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An investigation of the effectiveness of the division of corporate finance as a monitor of financial reporting

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ABSTRACT

This study investigates whether the Securities and Exchange Commission's Division of Corporate Finance (DCF) allocates resources toward public companies that investors perceive as having poor financial reporting quality. Resource allocation within the DCF is an important topic given the SEC's overall mission to improve disclosures and protect investors. The findings are consistent with the DCF being more likely to allocate resources toward firms that market participants perceive as having poor financial reporting quality.

Introduction

This study uses Securities and Exchange Commission (SEC) comment letters to investigate the SEC's role as a monitor of financial reporting. The SEC's Division of Corporate Finance (DCF) reviews filings made under the Securities Acts of 1933 and 1934 to identify deficiencies and enhance material disclosures. While research is prevalent concerning SEC enforcement actions, relatively little is known about the Commission's method of reviewing and selectively commenting on filings. The SEC's endeavor to make comment letters publicly available on EDGAR provides a context for investigating how effectively the SEC identifies financial reporting deficiencies and allocates resources toward comment letter recipients.

An effective monitoring process is pertinent to the Division's success given the importance of maintaining a reliable U.S. financial reporting regime. The Sarbanes–Oxley Act of 2002 (SOX) requires the Division to review all public companies at least once every three years. The Division is also responsible for performing full reviews on initial public offerings, contested proxy solicitations, tender offers and going private transactions due to the potential impact on investors. The DCF conducts this extensive monitoring role with a limited budget of approximately $135 million (SEC Budget Justification FY 2017)[1] and has requested that the budget be increased every year since 2009. Further, the recently introduced SEC Regulatory Accountability Act (H.R. 5429) could pose additional constraints to the DCF's already limited resources (Mont, 2016). [2] The scope of the DCF's mission coupled with a limited budget pose a threat to the Division's ability to make meaningful improvements unless the DCF is efficient in focusing its attention and resources on firms with the greatest financial reporting deficiencies.

To gauge whether the DCF is effective in targeting these firms, we examine the association between DCF resource

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[1] The SEC Budget Justification for Fiscal Year 2017 indicates that the DCF has 463 full time employees. The DCF's budget of approximately $135 million is small when compared to other monitors and enforcement agencies. For example, Financial Industry Regulatory Authority (FINRA) operates on a budget of approximately $1.03 billion (FINRA, 2015) and the PCAOB has a budget of approximately $250 million (Public Company Accounting Oversight Board Budget, 2015). Further, large auditing firms operate with considerably more resources than the DCF. For example, E&Y had global revenues of approximately $30 billion in 2016 (Cohn, 2016).

[2] Specifically, H.R. 5429 would require the SEC to evaluate the costs and benefits of all proposed and existing regulations to determine whether the costs are justified. The SEC would also be required to continuously review whether any regulation is ineffective or overly burdensome by evaluating regulations within one year of enactment and then again, every five years (Mont, 2016). The Congressional Budget Office estimates that implementing H.R. 5429 would require the SEC to hire an additional 24 staff at a cost of approximately $27 million over 2017–2021.

allocation and earnings and disclosure quality. We utilize comment letter cases as a measure of DCF resource allocation and contemporaneous and forward earnings response coefficients (ERC and FERC)[3] to estimate the market's perception of earnings and disclosure quality. Results indicate that comment letter recipients have significantly lower ERCs and FERCs than non-comment letter recipients. This finding should interest regulators as it provides some evidence consistent with the conjecture that the DCF focuses resources on firms where investors perceive that financial reporting quality is low.

The results can also be interpreted as evidence consistent with earnings and disclosure quality being a determinant of receiving a comment letter. The determinants of comment letters should interest management, audit committees, and auditors who all participate in costly comment letters cases.[4] Additionally, the study should interest financial statement users as it provides evidence consistent with the DCF addressing investors' needs by expending resources toward firms that investors perceive to have poor financial reporting quality. The study adds to the literature examining the SEC's role as a monitor of financial reporting and disclosure (Cassell, Dreher, & Myers, 2013; Fogel, El-Khatib, Feng, & Torres-Spelliscy, 2015; Hughes, Sander, & Snyder, 2009).

