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The Financial and Market Effects of the SEC's Accounting and Auditing Enforcement Releases

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1. *Introduction*

This paper explores three questions related to the SEC's accounting enforcement program: (1) what types of accounting and auditing problems motivate enforcement actions, (2) what are the consequences of investigations on targets' financial statements, managers, and auditors, and (3) how do investors and other market agents view the SEC's actions? The SEC enforcement program, which consists of investigations and subsequent injunctive actions or administrative proceedings against offending registrants and auditors, is designed "to concentrate on particular problem areas and to anticipate emerging problems" (SEC [1989, p. 1]). The potential for SEC enforcement actions provides incentives for corporate officers and independent CPAs to avoid unacceptable practices whose "effective prosecution is

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essential to preserving the integrity of the disclosure system" (SEC [1989, p. 8]).[1]

The agency summarizes its accounting-based enforcement actions in the *Accounting and Auditing Enforcement Releases* (*AAERs*).[2] We examined the 224 *AAERs*, issued between April 1982 and April 1989, describing the results of investigations against 188 firms. In the sample period, the SEC most often pursued overstatements of accounts receivable and inventories resulting from premature revenue recognition and delayed write-off, respectively. These two accounts make up 70% of the investigations. The income effects of these financial disclosure violations average more than 50% of reported income. We find that the disclosure of these reporting violations changed expectations of targets' future earning as reflected in financial analysts' reduced earnings estimated after the disclosures.

Disclosures and investigations of reporting violations have other consequences. Typically, targets' managers settle enforcement actions by consenting to an injunction that prohibits future violations of the securities laws. Subsequently, more than 72% of the enforcement targets fired or forced the resignation of top managers and 81% were sued by their shareholders. In 42% of our sample, the SEC also censured the target's auditor; criticism and penalties were more likely for smaller audit firms.

In exploring how market agents react to the enforcement process, we focus on market returns around disclosures of alleged reporting

[1] The Securities Act of 1934 gives the SEC authority over the form and content of financial statements. While the agency historically has avoided determining all the minutiae of *GAAP*, the SEC can use its statutory powers to influence registrants' accounting decisions. Sack [1988] asserts that the agency's enforcement activities defend against the erosion of accounting principles, which is defined as "an accounting treatment that develops in practice in response to a new kind of transaction but that stretches to distortion the logic of the supposed underlying theory."

[2] The SEC [1989, p. 8] categorizes *AAERs* as financial reporting violations cases. The agency pursues injunctive actions under the fraud provisions of the Securities Act of 1934 when it charges an intentional material misstatement. It pursues injunctive actions under the reporting sections of the Securities Act of 1934 when the reporting violations represent "recklessness" or gross negligence by the accused. The agency pursues administrative proceedings under the 1964 amendments when it believes that the registrant failed to comply with the reporting provisions of the 1934 Act. The administrative proceedings do not imply charges of fraud or gross negligence. *Exchange Act Releases* do not subject a registrant to a formal court or administrative proceeding but often result in public criticism of the registrant's accounting. The registrant is invited to contribute a reply that is often published as part of the *Exchange Act Release*. In general, the injunctive actions are associated with misconduct or negligence while the *Exchange Act Releases* and *Administrative Proceedings* describe accounting disputes. Approximately 56% of the sample *AAERs* are injunctive actions. Following the terminology adopted by the SEC [1989, p. 8], we use the term "reporting violations" to describe this heterogeneous sample of *AAERs*.

violations, investigations, and final settlements. Disclosures of the reporting violations are associated with average two-day abnormal returns of −13%; the magnitude of these returns is highly correlated with the earnings impact of the disputed accounting. We also observe abnormal returns of −6% at disclosures of investigations, even when the accounting errors were announced earlier. These negative returns imply substantial incentives for managers to avoid these investigations.[3] We do not observe any changes in targets' share values at the investigations' final settlement.

Section 2 describes the enforcement process. Section 3 documents the effects of the investigations and settlements on firms' financial statements, managers, and auditors. Section 4 addresses the market's reactions to the disclosure of reporting violations, investigations, and settlements. Section 5 provides conclusions.

