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Rules-Based Accounting Standards and SEC Enforcement

Devon Baranek*

Abstract

This archival study investigates the association between rules-based violations and the likelihood of SEC enforcement. I utilize two samples of firms subject to SEC investigations: 1) firms with investigations that end in an enforcement action and 2) firms with investigations that are dropped, and examine the impact of rules-based accounting violations on enforcement. Each enforcement action in the sample specifically cites the GAAP standard violated, and the degree to which the standards contain rules-based characteristics is quantified. The violations are classified as either rules-based or principles-based and a multivariate analysis is performed. The “roadmap” theory suggests that firms who commit rules-based violations are more likely to be subject to SEC enforcement, while the “roadblock” theory predicts the opposite effect.

Overall, the results suggest the SEC is less likely to litigate cases that involve rules-based accounting violations, or more likely to drop/dismiss investigations centered on rules-based violations, consistent with the “roadblock” theory. No evidence is found of a relation between rules-based accounting violations and the dollar magnitude of penalties assessed. These results are relevant for financial statement preparers, auditors, and regulators.

Keywords: accounting standards, rules-based, principles-based, SEC enforcement actions, dropped enforcement actions, SEC monetary penalties.

I. INTRODUCTION

Although the dust from the accounting scandals of the early 2000s has settled, many of the accounting issues contributing to these public embarrassments remain unresolved. In particular, the topic of principles- versus rules-based accounting standards has returned recently as part of broader discussions relating to revenue recognition. To date, there is still no consensus on which type of standard is superior.

Many preparers, auditors, and regulators blame the rules-based nature of U.S. GAAP for contributing to the opacity and aggressive accounting techniques utilized by companies (Enron, Worldcom, Adelphia, etc.) before their accounting frauds were exposed. During that time the FASB, SEC and other regulators debated altering the existing conceptual framework underlying U.S. GAAP and also considered a shift to the more principles-based International Financial Reporting Standards (FASB, 2002; SEC, 2003; and FASB, 2012). However, little tangible progress resulted from those debates and the question of whether shifting from rules-based to principles-based standards impacts the transparency and quality of financial reporting remains unanswered.

Consistent with prior literature, I suggest the current GAAP standards are not built on clear-cut rules or principles and lie along a continuum with respect to the degree that they exhibit rules-based characteristics (Nelson, 2003). Standards with

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fewer rules-based characteristics are considered to be “principles-based”, while standards with multiple rules-based characteristics are considered to be “rules-based”.

This study examines the implications of rules-based accounting standards on SEC enforcement. I present two arguments on whether firms that commit rules-based accounting violations are more or less likely to be subject to an enforcement action from the SEC. The “roadmap” theory suggests that firms who commit rules-based violations are more likely to be subject to SEC enforcement, while the “roadblock” theory predicts the opposite effect.

I utilize an instrument developed by Mergenthaler (2010) and adopted by Donelson, McInnis, and Mergenthaler (henceforth DMM, 2012) that measures the presence of rules-based characteristics contained in an accounting standard and examine two samples of firms subject to SEC investigations to test the impact of rules-based accounting violations on enforcement. I find a negative association between rules-based characteristics and the likelihood of SEC enforcement, consistent with the “roadblock” theory. These results suggest the SEC is less likely to litigate (or more likely to drop or dismiss) cases involving rules-based violations. I find no evidence of an association between rules-based standards and the dollar magnitude of any fines or penalties assessed by the SEC.

This study informs on the debate between rules- and principles-based accounting standards, which continues to be relevant in the consideration of rules-based U.S. GAAP and principles-based International Financial Reporting Standards (IFRS). It also contributes to the prior literature on SEC enforcement by providing empirical evidence on the relation between rules-based accounting standards and SEC enforcement actions. This should be of interest to regulators, public companies and investors as well as accounting and legal professionals.

II. PRIOR LITERATURE AND INSTITUTIONAL BACKGROUND

2.1. Prior Literature

Little empirical research exists on legal and regulatory enforcement as it relates to GAAP violations for rules-based versus principles-based standards because they are difficult to proxy for and quantify. There is a branch of literature on rules/principles based standards and aggressiveness of financial reporting. Agoglia et al. (2011) investigate the mechanisms driving aggressive CFO reporting decisions and find CFOs to exhibit greater agreement and less aggressive reporting under more principles-based standards than under rules-based standards. Nelson (2003) examines experimental and survey data and finds that precise standards help auditors constrain aggressive financial reporting, and that aggressiveness of reporting decisions increases with the imprecision of the relevant reporting standard.

More recently, Brown et al. (2013) examine how the adoption of SFAS 95 impacted the information environment of firms various dimensions and conclude the former principles-based standard (APB 19) was superior to the rules-based SFAS 95 along the dimensions examined.

The SEC and FASB agree rules-based standards are more complicated and often require preparers to navigate a complex maze of exceptions and tests (FASB, 2002; SEC, 2003). However, the SEC also suggests that imperfections exist when standards are established on a rules-only or principles-only basis. Mergenthaler (2010) examines earnings management and finds that rules-based characteristics are positively associated with the dollar magnitude of earnings management, and negatively associated with the probability of being penalized by the SEC.
DMM (2012) examine the impact of rules- versus principles-based standards in the private securities litigation setting. They investigate whether rules-based standards are associated with the incidence and outcome of securities class action litigation by utilizing a comprehensive database of securities class actions that cite accounting standards. They compare standards cited by plaintiffs in cases that do not involve restatements to the standards identified in each sued firm’s significant accounting policies and find that rules-based standards provide a “safe harbor” and are not often named in lawsuits.

2.2. Institutional Background

1) Rules-Based and Principles-Based Standards

To the extent U.S. GAAP is concerned with providing financial information characterized by “decision usefulness” supported by relevance, reliability, and comparability, it is principles-based (Schipper, 2003). However, over time principles-based standards often become more rules-based through the provision of detailed interpretive and implementation guidance, making the current U.S. standards more of a rules-principles hybrid. According to the SEC, U.S. GAAP, “…despite being the historical product of a mixture of standard setting approaches, constitutes the most complete and well developed set of accounting standards in the world. These standards vary significantly in their level of detail, adherence to a conceptual framework, and reliance on objectives and rules” (SEC, 2003). Accounting regulators agree that more can be done, as the rules- versus principles-based debate is representative of larger issues in financial reporting: complexity, transparency and accuracy.

