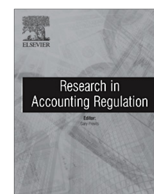
Research in Accounting Regulation 26 (2014) 83–89

Contents lists available at ScienceDirect

Research in Accounting Regulation

journal homepage: www.elsevier.com/locate/racreg



Research Report

An investigation of SEC "Speech GAAP"

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ARTICLE INFO

Article history:
Available online 18 March 2014

Keywords:
Regulation
Disclosure
Accounting principles
SEC

ABSTRACT

This study investigates the financial reporting regulation effects of the Securities and Exchange Commission (SEC) staff comments made during the American Institute of Certified Public Accountants (AICPA) Annual Current SEC & Public Company Oversight Board (PCAOB) Developments Conference in Washington, D.C. (SEC Conference). At this conference, the SEC staff communicates its preferences about areas where it believes companies are misapplying GAAP (Generally Accepted Accounting Principles). We call this communication SEC Speech GAAP. One outcome of the SEC Conference may be that companies re-evaluate their previous financial reporting by restating their financial statements. We find, first, that firms with restatement issues similar to those covered at the SEC Conference experience a decrease in the association between earnings and future cash flows after the restatement. Second, we find little market reaction to the disclosure of restatements related to SEC Conference issues, but the disclosure of non-conference related restatement issues has a significantly negative affect on investors' valuation decisions. Our findings suggest that SEC Speech GAAP is associated with financial statements that are less informative to investors and investors find the valuation consequences of restatements prompted by SEC Speech GAAP to be less important than the valuation consequences for restatements prompted for other reasons.

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Introduction

The SEC's Division of Corporation Finance (DCF) and Office of the Chief Accountant (OCA) both are required by law to monitor the financial reporting and disclosure of the approximately 15,000 publicly traded companies on U.S. stock exchanges. SEC registrant companies know (and, to a certain extent, fear) the SEC's power to regulate financial reporting and disclosure. We focus on the guidance[1] provided by DCF and OCA (which we jointly call the SEC staff) during the American Institute of Certified Public Accountants Annual Current SEC & PCAOB Developments Conference in Washington D.C. (the SEC Conference). At this conference, the SEC staff communicates its treatment preferences directly to a large portion of the auditing community and SEC registrants about accounting areas where it believes companies are misapplying GAAP (Generally Accepted Accounting Principles). One outcome of the staff's Conference statements may be that companies re-evaluate their

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[1] At the FASB and SEC the feeling is that this sometimes goes beyond guidance. The term that is used is "speech GAAP." A google search yields a number of references to this term.

http://dx.doi.org/10.1016/j.racreg.2014.02.008
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previous financial reporting by restating their financial statements.[2]

We use two measures to evaluate the value to investors of the SEC staff guidance at the SEC Conference. First, past accounting research indicates that the quality of financial accounting information to investors may be measured by its association with future cash flows. We find that firms that restate their earnings to be in conformity with SEC Speech GAAP guidance (the Conference sample restatements) experience a decrease in the association between earnings and future cash flows after the restatement. This is contrary to the findings of past restatement research which finds that accounting restatements resulting in higher quality disclosure occasion a higher correlation between earnings and future cash flows. Second, past restatement studies find a large negative stock price reaction to accounting restatements, suggesting this negative reaction reflects a change in investor confidence in a company's financial accounting information due to the need to restate. We find a large negative reaction to the firm restatements made for reasons unrelated to GAAP Speech issues (the Other sample restatements) but a significantly different and less negative reaction to firm restatements related to issues found in SEC Speech GAAP guidance (the Conference sample). We suggest these differential stock return effects indicate that investors perceive little benefit from the disclosure of Conference sample restatements while disclosure of the Other sample restatements affects investors' valuation decisions significantly negatively. Overall, our results suggest that restatements prompted by SEC Speech GAAP are associated with financial statements that may be less informative to investors than the originally stated financial statements and are not viewed by investors as having the same important valuation consequences as restatements prompted for non-SEC Speech GAAP reasons.