2. *Accounting and Auditing Problems That Attract the SEC's Interest*

Between 1937 and April of 1982, the SEC issued 307 *Accounting Series Releases*, about 200 of which announced adoptions or amendments of accounting rules or presented the Commission's views on accounting issues. The remainder announced enforcement actions involving independent public accountants and internal accountants. In 1982, the Commission replaced the *Accounting Series Releases* with two new series. The *Financial Reporting Releases* provide either new accounting rules or new interpretations of existing rules. The *Accounting and Auditing Enforcement Releases* describe the SEC's investigations of alleged violations of accounting provisions of the securities laws. *Release No. 1* incorporates by reference 20 of the *Accounting Series Releases* into the new enforcement series.

We examined the 224 *Accounting and Auditing Enforcement Releases* issued between April 1982 and April 1989. These releases describe allegations of financial disclosure violations by 188 firms and their employees including fraud, nonfraudulent but reckless disclosure, and accounting disputes that allege neither fraud nor recklessness. The number of releases alleging reporting violations exceeds the number of cited violations because some violations are the subject of multiple releases. Thus, 188 reporting violations committed by 188 registrants constitute the complete sample.[4]

[3] While prior research has not addressed the market effects of SEC enforcement actions, other research on the share price effects of the SEC's mandated disclosures includes Benston [1969], Griffin [1977], Smith, Stettler, and Beedles [1984], Foster and Vickrey [1978], and Pastena [1979]. In contrast to most prior work, this study provides evidence of economic consequences to the SEC's actions.

[4] None of the sample registrants committed more than one reporting violation.

The tests of market reactions are based on the market sample of 58 firms that meet two criteria: (1) press releases disclosing the error, its investigation, or its settlement were reported in the *Wall Street Journal*, *Funk and Scott's Index*, or available 8-K filings and (2) stock price data were available for the period starting ten days prior to disclosure and ending five days after disclosure either through the *CRSP Daily Returns File* or the *Standard and Poor's Daily Stock Price Record*.[5] Table 1, panel A, illustrates that the first of these criteria eliminated 119 of the original 188 firms, and the second eliminated 11. The remaining 130 firms in the complete sample constitute the nonmarket sample. Table 1, panel B, shows that 34 of the 58 firms (59%) in the market sample are listed on the New York or American Exchanges, but only 7 of the 130 firms (5%) in the nonmarket sample are listed. Appendix A provides a case study for each of the 58 firms in the market sample.

2.1 HOW SEC INVESTIGATIONS ARE STARTED

Pincus, Holder, and Mock [1988, p. 45] report that the SEC obtains enforcement leads from several sources: (1) the market surveillance programs of the American and New York Stock Exchanges and the National Association of Securities Dealers; (2) public complaints, tips, referrals from other law enforcement agencies, and financial press

TABLE 1

Sample Firms Named as Targets of Accounting and Auditing Enforcement Releases No. 1 Through No. 224 (Issued from April 1982 to April 1989)

Panel A: Sample Segmentation

Firms mentioned in *AAERs 1-224*	188
Firms with missing disclosure dates	119
Subtotal	69
Firms with insufficient price data	11
Firms in the market sample	58
Firms in the nonmarket sample[a]	130

Panel B: Sample Firms by Exchange Listing

	New York	American	OTC	Total
Market sample	29	5	24	58
Nonmarket sample	4	3	123	130
	33	8	147	188

[a] The firms in the market sample and the nonmarket sample differ in that stock prices sufficient for market tests were available only for firms in the market sample.

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[5] We obtained firms' Form 8-K reports for 1987, 1988, and 1989 at the New York Regional Office of the SEC. Reports for years prior to 1987 were not available because the regional offices discard reports after four years.

information; and (3) reviews of 1933 and 1934 Securities Acts filings.[6] SEC analysts from the Division of Corporate Finance first scrutinize reports for violations of routine screening criteria and for suspicious subjective factors.[7] When a lead warrants further scrutiny, the agency proceeds to an informal investigation and invites persons with relevant information to cooperate by providing documents and testimony. In such an investigation, the SEC need not formally notify its target, thus protecting firms that are cleared by the inquiry. If the SEC provides formal notification to the target, the investigation may become public.[8] As a matter of policy, the SEC makes its enforcement activities public only when it files a formal complaint alleging securities law violations and seeks settlement with the enforcement target.