The terms “rules-based” and “principles-based” standards are not well defined and are subject to a variety of interpretations. Practitioners, academics, and regulators consider rules-based standards to contain the following characteristics: a) bright-line thresholds, b) scope and legacy exceptions, c) extensive implementation guidance and d) a high level of detail (FASB, 2002; Nelson, 2003; Schipper, 2003; and SEC, 2003). Some of this detail and complexity is published in the body of the standard (usually as scope or treatment exceptions) but much of it arises from implementation guidance published by the FASB (Benston et al., 2005). The goal of providing this level of detail is a more consistent application of accounting information, but the effect is that certain areas of the authoritative literature are overwhelming.

In practice, rules-based standards may, “...foster a ‘check the box’ or compliance mentality that is......an open invitation to financial structuring and other activities that subvert high quality financial reporting” (Schipper, 2003). Internal inconsistencies, exceptions and bright-line tests provide opportunities for financial engineering around the intent of the standards, resulting in transactions that are not “…representationally faithful to the underlying economic substance of transactions and events” (SEC, 2003). Rules-based standards may unintentionally provide opportunities for the avoidance of the accounting objectives desired by regulators.

Principles-based standards are characterized by more broadly applicable standards with few exceptions or internal inconsistencies, and reduce the need to provide lengthy interpretation and guidance for application or implementation. These standards require a complete, consistent and clear conceptual framework for financial reporting, which reduces complexity and increases comparability (FASB, 2002; SEC, 2003).

Some argue that principles-based standards provide a better balance of structure and flexibility for preparers and auditors, because they are malleable in the
interpretation and presentation of company-specific accounting information in a way that best conveys the underlying economic transactions (Folsom et al., 2011). Principles-based standards are also durable enough to accommodate future developments in the marketplace. Because “…the standards are less detailed and specific, they are more responsive to emerging issues in the changing financial and economic environment in which many companies operate” (FASB, 2002).

One criticism of principles-based standards is the considerable reporting discretion they afford managers, which can reduce financial statement comparability. In a hearing with the U.S House of Representatives Committee on Financial Services, former Acting PCAOB Chairman Gradison (2006) testified that, “principles-based standards have the seductive appeal of allowing more flexibility and professional judgment in dealing with different situations but, precisely because of that characteristic, they are likely to lead to increased variability in results, even when applied by conscientious corporate managers and checked by competent independent auditors.” Variations in terminology, classification, and presentation format can decrease comparability and therefore decrease usefulness (Brown et al., 2013). Principles-based standards are also susceptible to abuse if the principles are not applied in good faith consistent with the intent and spirit of the standards, resulting in a further loss of comparability. As a result of limited guidance, principles-based standards require a significant amount of professional judgment on the part of preparers and auditors. This may lead to increased time and cost associated with financial reporting, as well as increased liability exposure for preparers and auditors.

III. HYPOTHESES

DMM (2012) concentrate numerous arguments relating rules-based standards and private securities litigation into two competing theories – the “protection” theory and the “roadmap” theory. I extend this framework to two similar theories in the context of SEC legal proceedings, which have numerous differentiating features, including the motivation behind filing an action, monetary impact of outcome, firm characteristics attracting each type of litigation, the legal discovery processes and pleading standards, and potential outcomes. In particular, establishing the intent of a violation is less of a priority for the SEC than during a class action lawsuit – the focus of an SEC investigation shifts to establishing conformity (or nonconformity) with the laws and rules that govern the securities industry. With this adjustment in mind, I reframe the DMM “roadmap” theory and introduce the “roadblock” theory.

Roadmap theory: the specificity of rules-based standards provides the SEC with a “roadmap” to successfully detect and litigate violations.

The “roadmap” theory suggests that rules-based standards increase the possibility of a lawsuit since a documented violation of a clear rule can help to establish intent. The specific nature of rules-based accounting standards allows the SEC to more easily detect and successfully litigate these types of violations. Nelson et al. (2009) find evidence that executives are more likely to attempt earnings management with respect to “precise” (i.e. rules-based) standards, supporting the idea that characteristics in accounting standards can encourage/deter earnings management.

Kedia and Rajgopal (2011) find evidence that the SEC is more likely to investigate firms located closer to its offices due to constrained resources (staff, time, budget, etc.) which supports the theory that a resourced-constrained SEC would be more likely to bring enforcement actions against firms violating rules-based standards because it takes less time and investigative effort to show that a rules-based standard...
has been violated. For example, the former standard for lease accounting, SFAS 13, contains four numeric thresholds requiring a leased asset to be capitalized and recorded on the balance sheet:

1. Lease transfers ownership of the asset to the lessee by the end of the lease term.
2. Lease contains a bargain purchase option.
3. Lease term is equal to 75% or more of the estimated economic life of the leased property.
4. The present value of the minimum lease payments is greater than or equal to 90% of the fair market value of the leased asset.

The SEC only needs to examine the above thresholds to determine if a firm violated this standard (Mergenthaler, 2010). Objective evidence can be used to demonstrate this type of standard has been violated, increasing the likelihood of detection (via an internal auditor or other employee, external auditor, etc.) This type of violation is also more likely to be successfully litigated since the SEC can argue that defendants acted negligently through the violation of a clearly established rule. By targeting violations of rules-based standards, the SEC can maximize the number of successful cases it litigates, given its staff, time, and budgetary constraints.

The subjective nature of principles-based accounting standards supports the “roadmap theory”, since this type of violation is more costly to litigate and enforce. Concepts like relevancy, the ability to make a difference in user decisions and neutrality are highly subjective and may differ from person to person. When there is little ground for disagreement (as exists in a clear, rules-based standard) the SEC can more easily prove a violation has occurred. Even proponents of principles-based standards agree principles-based accounting violations are more costly and time consuming to litigate. Former FASB Chairman Herz (2003) admits, “...it simply may be harder to properly enforce a principles-based system...this process takes more time than the (already considerable) time required to decide if a given registrant followed a clearly written rule.” Since principles-based violations require greater resources to litigate, the SEC will minimize this type of investigation in order to avoid a reduction in the overall number of investigations.

Roadblock theory: the specificity of rules-based accounting standards acts as a “roadblock” to the SEC in detecting and litigating violations when users are able to comply with the letter, but not the intent, of a standard.