The remainder of this paper is organized as follows. The next section provides background information on the comment letter process. The third section includes the hypothesis. The fourth section describes the research design. The sample and descriptive statistics are presented in the fifth section and results are presented in sixth section. Finally, the last section includes concluding remarks and suggestions for future research.

Important implications of the study for key parties

Comment letters have implications for multiple parties including management, financial statement users, auditors, and audit committees. In general, public companies do not want to be on the SEC's radar and there are several reasons that management would be concerned about being the subject of a SEC comment letter. First, comment letters require the firm to devote a substantial amount of time formulating an appropriate response to the SEC's concerns. Secondly, management must act quickly as the SEC requires a response within 10 days of receiving the first letter. This deadline often results in the firm redirecting its attention from important operational issues to resolving the comments. In fact, responding to comment letters involves an entire team and may include participation from the firm's auditors, legal counsel, accounting personnel, management, audit committee, etc. Third, depending on the type of issue involved, remediation costs can be high with accounting related issues producing the highest costs (Cassell, Dreher, & Myers, 2013). Finally, management is aware that comment letters are publicly available giving stakeholders access to the entire exchange between the SEC and firm including all issues raised by the SEC. The content of the exchange may raise issues about the quality of the firm's management especially its financial management and audit committee.

On the other hand, financial statement users benefit from comment letters in several ways. First, the publicly available comment letters serve as an additional source of information about the firm. They inform users of accounting and/or business problems and serve as red flags in comment letters with material accounting or disclosure issues. Certain investors even rely on comment letters to make investment decisions (Dechow, Lawrence, & Ryans, 2016). Furthermore, users benefit from improvements in the quality of the firm's financial reporting in the post comment letter period. Specifically, recent evidence is consistent with comment letters leading to higher quality and more consistent disclosures (Kubick et al, 2016) as well as increased earnings response coefficients (Johnston & Petacchi, 2017).

In certain cases, firms contact their auditor for help navigating the comment letter process. Specifically, audit firms are copied on the SEC's correspondence in between 8% and 10% of cases. When contacted, auditors help the firm negotiate the issues with the SEC. Firms are more likely to contact their auditor about cases involving multiple letters or material comments. For instance, auditors are more likely to be involved to help sort out complex topics such as revenue recognition cases (Usvyatsky, 2015). Audit firms also proactively keep clients informed on comment letter trends. The big four publish guides to help companies understand staff comments, plan for year-end reporting and respond to comment letters. Given that issues identified by the SEC may not be material, it is not necessarily a failing of the audit firm when a firm receives a letter. However, in some instances comment letters may reflect adversely on the quality of the firm's audit.

Reactions to a comment letter depend on the issues identified in the letter and the actions required to remediate the issues. Upon identifying deficiencies, the SEC may ask for additional information for clarification, require the firm to revise the issue in a future filing or amend the current filing. Naturally, there is greater potential for negative reactions when the SEC requires the filing to be amended. However, in most cases, the SEC is satisfied with the firm modifying its disclosures in future filings. Firms are only required to amend filings in approximately 17% of cases (Johnston & Petacchi, 2017). However, the receipt of a comment letter may be viewed negatively internally regardless of its implications given that audit committees may see the letter as a failure of the auditor to ensure compliance with filing requirements. Baldwin, Hurtt, and MacGregor find that receiving a comment letter corresponds with an increased likelihood of auditor change (Baldwin, Hurtt, & MacGregor, 2013) . Similarly, PCAOB inspections seek to identify defi-

[3] The FERC measures the association between current stock returns and future earnings (Collins et al., 1994). Prior research documents a positive relation between the level of voluntary corporate disclosure and the informativeness of current stock prices about future earnings (Gelb & Zarowin, 2002; Lundholm & Myers, 2002). Analysts, investors and regulators rely on disclosure for information about the amount, timing and uncertainty of future earnings. Theoretically, more or better disclosures should help investors improve their forecast of future earnings, strengthening the relation between current stock returns and future earnings.

[4] Dechow et al. (2016) document insider trading in the days leading up to the public disclosure of a comment letter suggesting that managers believe that comment letters are associated with negative market affects.