Depending on the outcome of the informal investigation, the enforcement staff will drop the case or seek an order from the SEC Commissioners to initiate a formal investigation, which grants subpoena power to compel testimony and the production of documents. Communications with present and former SEC officials indicate that the agency has more targets for formal investigations than it can practically pursue. Formal investigations are both costly and highly

[6] The SEC rarely provides the source of the leads that culminate in formal investigations. For the 58 firms in our market sample, the *AAERs* disclosed only two leads, reviews of the debt registration statements of Financial Corporation of America and Gelco. Similarly, among the 130 firms in the nonmarket sample, the *AAERs* disclosed only one lead, the referral of Computer Store Inc. by the Boston Stock Exchange. Former Chief Accountant of the Enforcement Division Robert Sack publicly addressed the sources of SEC enforcement leads at the SEC Continuing Education Session of the American Accounting Association in Nashville on August 11, 1991. In his opinion, the SEC obtains 50% of the leads from reviews of financial statements and securities offerings; a third of the leads arise from scanning the financial press, and the rest result from tips.

[7] The level of review depends on the perceived risk associated with the registrant. The agency reviews virtually all first-time registrations. The SEC [1985] reports that it reviewed over 97% of first registrations compared to one-third to the 1934 Act filings; thus, accounting problems associated with the initial public offering are most likely to receive a detailed review. The complete sample contains 41 initial public offerings which are listed in Appendix B. For established firms, the agency is likely to review tender offers, proxy statements with antitakeover provisions, 8-K filings concerning unusual events such as management/auditor disagreements, and annual reports with qualified auditors' opinions.

[8] In fact, *1934 Act Release No. 5092* requires the public disclosure of material information; this would include formal investigations by the enforcement division. An anonymous SEC enforcement lawyer (*WSJ* [September 22, 1983], p. 35) explains, "When the SEC tells a company it's a target, securities laws require disclosure to shareholders. This turns a private investigation into a public one... and if the investigation shows the party was innocent, the notification and forced disclosure could have blown a public offering or a reputation needlessly." On the other hand, we did not observe any penalties imposed on firms for failure to announce investigations on a timely basis.

visible; thus, the agency ranks candidates for formal investigation according to the probability of success and potential message value.

The SEC [1989, p. 140] illustrates the agency's preference for cases it can pursue successfully. Of 43 accounting-based formal investigations completed in 1989, only two did not result in reports of the registrant's consent to avoid the unacceptable practices in the future. No reports were issued in the two cases where the SEC did not "win."

2.2 ACCOUNTING ISSUES THAT ATTRACT THE SEC'S INTEREST

As previously cited, the SEC pursues both issues that threaten the integrity of this disclosure system and emerging accounting problems. Data in table 2 , panel A, indicate that more than 50% of the alleged reporting violations (29 instances in the market sample and 71 in the nonmarket sample) consist of overstatements of receivables due to premature revenue recognition. Another 14 errors, or 24% of the market sample, involve overstatements of inventory.

TABLE 2

Accounts Misstated According to SEC Enforcement Actions No. 1 Through No. 224 (Issued Between April 1982 and April 1989)

Panel A: Accounts Misstated

	Market Sample		Nonmarket Sample	
Accounts Misstated	Number	Percentage	Number	Percentage
Receivables	29	50	71	55
Inventories	14	24	18	14
Investments	2	3	13	10
Long-term assets	6	10	23	18
Liabilities	3	5	30	23
Marketable securities	1	2	2	1
Miscellaneous assets	5	9	6	4
Reclassifications	3	5	10	8
Total	63[a]		173[a]	

Panel B: Income Effects of Misstatements[b]

	Market Sample		Nonmarket Sample	
Income Effect	Number	Percentage	Number	Percentage
0 to 10%	8	14	10	21
10 to 50%	18	31	15	32
51 to 99%	11	19	10	21
100 or more	21	36	12	26
	58	100	47	100

[a] The percentages are based on 58 and 130 firms for the market and nonmarket samples, respectively. Because some errors affect a number of balance sheet accounts, the total number of errors exceeds the number of firms.