The opposing “roadblock” theory argues the SEC is less likely to litigate (or more likely to drop) cases involving rules-based violations. This theory posits rules-based standards can be used as a guide to comply with the letter, but not the intent of a standard, and that the existing rules-based system has contributed to the development of advanced financial and accounting engineering techniques. Since the letter of the law is not broken, the SEC cannot allege that a standard was violated, even if the outcome is inconsistent with the spirit of the standard. Former SEC Chairman Harvey L. Pitt, states, “…because the standards are developed based on rules, and not broad principles, they are insufficiently flexible to accommodate future developments in the marketplace. This has resulted in accounting for unanticipated transactions that is less transparent and less consistent with the basic underlying principles that should apply” (FASB, 2002).

Typically, rules-based standards are more complicated, lengthier, contain more bright-line thresholds and exceptions, provide more implementation guidance, and include a higher level of detail than principles-based standards. This complicated
nature provides for legal circumvention through loopholes and exceptions, making it difficult and time consuming for the SEC to detect violations and substantiate wrongdoing. Additionally, as DMM (2012) suggest, the complex nature of these standards allows firms to claim a violation was an “innocent misstatement”, making the burden of proof difficult to substantiate.

Furthermore, Mergenthaler (2010) suggests if the “task complexity impedes judgment accuracy, auditors will be less likely to detect violations of rules-based standards”. If auditors have trouble detecting these types of violations, it is logical to assume regulators would face the same difficulties.

In support of the “roadblock theory”, principles-based standards rely heavily on professional judgment, reducing the necessary investigation time required by the SEC. The Commission is ultimately able to decide the appropriateness of an accounting treatment, so the investigation can be limited to determining whether or not the preparers and auditors made “good faith” estimates or applications. Since rules-based violations take more time and effort to detect, the SEC may minimize this type of investigation.

The roadmap and roadblock theory are equally plausible, therefore I hypothesize in the null:

H$_1$: there is no association between the violation of rules-based accounting standards and the likelihood of an SEC enforcement action.

To paint a more complete picture of the SEC enforcement process, I examine the monetary sanctions imposed on firms committing rules-based or principles-based accounting violations. If one type of offense is more costly to enforce, the regulatory penalties may be higher in order to offset this increased cost. If the “roadmap” theory holds, then violations of rules-based standards may lead to lower penalties since these violations are easier to detect and litigate. The penalties assessed for violations of principles-based standards will be larger because these violations are more difficult to detect and litigate. If the “roadblock” theory holds, then violations of rules-based standards may lead to higher penalties, and violations of principles-based standards may lead to lower penalties.

Another consideration of monetary penalties assessed by the SEC is the deterrent effect for potential future violators. Jennings et al. (2011) find significant deterrence associated with SEC enforcement actions, with repeated and sustained enforcement of specific criteria providing the most effective deterrence. It is possible that the SEC views either rules-based or principles-based violations as more egregious, and therefore the penalties assessed are higher in order to deter other firms from similar violations.

H$_2$: there is no association between violations of rules-based standards and the monetary penalty assessed to firms.

IV. EMPIRICAL ANALYSIS

4.1. Measuring Rules-Based Standards

Mergenthaler (2010) develops an instrument measuring the extent to which an accounting standard contains certain rules-based characteristics. He uses numerous authoritative sources to develop the Rules-Based Continuum (RBC) Score. DMM (2012) utilize this score to measure the presence of rules-based characteristics in their sample and validate the measure to confirm it captures the underlying construct of rules-based accountings standards.
I calculate the RBC score following the methodology of Mergenthaler (2010). Each relevant accounting standard is examined, and four characteristics of the standard are included in the measure: 1). bright-line thresholds, 2). scope and legacy exceptions, 3). large volumes of implementation guidance, and 4). a high level of detail.

Bright-line thresholds – BLTs are a defining characteristic of rules-based standards (FASB, 2002; SEC, 2003). For the purpose of computing the RBC score, a BLT is defined as any numeric threshold that delineates which of two different accounting treatments is applicable (Mergenthaler, 2010). Some examples of BLT include:
1). ARB 51 – Consolidation – 50%.
2). EITF Issue No. 90-15 – Consolidation of SPEs – 3%.
3). SFAS No. 66 – Down payment needed to achieve full accrual profit recognition method on sales of real estate – 5%, 10%, 15%, 20%, or 25%, depending on the type of real estate.

To determine the presence of a BLT, I search each standard using the following key words: 1). criter*, 2). condition*, 3). provision*, 4). require*, and 5). percent*. The paragraphs surrounding the key words are reviewed to determine if a BLT is present. The total number of BLTs for each standard is recorded.

Scope and legacy exceptions – (SLEs) are another hallmark of rules-based standards (FASB, 2002; Schipper, 2003; and SEC, 2003). Scope exceptions limit the comprehensiveness of a standard, while legacy exceptions exempt certain industries from complying with a standard. Some examples of scope and legacy exceptions include:
1). SFAS 133 (Accounting for Derivatives and Hedging Activities) – contains nine scope exceptions in paragraphs 10 and 11.
2). SFAS 141 (Business Combinations) – contains a scope exception for certain business combinations involving not-for-profit entities and mutual entities.
3). SFAS 143 (Accounting for Asset Retirement Obligations) – provides for a deviation from fair value measurement in order to reduce income volatility in paragraphs 49-52.

To determine the presence of a SLE, I search each standard using the following key words: 1). not subject, 2). not consider*, 3). exclusion*, 4). exempt*, 5). except*, 6). scope, and 7). does not apply. Each paragraph around the keyword is read to determine if a SLE is present. The total number of SLEs for each standard is recorded.

Large volumes of implementation guidance – rules-based standards “…further a need and demand for voluminously detailed implementation guidance on the application of the standard…” (SEC, 2003). To operationalize this characteristic, the number of “interpretive pronouncements” associated with each standard is recorded, and the totals are sorted and ranked by decile. The standards in the top decile are classified as having large volumes of implementation guidance.

High level of detail – another characteristic of rules-based standards is that they contain a high level of detail. This characteristic is operationalized by recording the number of words in each standard and ranking the standards by total word count into deciles. The standards in the top decile are classified as having a high level of detail.

