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Soft Stick Regulation Improves Disclosure

Open communication between regulator and company improves disclosure practices and reduces investor uncertainty.

In the wake of the financial crisis of 2007-2008, fair value reporting came under attack from politicians who were convinced that mark-to-market accounting both caused and exacerbated the economic downturn. In response to critics calling for the suspension of fair value reporting, the American market regulator, the Securities and Exchange Commission (SEC) concluded that fair value accounting should not be removed, but could be improved. The SEC subsequently warned companies of its intent to enforce fair value reporting and disclosures.

Fair valuation practices are controversial because many of the assets and liabilities companies hold are not widely traded and therefore don't have a widely agreed upon value, unless it's a publicly traded commodity or security. Companies must use estimates or models to give a sense of an asset's value.

Under current U.S. generally accepted accounting principles (US GAAP) as well as international financial reporting standards (IFRS), companies have to use a three-level hierarchy when valuing assets and liabilities. This hierarchy goes from level one to level three; level one is a frequently traded, liquid asset that has a generally agreed upon price (such as a stock) and level three is a barely traded asset that is hard to value and is therefore valued in a unique way by the firm that holds it. This has caused criticism of not just the companies but also the regulators for the way they monitor and enforce these practices.

The SEC uses a "comment letter" process as an initial approach to address potentially deficient financial reporting. In the event that a company's accounting choices are unclear, the SEC asks the firm to provide more details, first to the SEC privately and then perhaps to all investors publicly. In light of all of the criticism of fair value reporting in particular, how effective is such communication between the SEC and the company with regards to addressing investors' information needs?

Let's talk

Very effective, according to my paper, **"The Impact of SEC Disclosure Monitoring on the Uncertainty of Fair Value Estimates"**, with Mei Cheng of the University of Arizona and Monica Neamtiu of Baruch College, CUNY. We measured how investors reacted to the letters and firm responses by analysing the bid-ask spreads of their publicly traded stock (narrower as opposed to wider spreads illustrates greater investor confidence in information quality) in response.

We found evidence that investor uncertainty declined after companies received letters, as the firms responded with more clarity on their valuation methods. We also found that the reduction in uncertainty is larger when respondents explicitly acknowledged that they would improve their future disclosures in response. In our data, which included all companies receiving a comment letter between 2007 and 2012, 64 percent said they would do so.

When a firm receives a comment letter from the SEC, it allocates management time and resources to communicating on the query to reassure investors that its disclosure practices are sound. Urgency is added by the fact that the SEC's comment letters are publicly available, which means investors, competitors and other stakeholders are watching the review process. Companies have ten days to respond and firm responses are also made public by the SEC within 45 days of the review's completion.

Accounting firm Deloitte recommends that companies assemble a team – including CEO, CFO, independent auditors and legal counsel – to respond to a comment letter. Once involved in the process, managers and auditors may increase their scrutiny of the assumptions used in fair value estimation models.

This gives the firm an incentive to learn from the experience and improve its disclosure going forwards. Reducing management time and reassuring investors about the quality of the firm's disclosure, one of the reasons the SEC uses the comment letter approach.

When the going gets tough

Interestingly, we also observed that the declines in investor uncertainty following SEC comment letters were most pronounced in the years during and immediately following the financial crisis of 2007-2009. Because our data spanned pre- and post-financial crisis, we were able to observe that the effect of SEC fair value enforcement via comment letters was most notable during these years as investors paid closer attention to fair values during times of market illiquidity, periods that make fair valuation more difficult. This suggests that the SEC's methods are not only effective in non-crisis periods, but more important during times of crisis.

The value of good disclosure, therefore, should not be discounted. Further, the SEC's comment letter approach, which does not involve legal fines or other penalties but is rather a "soft stick", does yield benefits. Given the public nature of the query, firms are given good incentives to share their fair value estimation methods and improve disclosure going forwards. Our findings clearly demonstrate that the SEC's "soft stick" approach is effective in both reducing investor unease and improving firm disclosures.

These findings have prompted us to look at similar forms of regulation and whether increased communication between regulator and market participant has value. Our current research looks at the audit opinions of accounting firms in the U.K. and Ireland. Our initial findings suggest similar results; that uncertainty is reduced both in bid-ask spreads and earnings forecasts by securities analysts when more information regarding the depth of company audits is shared.

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Bens wrote a more in-depth version of this article, drawing on multiple research insights, for the European Financial Review. ***The article*** *was published in February 2018.*