[b] Many releases provided income effects as percentages of Net Income. When available from *Releases*, we used the SEC's estimates. Otherwise, income effect of the correcting entry is scaled by the registrant's latest four quarters of reported income. The income effect of the enforcement action was available for only 47 firms out of the 130 in the nonmarket sample. A number of enforcement cases (including those against Tonka, Continental Illinois, and Allegheny International) deal with misclassifications that do not affect income.

Table 2, panel B, describes the income effects of the disputed accounting. When available, we use the SEC's estimates of the percentage of income overstatement; otherwise, we scale the error's income effect by the registrant's reported income for the last four quarters. The median effect of reversing the target's accounting treatment is to lower income by 50% across both the market and the nonmarket samples. For 21 of the 58 firms (36%) in the market sample, the income effect of the error exceeds the income reported in the preceding four quarters.

The SEC's response to 'innovative" accounting in the electronics and financial services industries reflects its willingness to confront emerging problems to stem the "erosion" of *GAAP*. These two industries constitute almost 40% of the complete sample. Of the 188 firms in the complete sample, 23 (12%) are in two-digit SIC Code No. 36 which includes electronics and computers. In the 1980s this industry experienced major product and marketing changes, altering the traditional revenue realization cycle. In fact, 22 of the 23 electronics firms cited for financial disclosure violations recognized revenue prematurely in that major costs had not been incurred or cash realization was not assured.[9] The SEC cited these revenue recognition criteria from *APB No. 4* to clarify its position.

There are 17 financial firms (29%) in the market sample and 30 financial firms (23%) in the nonmarket sample. Despite having created many new financial products during the 1980s, many of these firms experienced financial distress by the end of the decade. Consistent with its goals of anticipating emerging problems, in 1984 the SEC initiated investigations of inadequate disclosures of repurchase and reverse repurchase agreements including those of Charter Co., Baldwin United, and American Savings and Loan of Florida. While critical of these registrants' disclosures, the agency admitted the need for further guidance and issued *Financial Accounting Release No. 24* in January 1986 to clarify disclosure requirements about the inherent risks of financial instruments. The FASB formally incorporated these disclosures into *GAAP* with *FASB No. 60*, issued later in 1986, and *FASB No. 105*, issued in 1990.

2.3 AUDITING ISSUES THAT ATTRACT THE SEC'S INTEREST

Diacont [1991] points out that in cases of financial fraud by a registrant, the SEC examines the role of the independent auditor. Based on its examination, the SEC may include the auditor as a codefendant in the enforcement action or initiate a separate action against the auditor. In our sample, the *AAERs* censure the auditors

[9] For example, Datapoint recognized revenue upon shipment of its minicomputers despite the existence of extensive installation, training, and service obligations subsequent to shipment.

of 85 firms. Using the framework provided in Diacont [1991], table 3, panel A, details the audit deficiencies stressed in the sample *AAERs*. The three most cited audit deficiencies are failures to obtain competent evidence (33 audits), to perform audit procedures required by the audit program (29 audits), and to corroborate client assertions (22 audits). One commonality among these most cited deficiencies is that the auditors failed to gather sufficient evidence to support their opinion on the client's financial position and accounting methods.

In addition to citing audit deficiencies, the SEC uses its enforcement actions to inform auditors about its views on the proper conduct of an audit practice. Using Diacont's framework, table 3, panel B, tabulates the sample *AAERs*' practice messages to auditors. The

TABLE 3

Audit Deficiencies Cited in SEC Enforcement Actions No. 1 Through No. 224 (Issued Between April 1982 and April 1989)

Panel A: Audit Deficiencies Cited by the SEC[a] Audit Deficiency	Times Cited
Opinion shopping	5
Lack of objectivity and skepticism	4
Incompetence	5
Inadequate independent verification	22
Not critically evaluating transactions	10
Not exercising sufficient professional skepticism	7
Failure to perform audit program procedures	29
Failure to properly supervise subordinates	8
Failure to obtain sufficient, competent evidence	33