The presence of each of the above four characteristics in an accounting standard will increase the final RBC score by one. Therefore, the RBC score ranges from a value of zero (for a principles-based standard) to four (for a standard that is highly rules-based).
4.2. Sample Selection

4.2.1. SEC Enforcement Action Sample

I collect a sample of firms subject to SEC enforcement actions from the SEC litigation release archives and the Accounting and Auditing Enforcement Release (AAER) archives. Enforcement actions are selected that were litigated between 1994-2013 and that include citations of specific GAAP accounting standard violations, so that I can determine if the violation was based on a rules- or principles-base standard. Accounting guidance appearing in the sample include: Statements of Financial Accounting Standards (SFAS), Statements of Financial Accounting Concepts (SFAC), Staff Accounting Bulletins (SAB), FASB Interpretations (FIN), Emerging Issues Task Force Abstracts (EITF), Accounting Principles Board Opinions (APB), Accounting Research Bulletins (ARB), and AICPA Statements of Opinion (SOP).

Enforcement actions involving non-accounting related violations are excluded from the sample, as are enforcement actions involving companies that trade on the OTC and Pink Sheet markets in order to ensure compustat coverage. Each action is reviewed and the accounting standard(s) found to be violated by the SEC is recorded. Additional data collected includes relevant dates, descriptions and details regarding the violations, fines or penalties imposed, and any other relevant information.

4.2.2. No SEC Enforcement Action Sample

Not every SEC investigation ends in an enforcement action. Factors such as the availability of evidence, the strength of the case, the severity of the alleged violation, and SEC budgetary restrictions can play a role in whether an action is dismissed. I identify firms that were involved in SEC investigations that do not end in an enforcement action by a keyword search in Factiva, which included variations of the following terms: no enforcement action, close* probe, investigation end*, investigation close*, conclude* inquiry, drop* probe and dismiss* investigation.

For each potential sample item, I read the related article and confirm the existence of an SEC investigation on the Form 10-K, 10-Q or 8-K filings. These filings are reviewed carefully to establish whether or not the alleged violation is an accounting violation, and if so, what the accounting violation presumably is (which specific GAAP standard(s) is violated). To do this, I first review the firm’s significant accounting policy disclosures in the Form 10-K during the potential violation period and compare these policies to the violation in question. And second, I review other business and professional news sources for any additional details concerning the investigation (Wall Street Journal, New York Times, Bloomberg, etc). Third, when possible, I review complaints from class action lawsuits corresponding to the same accounting violations from the Stanford Securities Class Action Clearinghouse (2014). Fourth, when relevant, I compare the details of enforcement actions with explicitly stated accounting violations to the alleged violations of companies under investigation for any similarities. I include cases in my “no enforcement action sample” if the alleged accounting violations motivating the SEC investigation can be reasonably determined.

This hand collection yields a sample including 131 firms that were investigated by the SEC and subject to enforcement actions, and 81 firms that were investigated by the SEC but had no enforcement action pursued. I obtain financial information necessary for control variables from compustat for the years 1993-2013. Bankruptcy information is generously provided by the UCLA-LoPucki Bankruptcy Research Database. Political affiliations of the current and former SEC Commissioners and Chairman are hand collected from the SEC website, and information about the existence of related private class action litigation is collected from the Stanford
Securities Class Action Clearinghouse (2014). I am able to obtain complete data from compustat for 127 of the 131 firms with enforcement actions and 79 of the 81 firms with no enforcement action.

4.3. Research Design

4.3.1. Test of H₁

To study the impact of rules-based standards on the filing of SEC enforcement actions, I estimate the following probit regression, based on DMM (2012):

\[
\text{Prob (EA= 1)} = F(ơ+ \beta_1 \text{RBC} + \beta' \text{[Controls]})
\]

(1)

Where:

(1) \(EA\) is an indicator variable equal to 1 if the SEC litigates an enforcement action, and 0 otherwise.

(2) \(\text{RBC}\) is the average Rules-Based Continuum score for standards violated (or for alleged violations that are determinable), measured as of the year before the start of the investigation. If numerous standards are violated, the average RBC score is used.

(3) Control variables are included for firm size, return on assets, whether or not the firm is audited by a Big 4 auditor, amount of shareholder losses, whether the firm is in an especially litigious industry, whether there is a related class action lawsuit, the number of standards violated and the total amount of fines assessed by the SEC. Year and industry fixed-effects are also included. See Appendix A for a complete list of all variable definitions.

I also include variables that measure the ability of a firm to pay fines or penalties (deep pockets) since the SEC strives to return funds to harmed investors when possible. Variables that track the political affiliation of the SEC Commissioners and SEC Chairman are included since the SEC is a government regulatory agency and may face political pressure from various sources (Gipper et al., 2013). These pressures may impact the standard setting arm of the SEC, and contribute to inconsistent patterns of enforcement.

The coefficient for \(\beta_1\) provides evidence on my first hypothesis. A negative value implies that firms violating rules-based standards are less likely to be litigated by the SEC, consistent with the “roadblock” theory. A positive value for \(\beta_1\) implies firms violating rules-based standards are more likely to be litigated by the SEC, consistent with the “roadmap” theory.

4.3.2. Test of H₂

To study the impact of rules-based standards on the fines/penalties assessed on firms with SEC enforcement actions, I estimate the following OLS regression:

\[
\text{Fines} = ơ+ \beta_1 \text{RBC} + \beta' \text{[Controls]}
\]

(2)

Where:

(1) \(\text{Fines}\) is the natural log of total fines and penalties impose by the SEC.

(2) \(\text{RBC}\) is the average Rules-Based Continuum score for standards violated (or for alleged violations that are determinable) measured as of the year before the start of the investigation.

(3) Control variables include shareholder loss, investigation length, number of standards violated, firm size and whether or not the firm went bankrupt. Year and industry fixed effects are included in the analysis. Similar to the prior regression, political affiliations of SEC Commissioners and Chairmen are included.

The estimate for \(\beta_1\) provides evidence on my second hypothesis. A negative value for \(\beta_1\) implies rules-based standards are associated with less severe penalties. This may occur as a concession from the SEC, since the Commission recognizes that rules-based standards are extremely complicated, and may not have been violated purposefully. A positive value for \(\beta_1\) implies rules-based standards are associated with more severe penalties. This may occur if the SEC feels that a clear rule was flagrantly violated.
V. RESULTS

5.1. Descriptive Statistics

The RBC measure is validated in three ways by DMM (2012) to confirm that the score captures the differences in the characteristics of accounting standards; therefore I do not repeat construct validity tests. I examine the correlations between the four dimensions of the RBC measure (Table 1 Panel A) to confirm that they are positive. Standards with bright-line thresholds tend to have more exceptions, implementation guidance and high levels of detail, consistent with the theory that these four characteristics proxy for a common construct.