The SEC as a monitor

To better understand the controversy surrounding SEC Speech GAAP it is important to understand the SEC's monitoring function within the financial accounting reporting and disclosure environment. The SEC monitoring process differs both theoretically and statutorily from other financial reporting monitoring mechanisms such as the company's board of directors, management and external auditor. Past research (Jensen & Meckling, 1976; Watts & Zimmerman, 1986) provides a conceptual framework suggesting these latter monitoring mechanisms may be voluntarily adopted by the manager to minimize agency costs and thus minimize the cost of capital. SEC monitoring is required by statute (the Sarbanes Oxley Act of 2002, section 408) and is mandatory for U.S. companies with publicly traded debt or equity. Companies accept the monitoring as a consequence of being allowed to raise capital through US public offerings, but they have no control over the degree of SEC oversight that they receive. So this SEC monitoring does not fit the "voluntary" aspects of the agency cost minimization framework.

In addition, the SEC review process examines *past* financial information that has already been issued by the company.[3] In contrast, voluntary oversight (by management, auditors, and the board of directors) normally takes place *before* financial information is released to the public. Therefore, SEC monitoring improves the financial reporting process to the extent that correcting the reporting in *past* company filings will improve the reporting in the *future* company filings, rather than improving information reporting *prior to filing.*

The SEC has the statutory authority to monitor a SEC registrant's filings to enhance their compliance with the Securities Act of 1933 and Securities Act of 1934.[4] In the event that violations in GAAP are discovered, the SEC has the authority to deny the registrant access to capital markets. In addition, non-GAAP compliant registrants may be denied access to secondary markets when exchange rules make GAAP-prepared financials a requirement for exchange listing. This SEC authority promotes an atmosphere where registrants and their monitors (i.e., auditors, boards of directors or management) are sensitive to any implications that the registrants may not be in compliance with GAAP.[5]

The SEC staff conducts two distinctive types of registrant monitoring. The first type of monitoring is the review and comment process that is carried out by the eleven DCF offices. The DCF Chief Accountant has a staff providing consulting services to each of these industry-centric offices.

The second type of monitoring is the oversight of registrant filings by the OCA staff. This staff tends to be small (15 or 20 accountants), consisting largely of accountants drawn from the SEC Professional Accounting Fellow program.[6] The OCA staff reviews registrant issues associated with its support of the DOE, responds to inquiries related to "no-action" letters[7] and provides support to the SEC

[2] The importance of the SEC Conference is summarized in Ciesielski and Weirich (2008). The staff remarks may be very specific, such as those of OCA Professional Accounting Fellow Pamela Schlosser concerning the application of the shortcut method for interest rate swaps and cash flow hedges under SFAS133. The remarks often reflect accounting problem areas that have been identified by the DCF or OCA in their monitoring and review process.

[3] The SEC reviews *all* S-1 and S2-B filings before they are issued. However, the financial statement information referenced in these filings is past financial information.

[4] For a complete explanation of this process see *Filing Review Process* at http://www.sec.gov/divisions/corpfin/cffilingreview.htm

[5] Past research by Gleason, Jenkins, and Johnson (2008) provides evidence about investors' reactions to de-listings.

[6] The Professional Accounting Fellow program positions are coveted by senior managers at the major public accounting firms. These senior managers enlist to work for the SEC in OCA for a three year period. After the three years are completed, these accountants often return to their previous firms as partners or take senior positions in government or industry. The OCA staff is divided into those specializing in derivative securities and those focusing on other emerging issues.

[7] An individual or entity that is not certain whether a particular product, service, or action would constitute a violation of the federal securities law may request a "no-action" letter from the OCA staff. Most "no-action" letters describe the request, analyze the particular facts and circumstances, discuss applicable laws and rules, and, if the request is granted, concludes that the OCA staff would not recommend any enforcement action against the requester based on the facts and representations described in the individuals or entities original letter. The OCA staff also responds to some requests for clarification of the legality of certain activities with a "no-action" letter.

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