Panel B: Enforcement Messages Against the 85 Auditors Censured **Enforcement Message**	**Times Cited**
Even in the absence of specific rules, "improper professional conduct" can be basis of agency actions	29
Auditor should consider clients' fraud potential	17
Improve quality control	23
An auditor must maintain independence	19
Nonpartners will also be held responsible for failure to follow their professional duties	5
The auditor has a responsibility under *SAS 8* to assure the veracity of nonfinancial statements disclosures	3
Audit consultation must be documented	2
Concurring partners are subject to investigations	2

[a] We compiled the audit deficiencies and enforcement messages on the framework provided in Diacont [1991].

most frequent messages warn auditors to be aware of potential client fraud, assure quality control, maintain both the appearance and fact of independence, and strive for "proper professional conduct." The last of these means that auditors are subject to SEC sanctions for improper conduct even if the violations are not currently delineated in current AICPA rules. Consistent with its stated goal of anticipating emerging problems, many of the views as expressed by the SEC in the *AAERs* are precursors of future auditing standards. For example, the SEC's position that auditors must be aware of the potential for client fraud was reflected in *SAS No. 53*, issued in 1988. Also, in 1991 the AICPA strengthened independence rules, especially those limiting bank loans to auditors.

3. *The Timing and Consequences of SEC Investigations*

3.1 TARGET ACTIONS, FORMAL INVESTIGATIONS, AND SETTLEMENTS

Table 4 presents the timing of targets' actions and disclosures for the market and nonmarket samples. We obtained the initiation and settlement dates from the SEC *Releases* and we used the *Wall Street Journal Index* and *Funk and Scott's Index* to obtain the disclosure date of the error and/or the disclosure of the SEC's formal investigation. The initiation dates for informal investigations are not a matter

TABLE 4

Time of Events Associated with AAERs No. 1 to No. 224

Time Gap	From Start of Reporting Violation to First Disclosure	From First Disclosure of Reporting Violation to Disclosure of Investigation	Total Period[a]	Total Period[a]
	58-Firm Market Sample	58-Firm Market Sample	58-Firm Market Sample	130-Firm Nonmarket Sample
Same day	0	25	0	0
1 month	0	4	0	2
1-12 months	20	11	2	10
13-24 months	17	8	5	27
25-36 months	9	8	9	24
37-48 months	6	2	19	27
49-60 months	3	0	13	16
Excess of 60 months	3	0	10	24
Total firms	58	58	58	130
Mean gap in months	24	10	25	40

[a] The total period includes the interval from the start of the errant accounting to final settlement; thus, the total period includes three intervals: (1) start of disputed accounting to first disclosure, (2) first disclosure to disclosure of the SEC investigation, and (3) disclosure of the SEC investigation to final settlement. The *Accounting and Auditing Enforcement Releases* provide information about initiation date of the error and the settlement of the enforcement action. We obtained the first disclosure date and SEC investigation disclosure dates from the *WSJ* and *Funk and Scott's Index*.

of public record because the SEC does not disclose investigations until they are completed.

The last line of table 4 indicates that there is a mean interval of 24 months between the initiation of disputed reporting and its first public disclosure. The former is the date of the first quarterly or annual report cited as being inaccurate by the *Accounting and Auditing Enforcement Releases*. The mean interval between the disclosure of the disputed accounting and the press release disclosure of the formal SEC investigation is 10 months, with a range of 0 days to 4 years. Finally, the mean interval from the inception of the disputed accounting to final settlement with the SEC was 52 months for the firms in the market sample. By comparison, the average interval for the nonmarket sample is 40 months.

As illustrated in table 5, five of these first public disclosures are associated with auditor qualifications or resignations. Announcements of SEC investigations account for 25 of the first public disclosures while four shareholder lawsuits, two *WSJ* rumors, and two governmental investigations (not SEC) account for the others. Another 20 are announcements of "internal investigations" typically conducted in conjunction with the annual audit.