Table 1
RBC Score Details

Panel A: Pearson Correlations among Rules Based Characteristics

|                      | Bright Line Thresholds | Exceptions | Implementation Guidance |
|----------------------|------------------------|------------|------------------------|
| Exceptions           | 0.203                  | 0.232      | 0.221                  |
|                      | (0.044)                | (0.007)    | (0.028)                |
| Implementation Guidance | 0.268                  | 0.191      | 0.160                  |
|                      | (0.007)                | (0.058)    | (0.114)                |
| High Level of Detail | 0.191                  | 0.160      | 0.221                  |
|                      | (0.058)                | (0.114)    | (0.028)                |

Panel B of Table 1 presents the RBC score for select standards. The higher the RBC score, the more rules-based characteristics the standard contains. For example, the SEC characterizes certain standards as being rules-based, including the standards on pensions, transfers, leases and stock compensation (2003). Consistent with this, the RBC score for pensions (SFAS 87) is a three, transfers (SFAS 140) is a four, leases (SFAS 13) is a three, and stock compensation (SFAS 123) is a three. Standards that have been characterized as more principles-based include APB 10 (consolidation), with an RBC score of zero, SFAC 2 (qualitative characteristics of accounting information), which also has an RBC score of zero, and SFAS 5 (contingencies) which has an RBC score of one. These scores are also consistent with the prior literature utilizing the RBC measure.

Panel B: Rules-Based Continuum Score for Select Standards

| Standard | Standard Name                                                      | RBC Score |
|----------|-------------------------------------------------------------------|-----------|
| APB 10   | Consolidated financial statements poolings of interest            | 0         |
| SFAC 2   | Qualitative characteristics of accounting information             | 0         |
| SFAS 57  | Related party disclosures                                         | 0         |
| EITF 03-16 | Accounting for investments in limited liability companies        | 1         |
| FIN 39   | Offsetting of amounts related to certain contracts                 | 1         |
| SFAS 5   | Accounting for contingencies                                      | 1         |
| ARB 51   | Consolidated financial statements                                 | 2         |
| SFAS 142 | Goodwill and other intangible assets                               | 2         |
| SFAS 157 | Fair value measurements                                           | 2         |
| SFAS 13  | Accounting for leases                                            | 3         |
| SFAS 123 | Share-based payment                                              | 3         |
| SFAS 87  | Employers' accounting for pensions                                | 3         |
| SFAS 109 | Accounting for income taxes                                       | 4         |
| SFAS 140 | Accounting for transfers and servicing of financial assets and    | 4         |
|          | extinguishments of liabilities                                    |           |
Table 2
Most Common Standards Violated

Panel A: Enforcement Action Sample

| Standard | Standard Name                                      | Freq. | RBC Score |
|----------|----------------------------------------------------|-------|-----------|
| SFAS 5   | Accounting for contingencies                       | 36    | 1         |
| SFAC 5   | Recognition and measurement in financial statements of business enterprises | 29    | 1         |
| APB 25   | Accounting for stock issued to employees           | 23    | 1         |
| SAB 101  | Revenue recognition in financial statements        | 18    | 2         |
| SOP 97-2 | Software revenue recognition                       | 16    | 1         |
| APB 20   | Accounting changes                                 | 14    | 1         |
| SFAS 48  | Revenue recognition when right of return exists    | 13    | 1         |
| ARB 43   | Restatement and revision of ARBs                   | 8     | 0         |
| SFAS 133 | Accounting for derivative instruments and hedging activities | 7     | 2         |
| SFAC 6   | Elements of financial statements                    | 6     | 1         |
| SFAS 146 | Accounting for costs associated with exit or disposal activities | 5     | 0         |
| SFAS 113 | Accounting and reporting for reinsurance of short-duration and long-duration contracts | 5     | 1         |
| SFAS 125 | Accounting for transfers and servicing of financial assets and extinguishments of liabilities | 5     | 1         |
| APB 18   | The equity method of acc. for investments in common stock | 4     | 2         |
| APB 29   | Accounting for nonmonetary transactions            | 4     | 2         |

Panel B: No Enforcement Action Sample

| Standard | Standard Name                                      | Freq. | RBC Score |
|----------|----------------------------------------------------|-------|-----------|
| APB 25   | Accounting for stock issued to employees           | 16    | 1         |
| SFAS 48  | Revenue recognition when right of return exists    | 11    | 1         |
| SFAS 5   | Accounting for contingencies                       | 11    | 1         |
| SFAC 5   | Recognition and measurement in financial statements of business enterprises | 10    | 1         |
| SFAS 140 | Accounting for transfers and servicing of financial assets and extinguishments of liabilities | 6     | 4         |
| SAB 101  | Revenue recognition in financial statements        | 5     | 2         |
| SAB 104  | Revenue recognition                                | 4     | 0         |
| SFAS 109 | Accounting for income taxes                        | 4     | 4         |
| APB 20   | Accounting changes                                 | 3     | 1         |
| ARB 43   | Restatement and revision of ARBs                   | 3     | 0         |
| SFAC 2   | Qualitative characteristics of accounting information | 3     | 0         |
| SFAS 115 | Accounting for certain invest. debt and equity securities | 3     | 2         |
| SFAS 125 | Accounting for transfers and servicing of financial assets and extinguishments of liabilities | 3     | 1         |
| SFAS 13  | Accounting for leases                              | 3     | 3         |
| SFAS 141 | Business combinations                              | 3     | 3         |

Table 2 presents the most common standards violated for the sample of firms that are investigated by the SEC that end in an enforcement action (Panel A) and the sample of firms that are investigated by the SEC and end without an enforcement action (Panel B). For the Enforcement Action sample, the most commonly violated standards are SFAS 5 (contingencies, RBC= 1), SFAC 5 (recognition and measurement, RBC= 1), APB 25 (stock, RBC= 1), SAB 101 (revenue recognition, RBC= 2), and SOP 97-2 (software revenue recognition, RBC= 1). For the No Enforcement Action sample, the most commonly violated standards are APB 25 (stock, RBC= 1), SFAS 48
(revenue recognition, RBC= 1), SFAS 5 (contingencies, RBC= 1), SFAC 5 (recognition and measurement, RBC= 1), and SFAS 140 (transfers, RBC= 4).

