Corporate Disclosure Response to SEC Litigation

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This study investigates changes in the Form 10-K narrative disclosures of 31 firms in response to litigation instituted by the United States Securities and Exchange Commission (SEC). Informed market participants are aware of the publication of Accounting and Auditing Enforcement Releases (AAERs). Prior research suggests that fraudulent firms may use disclosure complexity or herding to avoid detection or litigation. Disclosure complexity or readability has been studied in relation to trading, earnings management, and the occurrence of fraud, but there is a significant gap in the literature pertaining to changes in disclosures caused by non-regulatory actions. Our sample focuses on changes in revenue recognition disclosures following the release of related AAERs. The sample is drawn from the 526 Administrative Accounting Enforcement Releases (AAER) filed between 2009-2012. We screened the AAERs for firms suspected of fraudulent financial reporting relating to revenue recognition. After eliminating firms for which 10-K filings for one year before and after the year of infringement could not be located, we were left with a sample of 31 firms. Narrative disclosures were downloaded for the years preceding and following the dates of infringement listed on the AAER. Because AAERs may be issued many years after alleged improper revenue recognition occurred, the per company period of disclosures ranges from 3 – 9 years. Variables of interest include word count, Flesch-Kincaid and Fog Index; Control variables include firm size, leverage and profitability. Data is analyzed using time series analysis and similarities and differences in comparative word strings.