Firms' internal investigations may be motivated by ongoing annual external audits and informal SEC investigations. During the course of an informal SEC investigations, targets have incentives to begin their own investigations because their public images should fare better if they can claim to have discovered the problem before the start of a formal SEC investigation. On the other hand, a firm's disclosure of an internal investigation may motivate the SEC to begin its own inquiries.[10]

TABLE 5

Sources of First Disclosure of Reporting Violations

Source of Public Disclosure[a]	Number	Percentage
Announcement of SEC investigation	25	43
Announcement of firms internal investigation	20	34
Auditor qualification or resignation	5	9
Shareholder lawsuits	4	7
Wall Street Journal rumors	2	3
Announcement of investigations by government agencies other than the SEC	2	3
	58	100

[a] We obtained the sources of first disclosure from the *Wall Street Journal* and Form 8-K disclosures. Several Form 8-K disclosures informed shareholders of targets' prior press releases. These earlier press releases rather than the Form 8-K are classified as the first disclosure.

[10] We could not determine if all reported internal investigations lead to SEC investigations, but this is not likely given that there are more than 10,000 registrants and limited agency resources.

3.2 SANCTIONS AGAINST REGISTRANTS AT FORMAL SETTLEMENT

When the results of the SEC's formal investigations indicate alleged disclosure violations, the agency considers an enforcement action that will lead to formal settlement. The SEC [1989, p. 2] reports that its primary enforcement action is obtaining an injunction in civil court. The SEC can seek permanent injunctions against any firm or person who is violating or about to violate any provision of the securities laws. Conduct which violates an injunction is punishable by civil or criminal contempt, and violators are subject to fines and imprisonment. None of our sample defendants, having been previously enjoined from future violations, returned to the court as a repeat offender. The SEC can also petition the court to disgorge defendants of illegal profits.

In accounting and disclosure cases, the SEC pursues civil actions when it accuses a target or its management of fraud, as described in section 10 of the Securities Act of 1934. Fraud implies *scienter* or intent to deceive by the accused. Although there is no formal admission of guilt, managers' consent to be enjoined from engaging in future fraud produces negative publicity. The *Wall Street Journal* typically reports the consent agreements by sample firms or their (former) executives.[11] Also, evidence gathered by the SEC for use in civil cases can be used in criminal trials. Table 6 indicates that 83 of the 188 sample enforcement actions were settled by the defendants' consent to avoid future fraudulent activities. Some executives, including those of Pepsico and Regina, received jail sentences in related criminal cases. Other executives, including those at Florafax and U.S. Surgical, were disgorged of managerial bonuses resulting from the impact of overstated income.

TABLE 6

Basis of Settlements[a] of AAERs No. 1 through No. 224

Types of Action at Settlement	Firms in Market Sample $N = 58$	Firms in Nonmarket Sample $N = 130$	Entire Sample $N = 188$
Civil actions for fraud	35	48	83
Civil actions for negligence	9	13	22
Administrative proceedings	11	59	70
Exchange Act Releases	3	10	13
Total	58	130	188

[a] The *Accounting and Auditing Releases* are the source of information about sanction at settlement.

[11] The *Wall Street Journal* reported consent agreements for all the market sample firms in existence at the time of the consent agreement.

In addition to fraud, the SEC can file civil court actions for violations of the reporting and record-keeping requirements of the Securities Acts. Sack [1988] states that the agency pursues this class of civil injunctive action when the agency believes that management's actions have displayed "recklessness" but without *scienter*. The SEC accused 22 targets of such violations. It should be noted that "recklessness" or gross negligence by management provides third parties a basis for suits under the federal securities laws. These 22 accused firms (and managers) consented to be enjoined from violating the reporting and record-keeping provisions of the securities acts but avoided the stigma of official association with fraud.

When the SEC's investigation indicates disclosure violations but a lack of *scienter* or recklessness, the agency pursues administrative proceedings or *Exchange Act Releases*. Table 6 indicates 70 of the actions concluded in administrative proceedings. Settlements required that defendants restate financial statements and/or issue 8-K reports describing both the proscribed accounting and its correction. An additional 13 target firms avoided administrative proceedings by agreeing to restate their financial statements in footnotes on a "pro forma" basis consistent with the SEC's position. The agency issued *Exchange Act Releases* that were critical of these firms' accounting and disclosure policies.