Table 3 outlines the number of firms under SEC investigations by year. Panel B illustrates the sample distribution of firms during the investigation period. The majority of investigations were active during 2002-2009, consistent with the uptick of SEC enforcement in the aftermath of the financial crisis.

**Table 3**

### Panel A: Sample Summary

| Firms investigated and subject to an SEC Enforcement Action | 127 |
|------------------------------------------------------------|-----|
| Firms investigated by SEC but not subject to an Enforcement Action | 79  |
| Total number of firms included in sample                   | 206 |

### Panel B: Sample Distribution During Investigative Period

| Year | Firms investigated and subject to an SEC Enforcement Action | Freq. | %  |
|------|------------------------------------------------------------|-------|----|
| 1995 | 1                                                          | 0.26% |
| 1996 | 1                                                          | 0.26% |
| 1997 | 3                                                          | 0.79% |
| 1998 | 7                                                          | 1.83% |
| 1999 | 13                                                         | 3.40% |
| 2000 | 19                                                         | 4.97% |
| 2001 | 17                                                         | 4.45% |
| 2002 | 29                                                         | 7.59% |
| 2003 | 31                                                         | 8.12% |
| 2004 | 33                                                         | 8.64% |
| 2005 | 32                                                         | 8.38% |
| 2006 | 58                                                         | 15.18%|
| 2007 | 53                                                         | 13.87%|
| 2008 | 41                                                         | 10.73%|
| 2009 | 28                                                         | 7.33% |
| 2010 | 11                                                         | 2.88% |
| 2011 | 4                                                          | 1.05% |
| 2012 | 1                                                          | 0.26% |
| **Total** | **382**                                                    | **100.00%** |

| Year | Firms investigated by SEC but not subject to an Enforcement Action | Freq. | %  |
|------|---------------------------------------------------------------------|-------|----|
| 1995 | 0                                                                  | 0.00% |
| 1996 | 0                                                                  | 0.00% |
| 1997 | 1                                                                  | 0.48% |
| 1998 | 2                                                                  | 0.97% |
| 1999 | 1                                                                  | 0.48% |
| 2000 | 1                                                                  | 0.48% |
| 2001 | 2                                                                  | 0.97% |
| 2002 | 4                                                                  | 1.93% |
| 2003 | 13                                                                 | 6.28% |
| 2004 | 19                                                                 | 9.18% |
| 2005 | 31                                                                 | 14.98%|
| 2006 | 43                                                                 | 20.77%|
| 2007 | 32                                                                 | 15.46%|
| 2008 | 17                                                                 | 8.21% |
| 2009 | 12                                                                 | 5.80% |
| 2010 | 10                                                                 | 4.83% |
| 2011 | 10                                                                 | 4.83% |
| 2012 | 9                                                                  | 4.35% |
| **Total** | **207**                                                   | **100.00%** |

Note: * SEC investigation lengths can vary greatly depending on firm and investigation-specific factors. The total number of firm-year observations for the Enforcement Action sample is not equal to 127 because many of the investigations last more than one year. The total number of firm year observations for the Enforcement Action sample is not equal to 79 for the same reasons.

Insert Table 4 here.

Panel A of Table 4 presents summary statistics. The mean RBC score for the enforcement action sample is 1.14, significantly smaller than the score for the enforcement action sample (1.36). Both groups are similar in size and profitability. The enforcement action sample has significantly larger shareholder losses of $12,551,450; more than three times the losses of the no-enforcement action sample. Investigations for the enforcement action sample are significantly longer, with a greater number of standards are violated.
Table 4
Summary Statistics

Panel A: Descriptive Statistics

| Variable          | Enforcement Action Sample | No Enforcement Action Sample |
|-------------------|---------------------------|-----------------------------|
|                   | Obs. | Mean | Median | Std. Dev. | Obs. | Mean | Median | Std. Dev. |
| RBC               | 127  | 1.14 | 1      | 0.624     | 79   | 1.36 | 2.03** | 1          |
| AVG_AGE           | 127  | 28.97| 29     | 9.82      | 79   | 28.7 | -0.13  | 31         |
| SIZE              | 126  | 7.46 | 7.085  | 2.429     | 73   | 6.93 | -1.63  | 6.75       |
| ROA               | 127  | -0.43| 0.397  | 4.23      | 77   | -0.25| 0.31   | 0.42       |
| BIG4              | 127  | 0.84 | 1      | 0.366     | 79   | 0.82 | -0.37  | 1          |
| MAX_LOSS          | 121  | 12,551| 1,483  | 45,350    | 76   | 3,514| -2.03**| 703        |
| ln_MAX_LOSS       | 121  | 7.23 | 7.302  | 2.191     | 76   | 6.56 | -2.26**| 6.55       |
| LIT_RISK          | 127  | 0.22 | 0      | 0.416     | 79   | 0.3  | 1.34   | 0          |
| SUED              | 127  | 0.59 | 1      | 0.494     | 79   | 0.57 | -0.29  | 1          |
| INV_LENGTH        | 127  | 2.39 | 2      | 1.248     | 79   | 1.97 | -2.28**| 2          |
| NUM_STD_VLTD      | 127  | 2.43 | 2      | 1.824     | 79   | 1.68 | -3.33***| 1          |
| FINES             | 127  | 25,300,000| 0 | 148,000,000| 79   | 0    | -2.90***| 0          |
| ln_FINES          | 42   | 16.1 | 16.12  | 2.176     | 0    | 0    | 0      | 0          |
| COMPLX1           | 127  | 0.2  | 0      | 0.426     | 79   | 0.2  | 0      | 0.431      |
| COMPLX2           | 127  | 4.9  | 4.765  | 0.909     | 79   | 4.57 | -2.18**| 4.26       |
| BANKRUPTCY        | 127  | 0.1  | 0      | 0.27      | 79   | 0.57 | -0.29  | 1          |
| DEMOCRAT          | 127  | 0.4  | 0      | 0.489     | 79   | 0.4  | 0      | 0.489      |
| REPUB             | 127  | 0.6  | 1      | 0.489     | 79   | 0.6  | 1      | 0.489      |
| CHAIR_DEMO        | 127  | 0.2  | 0      | 0.431     | 79   | 0.2  | 0      | 0.431      |
| CHAIR_REPUB       | 127  | 0.8  | 1      | 0.431     | 79   | 0.8  | 1      | 0.431      |

