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Conservatism, SEC investigation, and fraud

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A B S T R A C T

We present evidence on the relationship between firms that have engaged in fraudulent financial reporting and accounting conservatism. We empirically investigate the extent to which US firms identified by the SEC in their Enforcement Releases demonstrate higher levels of conditional conservatism in order to mitigate information asymmetry and agency problems. Specifically, by assessing the timing of changes in the litigation risk environment for fraud firms, we document how differences in heightened legal liability guide changes in conservative accounting behavior. Compared to a matched non-fraud control sample, we document that fraud firms have significantly lower levels of accounting conservatism in the pre-fraud period. Consistent with changes in potential legal liability, we find an increase in accounting conservatism for fraud firms during the SEC investigation period. Subsequently, during the public discovery of fraud, any increases in accounting conservatism are marginal and appear to converge back to lower levels compared to the SEC investigation period. Overall, our findings suggest more temporary changes in conservative reporting in the short-term for fraud firms. We also document that increased levels of accounting conservatism for fraud firms are not due solely to the passage of the SOX Act. Our findings aid in explaining fraud firms' incentives and opportunities for accounting conservatism and lend support for why standard setters, regulators and auditors should continue to monitor and re-evaluate conservatism's short-term effects that are conditioned on changes in a firm's risk environment.

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1. Introduction

A large stream of research has evolved on accounting conservatism. However, little is known about whether or how conservatism manifests itself in fraud firms. The motivation for this study is to shed light on the current debate which centers on whether conservative financial accounting represents a universal desirable attribute of qualitative accounting information. Prior research has theoretically linked increases in accounting conservatism to unexpected changes in litigation risk (Watts, 2003b). Yet, it is not entirely clear whether firms accused of fraud, which are characterized by high levels of litigation risk, have higher levels of accounting conservatism or when changes in conservatism are likely to occur. Since Givoly et al. (2010, p. 221) state that it is important to examine the "episodic" nature of earnings management, we examine whether accounting conservatism, based on our sample, is sustainable.

US GAAP affords managers considerable reporting discretion, with accounting conservatism being one of those reporting practices (Bagnoli and Watts, 2005; Guay and Verrecchia, 2007). Studies reveal managers use accounting conservatism as a means to address information asymmetry and agency costs in their private information and financial reporting strategies (Chaney, 2007; LaFond and Watts, 2008). In this current study, we document how agency conflicts and the likelihood of legal liability affect fraud firms' corporate disclosure behaviors. Specifically, by assessing the timing of changes in the litigation risk environment surrounding the period of manipulation in the financial statements for fraud firms, we provide new insight on how fraud firms temporarily alter their conservative accounting practices in order to reduce information asymmetry and potentially regain investor confidence. The timing of changes is relevant because it is often assumed that fraud firms' aggressive accounting behaviors and accounting conservatism practices, in general, are not likely to persist, but rather vary in response to operating incentives and the likelihood of litigation. Understanding how accounting conservatism manifests itself in fraud firms also indirectly provides new evidence on the prediction of and remediation effects to accounting failures.

Although increases in accounting conservatism are suggested to aid in facilitating the effective monitoring of managers and contracts (Ball et al., 2000; Watts, 2003a, 2003b), we are motivated to study the interrelationship between fraud firms and conservatism because of the concern for how accounting conservatism, characterized as a monitoring-disclosure mechanism, is reflective of providing an economic benefit to market participants. Thus, labeling accounting conservatism as a quality metric under all circumstances appears problematic. Moreover, in a recent study, Jackson and Liu (2010) provide evidence that managers use the flexibility of conservatism as a strategic earnings management process which contradicts the notion that accounting conservatism provides an economic benefit. By focusing on individual accrual accounts, they show that the allowance for doubtful accounts has become more conservative over time and firms subsequently manage bad debt expense downward to meet or beat analysts' forecasts of earnings.

Prior research has generally regarded accounting conservatism as a mechanism that provides an economic benefit in response to a firm's incentives. Chen et al. (2007) state that contract efficiency can be improved upon by using accounting conservatism. Ahmed et al. (2002) report that accounting conservatism mitigates bondholder–shareholder conflicts over dividend policy. In this respect, accounting conservatism serves as a protective action that benefits lenders by providing them with a barrier to reduce downside risk. In particular, accounting conservatism leads to contracting benefits for borrowers in the form of lower interest rates (Zhang, 2008) and firms that institute higher standards of corporate governance have exhibited higher levels of accounting conservatism (García Lara et al., 2009). Moreover, Kim and Pevzner (2010) find a reduction in future bad earnings news for firms with conservative accounting practices. Chung and Wynn (2008) find that directors' and officers' liability insurance coverage and cash indemnification for Canadian firms reduces expected legal liability, causing a decrease in conservative earnings. García Lara et al. (2011) provide evidence that conservatism imposes greater verification requirements relating to increasing earnings, thus reducing information uncertainty and leading to a lower cost of capital.

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