Participants in alleged disclosure violations investigated by the SEC suffered other consequences. Our search of the *Wall Street Journal* and firms' reports in *Moody's Manuals* indicates the subsequent firing or resignations of high-level executives in 42 of the 58 of the market sample firms. Also, 19 firms in the market sample filed for Chapter 11 by the settlement date, and 4 others consented to mergers that did not protect the target managers' jobs. Finally, targets of investigations face an increased probability of successful shareholder suits (Palmrose [1991]). A search of the financial press, annual reports, and From 8-Ks indicates that at least 49 of the 58 market targets indicated shareholder lawsuits against the firm associated with the alleged reporting violations that motivated the enforcement actions.

3.3 THE ROLE OF AUDITORS AND SANCTIONS AGAINST AUDITORS

The SEC cited audit deficiencies in 85 of 188 sample *AAERs*. In many cases, the auditor provided the first indication of the alleged disclosure violation. Among the 58 firms in the market sample, an auditor resignation or qualification provided five of the first disclosures and the announcements of the 20 internal investigations of accounting errors occurred late in the target's fiscal year—a period of external audit activity. In fact, in ten cases in the market sample, auditors signaled the existence of possible reporting violations in unaudited quarterly reports by disallowing that accounting treatment in the audited annual report. However, the releases also list five instances of opinion shopping: Cardillo Travel, Petrofab, Alpex Computer, Southeastern S&L, and American Biomaterials.

We observe three cases where auditors publicly disagreed with the SEC's position and continued to oppose the agency's actions up to the settlement date. Examples include Arthur Young on American Express, Coopers & Lybrand on Digilog, and Peat, Marwick, Mitchell & Co. on Charter Financial. The SEC did not censure the auditors in these three cases, possibly because the accounting treatments in dispute had not been considered in *APB Opinions* or *FASB Statements*. In fact, SEC Commissioner Fleischman dissented on the American Express action on the basis that the Commission was imposing its after-the-fact judgment to reporting issues lacking prior authoritative guidance.

While many auditors exposed the disclosure violations or had a reasonable basis to maintain their positions, 85 auditors were censured by the SEC (about 45% of the 188 audits). Neither the *Releases* nor other available sources list the auditors in 15 of the 188 cases; however, none of these was censured. Thus, table 7 focuses on the 85 censures imposed on 171 known auditors of record. The eight largest public accounting firms were auditors of record at the time of disclosure in 87 cases and were censured 25 times (28%). The next five largest audit firms, designated national firms, were censured in 14 of 25 audits (56%). Local firms were censured for 46 of their 59 audits (78%).

Table 8 indicates that the largest accounting firms suffered lighter penalties when censured. Ten of the 25 censures against the largest auditors resulted in no penalty to the firm or its personnel while *all* 60 censures of the smaller firms resulted in penalties. In total, the largest firms suffered only five minor restrictions on their practices as a result of the enforcement actions. In contrast, the smaller auditors suffered severe penalties including 13 permanent suspensions from SEC practice. The median length of the practice restrictions was 18 months. Table 8 also indicates that two registrants filed financial statements with forged audit reports.

One explanation for the lighter penalties faced by larger audit firms is that they produced less egregious audit failures. Alternatively, larger firms have both greater resources and greater reputation-based incentives to confront the SEC's civil actions and administrative proceedings. Finally, it may be that during the 1980s the SEC wished to discourage local firms not subject to peer review from continuing their SEC practices and to assure that local firms merged into larger firms were subject to strict review of audit quality. Imposing stricter penalties against local firms and their typical merger partners, the national firms, would further the goal of main-

TABLE 7

Auditors of Record During the Commission of Reporting Violations Associated with AAERs No. 1 to No. 224 (Issued April 1982 to April 1989)