Note: *, **, *** Denote significance at the 0.10, 0.05, and 0.01 levels, respectively (two-tailed). All variables above are measured in the year before the SEC investigation began. For variable definitions, see Appendix A.
5.2. Results of H1

Table 5 presents multivariate results of the association between rules-based violations and SEC enforcement actions. I find a significant negative association between rules-based characteristics and SEC enforcement, which supports the “roadblock” argument that rules-based standards are less likely to be pursued by the SEC. I also find a positive association between investigation length, the number of standards violated and SEC enforcement. This is consistent with the idea that firms who violate multiple standards are more likely to be subject to an enforcement action, and that firms with longer investigation periods are more likely to be litigated by the SEC.

Table 5
Probit Regression Results

|        | Coef.  | z    | Coef.  | z    | Coef.  | z    |
|--------|--------|------|--------|------|--------|------|
| RBC    | -0.387 | -2.50** | -0.299 | -1.61 | -0.652 | -1.74* |
| SIZE   | 0.129  | 1.08 | 0.204  | 1.51 | 0.354  | 1.93* |
| ROA    | -0.052 | -1.76* | -0.063 | -1.86 | -0.017 | -0.39 |
| BIG4   | 0.092  | 0.31 | 0.235  | 0.71 | -0.305 | -0.55 |
| ln_MAX_LOSS | -0.011 | -0.09 | -0.098 | -0.70 | -0.243 | -1.35 |
| LIT_RISK | -0.194 | -0.82 | -0.241 | -0.87 | -7.148 | -0.02 |
| INV_LENGTH | -0.217 | -1.00 | -0.270 | -1.09 | -0.060 | -0.17 |
| NUM_STD_VLTD | 0.260  | 2.79*** | 0.232  | 2.31** | 0.324  | 2.03** |
| COMPLX1 | -0.292 | -1.18 | -0.352 | -1.28 | -0.513 | -1.39 |
| COMPLX2 | 0.214  | 1.90* | 0.582  | 3.44*** | 0.756  | 2.87*** |
| BANKRUPTCY | -0.532 | -1.02 | -0.592 | -1.05 | -0.206 | -0.23 |
| DEMOCRAT | 0.711  | 1.78* | 0.887  | 1.24 | 1.338  | 1.03 |
| CHAIR_DEMO | 0.539  | 1.04 | 0.431  | 0.56 | -1.062 | -0.80 |
| _cons  | -1.991 | -2.70 | -4.096 | -3.44 | -1.796 | -1.06 |

Note: *, **, *** significance at the 0.10, 0.05, and 0.01 levels, respectively (two-tailed).

All variables above are measured in the year before the SEC investigation began.
The dependent variable is EA - an indicator variable equal to 1 if the investigation ends in an enforcement action, 0 otherwise. For variable definitions, see Appendix A.

To determine which RBC characteristic has the largest impact on likelihood of SEC enforcement, I isolate each RBC characteristic and rerun the Equation 1; the results are presented in Table 6. Bright-line thresholds appear to be the most significant contributing factor of the RBC score. This is consistent with the notion that the SEC is resource constrained and must determine the most cost effective way to bring an enforcement action. The enforcement division has limited resources and manpower, so it focuses on more objective issues (such as bright-line thresholds) to judge whether or not a violation has occurred.
Table 6
Probit Regression Results for Individual RBC Characteristics

|          | (1)     |        | (2)     |        | (3)     |        | (4)     |        |
|----------|---------|--------|---------|--------|---------|--------|---------|--------|
|          | Coef.   | z      | Coef.   | z      | Coef.   | z      | Coef.   | z      |
| EA       | -1.72   | -3.58***| 0.24    | 0.65   | -0.08   | -1.32  | 0.00    | -2.14**|
| SLE      | 0.36    | 4.19***| 0.34    | 3.98***| 0.36    | 4.13***| 0.36    | 4.09***|
| INTRP_GUID| -0.08   | -1.32  |        |        |         |        |         |        |
| WRD_COUNT|         |        |         |        |         |        |         |        |
| SIZE     | 0.01    | -0.35  | -0.01   | -0.40  | -0.01   | -0.44  | -0.01   | -0.48  |
| ROA      | -0.53   | -1.68* | -0.71   | -2.25**| -0.68   | -2.17**| -0.70   | -2.2** |
| BIG4     | -0.30   | -3.27***| -0.28   | -3.05***| -0.29   | -3.18***| -0.28   | -2.99***|
| ln_MAX_LOSS| -6.81   | -0.06  | -6.48   | -0.06  | -7.02   | -0.03  | -7.16   | -0.03  |
| LIT_RISK | -0.05   | -0.26  | -0.08   | -0.42  | -0.06   | -0.31  | -0.13   | -0.66  |
| SUED     | 0.40    | 4.52***| 0.28    | 3.40***| 0.31    | 3.81***| 0.33    | 3.92***|
| INV_LENGTH| 0.36    | 4.62***| 0.38    | 4.36***| 0.38    | 4.41***| 0.37    | 4.34***|
| NUM_STD_VLTD| 0.43    | 4.62***| 0.38    | 4.36***| 0.38    | 4.41***| 0.37    | 4.34***|
| COMPLX1  | -0.43   | -2.24**| -0.51   | -2.68***| -0.55   | -2.91***| -0.50   | -2.63***|
| COMPLX2  | 0.62    | 4.68***| 0.59    | 4.47***| 0.60    | 4.6***  | 0.77    | 4.76***|
| BANKRUPTCY| 0.81    | 1.51   | 0.19    | 0.40   | 0.25    | 0.52   | 0.32    | 0.65   |
| DEMOCRAT | 1.24    | 1.99** | 1.24    | 1.99** | 1.43    | 2.24** | 1.42    | 2.2**  |
| CHAIR_DEMO| -0.68   | -1.03  | -1.10   | -1.66*| -1.22   | -1.84* | -1.25   | -1.88* |
| _cons    | -4.12   | -3.75  | -4.46   | -4.57  | -4.46   | -4.49  | -5.11   | -4.80  |
| Year FE  | Yes     | Yes    | Yes     | Yes    | Yes     | Yes    |
| Industry FE| Yes     | Yes    | Yes     | Yes    | Yes     | Yes    |

