The Regulatory Observer Effect: Evidence from SEC Investigations

Terrence Blackburne, Oregon State University

Abstract

Drawing on financial reporting, institutional, and social psychology theories, we consider whether awareness of SEC scrutiny affects the extent to which managers exercise financial reporting discretion. Because there is a higher probability that the SEC will detect misconduct and impose penalties on firms under investigation, we predict that managers will change their behavior during periods of increased scrutiny. We test our predictions using novel data on all Division of Enforcement (DoE) investigations completed during the 2000-2016 period. The evidence we present offers three insights.

First, our results suggest that managers perceive the SEC will be more concerned, and potentially more punitive, with firms that employ discretion through accruals rather than real activities. Second, the actions taken by managers appear to reflect improvements in accounting misstatement risk, reductions in accounting irregularities, and increases in conservatism.

Third, firms investigated by the SEC, but not ultimately subject to an enforcement action, exhibit decreased R&D and capital expenditures and increased likelihoods of CEO turnover, comment letter receipt, earnings restatements, and class-action lawsuits. The implications of our study should be of interest to academics, investors, and regulators in understanding how heightened regulatory monitoring over financial reporting can affect both accounting practices and operating decisions.