead, the study found, the market detected financial problems at these companies many weeks earlier — and had already driven down their stocks.

The study was done by Utpal Bhattacharya, an associate professor of finance at Indiana University, and two of his graduate students, Peter Groznik and Bruce Haslem. It has been circulating in academic circles

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for several months and can be found online at http://papers.ssrn.com/sol3/papers .cfm?abstract-id=332621.

The Aug. 14 deadline applied to all companies whose annual revenue was more than $1.2 billion and whose fiscal years coincided with the calendar year — a total of 688 companies. Of that total, the chief executives of 664 met the deadline while 24, including CMS Energy, a diversified energy company based in Dearborn, Mich., and Qwest Communications, a telecommunications company in Denver, did not. But the researchers, focusing on performance, volatility and trading volume, concluded that there was no difference on Aug. 15 in the average behavior of these two groups of stocks.

That conclusion will not surprise people who believe in the markets' efficiency. The markets can often do a better job of assessing the significance of financial data than any person can do individually.

The researchers found evidence of that efficiency in the poor performance of the noncertifying companies' stocks in the three months before the S.E.C. announced the certification requirement on June 27. During that time, the stocks of those companies performed about 10 percent worse, on average, than those of companies whose chief executives would certify results by the deadline.

The researchers found that in the seven weeks between the S.E.C. announcement and the deadline itself — June 27 to Aug. 14 — the noncertifiers' stocks recovered much of the ground they had lost over the three previous months. But because the noncertifiers' stock returns were all over the map, the researchers have little confidence that the average of those returns is statistically significant. But even if it were, the researchers still would have concluded that the markets didn't much care that certain companies' chief executives failed to certify.

While the researchers found the markets to be largely efficient, they do not think the markets can detect every company whose accounting is deficient or misleading. Notably, the markets were surprised by problems at Enron and WorldCom.

If the S.E.C.'s certification requirement had helped investors uncover additional financial problems, the shares of the noncertifiers should have lagged behind the others on Aug. 15.

BECAUSE they did not, the study provides support to those who never placed much confidence in the S.E.C.'s certification requirement. Skeptics have argued that chief executives for years have been signing financial statements, even while knowing that lying would constitute fraud for which they could be penalized. Since deliberate lying on financial statements was already illegal, why should the new requirement make any difference?

Though determined executives can hide evidence of problems for a considerable time, it nevertheless is impressive that the markets last year were able to detect financial problems among the companies that eventually didn't certify — and months before the deadline. This is yet another reason the markets are so difficult to beat.

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