5.3. Results of H2

Table 7
OLS Regression Results

|         | (1) Coef. | t      | (2) Coef. | t      | (3) Coef. | t      |
|---------|-----------|--------|-----------|--------|-----------|--------|
| RBC     | 0.00      | 1.06   | 0.25      | 0.17   | 1.35      | 0.7    |
| SIZE    | 0.00      | 2.24** | 0.17      | 1.35   | 0.25      | 0.17   |
| ln_MAX_LOSS| 0.00     | 2.24** | 0.17      | 1.35   | 0.25      | 0.17   |
| INV_LENGTH| 0.00     | 2.24** | 0.17      | 1.35   | 0.25      | 0.17   |
| NUM_STD_VLTD| 0.00   | 2.24** | 0.17      | 1.35   | 0.25      | 0.17   |
| BANKRUPTCY| 0.00    | 2.24** | 0.17      | 1.35   | 0.25      | 0.17   |
| DEMOCRAT| 0.00      | 2.24** | 0.17      | 1.35   | 0.25      | 0.17   |
| CHAIR_DEMO| 0.00    | 2.24** | 0.17      | 1.35   | 0.25      | 0.17   |
| _cons   | -6.132    | -2.27  | 4.070     | 0.55   | 0.048     | 0.01   |
| Year FE | No        |        | Included  |        | Included  |        |
| Industry FE| No       |        | Included  |        | Included  |        |
| Obs     | 121       |        | 121       |        | 121       |        |
| R-squared| 0.1895   |        | 0.305     |        | 0.504     |        |

Note: *, **, *** significance at the 0.10, 0.05, and 0.01 levels, respectively (two-tailed).

The dependent variable is ln_FINES, the natural log of the fine or penalty assessed by the SEC.

Table 7 presents the results of the fines and penalties analysis. I find no evidence of an association between rules-based characteristics and the amount of fines or penalties assessed by the SEC. The lack of results from this measure may be due to the fact that additional penalties firms face are not included in this framework. For example, this measurement does not include stock price declines, reputational costs to a firm, legal fees, increased insurance costs, etc. I do find a positive association...
between the length of the investigation and the amount of fines or penalties assessed. This is consistent with the idea that longer investigations tend to be more egregious and therefore face higher fines. It also suggests that longer, more complicated investigations require more staff resources, leading to increased penalties to offset the additional time and money expended on the investigation.

VI. CONCLUSION

This study provides empirical evidence on the association between rules-based accounting standards and SEC enforcement actions. The evidence is relevant to the rules- versus principles- based debate, which has returned in recent years.

I utilize two samples of firms subject to SEC investigations to examine the impact of rules-based accounting violations on enforcement. The “roadmap” argument predicts violating a rules-based standard provides a clear path to enforcement and litigation for the SEC, while the “roadblock” argument predicts violating a rules-based standard will impede the ability of the SEC to litigate or bring an enforcement action.

I find violations of rules-based standards are associated with a lower probability of enforcement or litigation by the SEC. This is consistent with the “roadblock” theory, suggesting the SEC is less likely to litigate cases involving rules-based violations, or that the Commission is more likely to drop or dismiss an investigation that is centered on a rules-based violation. I find no evidence of an association between rules-based standards and the dollar magnitude of any fines or penalties assessed by the SEC.

The evidence suggests rules-based accounting standards lessen the threat of SEC litigation and enforcement. These findings support the notion that shifting to a more principles-based accounting framework may weaken the rules-based “roadblocks” currently impeding the SEC enforcement process. Overall, it appears a shift to more principles-based standards may improve the ability of the SEC to monitor the quality and transparency of financial reporting in the U.S.

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**Appendix A**

**Variable definitions:**

- **Avg_Age** = age of the accounting standard in years, based on the initial passage year; if multiple standards are violated, the average age is used.

- **SIZE** = the natural log of the market value of equity at the end of the quarter preceding the end of the investigation period.

- **ROA** = earnings before extraordinary items for the quarter preceding the end of the investigation, scaled by total assets, expressed as a percentage.

- **Big4** = indicator variable equal to 1 if the auditor code from compustat is between 1 and 8, and 0 otherwise.

- **MAX_LOSS** = maximum shareholder loss, calculated as the highest market value of the firm during the investigation period minus the lowest value during the investigation period; if no quarterly data available, annual data is used.
ln_MAX_LOSS = natural log of maximum shareholder loss.
LIT_RISK = indicator variable equal to 1 if firm operates in a high litigation risk industry as defined by Francis et al. (1994) (includes biotechnology, computers, electronics, and retailing), and 0 otherwise.
INV_LENGTH = length of SEC investigation in years (if less than 1 full year, rounded up to 1).
SUED = indicator variable equal to 1 if there is a related class action lawsuit, 0 otherwise.
NUM_STD_VLTD = the number of standards violated (or the number of determinable standards allegedly violated).
FINES = dollar amount of fines and penalties imposed by the SEC.
ln_FINES = natural log of total fines and penalties imposed by the SEC.
COMPLX1 = indicator variable equal to 1 if the relevant accounting standard describes the underlying transaction addressed as: (1) complex*, (2) complic*, or (3) elaborat*, and 0 otherwise.
COMPLX2 = natural log of the number of words contained in the definition of the underlying transaction addressed by each standard - definitions found in FASB Codification Glossary; if no definition is applicable, the average is used.
BANKRUPTCY = indicator variable equal to 1 if the company declared bankruptcy during or after the investigation period, 0 otherwise.
DEMOCRAT = indicator variable equal to 1 if the majority of the SEC Commissioners are affiliated with the Democratic Party, 0 otherwise.
CHAIR_DEMO = indicator variable equal to 1 if the chairman of the SEC is affiliated with the Democratic Party, 0 otherwise.
REPB = indicator variable equal to 1 if the majority of the SEC Commissioners are affiliated with the Republican Party, 0 otherwise.
CHAIR_REPB = indicator variable equal to 1 if the chairman of the SEC is affiliated with the Republican Party, 0 otherwise.