Auditor[a]	Number of Clients	Numbers of Times Censured
Big Eight Auditors		
Arthur Andersen & Co.	18	3
Arthur Young & Co.	5	0
Coopers & Lybrand	9	3
Deloitte Haskins & Sells	9	5
Ernst & Whinney	10	1
Peat, Marwick, Mitchell & Co.	20	5
Price Waterhouse & Co.	9	3
Touche Ross & Co.	7	5
Total from "Big Eight"	87	25
National Auditors[b]		
A. Grant & Co./Grant Thornton	4	2
Laventhol & Horwath	9	3
Main Hurdman, KMG	5	2
Pullen & Co.	1	1
Seidman & Seidman	6	6
Total for National Auditors	25	14
Local Auditors		
B. Ashton	2	2
Cooper & Co.	1	0
D. Rogers	1	1
D. Lamoreaux	1	1
David Mitchell & Co.	1	0
Don Wilson	1	0
Etute Wardlaw & Co.	1	1
Fox & Co.	3	3
Francis Wright	1	1
Fried & Co.	1	1
Gary Jackson	1	1
Goodman & Co.	1	1
Holben & Co.	1	1
Horne & Co.	1	0
Huber & Butter	1	1
I. H. Anderson	1	1
J. Amundsen	1	1
Larry Dixon	1	1
Lawson Thomas & Holmes	1	1
Louis Pokat	1	1
M. Berryman	1	1
Main Judd & Landau	1	0
Marrind & Assoc.	1	1
Mayo Associates	1	1
Merger & Pierce	1	0
Morrison Strydensky	1	1
Murphy O'Connor & Quinn	1	1
Petersen & Brough	3	2
Pickens, Snodgrass & Koch	1	1

TABLE 7—*continued*

Auditor[a]	Number of Clients	Numbers of Times Censured
R. Schulman	1	1
R. G. Davy	1	1
Rasmussen	1	1
Richard Chepul	3	3
Ron Harrington	1	1
S. Grossman	1	1
S. Glick	1	1
Schmidt J. Co.	1	1
Schoenfeld & Mendelson	1	1
Smith & Stephens	1	1
Todman & Co.	1	1
Van Horn	1	1
Vincent & Parker	1	1
Warnick Strank Associates	1	1
Weinaug & Co.	1	1
William Glenfold	1	1
Winter & Co.	1	1
Wright & Herman	1	1
Total for local auditors	59	46
Grand Total	**171**	**85**

[a] The *Accounting and Auditing Enforcement Releases*, *Who Audits America*, and *Compact Disk Disclosure* were the sources of auditor information.
[b] National firms were as defined in the *Public Accounting Report* (1985).

TABLE 8
Penalties Imposed by the SEC on Censured Audit Firms in Connection with Cases Covered in AAERs No. 1 to No. 224 (April 1982 to April 1989)

Type of Auditor	Audits	Number[a] of Censures	No Penalty	Penalty[b] on a Partner	Penalty on Practice of the Firm
Big Eight	87	25	10	10	5
National firms	25	14	0	10	4
Local firms	59	46	0	32	14
Auditor not known	15	0	0	0	0
Forged audit report	2				
Total	188	85	10	52	23

[a] A test for differences in the censure rate between Big Eight and smaller audit firms, national and local, yields a χ^2 (1 *df*) of 9.78 ($p < 0.01$).
[b] The *Accounting and Auditing Releases* are the sources of information about penalties imposed on CPA firms and their employees.

taining high audit quality by requiring that CPAs obtain sufficient evidence to support their "clean" audit opinions.

4. Market Reactions to Disclosures of Errors, Investigations, and Final Settlements

This section explores the impact of enforcement action disclosures on analysts' earnings forecasts and reports targets' abnormal stock returns for the window covering the initiation of the disputed reporting to final settlement and three shorter windows surrounding disclosures of targets' disputed accounting, the SEC's investigations, and final settlement. The analysis of market reactions is limited to the market sample of 58 firms for which both market returns and a disclosure date are available. We use an event-type methodology and *CRSP* return data and *S&P* Daily Stock Price data (adjusted for dividends and stock splits). For the long-window tests, the cumulative abnormal returns are estimated using the market model. We adjust for the market's daily returns to calculate the abnormal returns in the short-window tests.

4.1 THE IMPACT OF ENFORCEMENT ACTIONS ON ANALYSTS' FORECASTS

For the 22 sample firms followed by *Value Line*, we found negative adjustments to earnings forecasts associated with the disputed accounting in 17 cases. Two forecasts were unchanged and three were revised positively in the period following the disclosure.

Prior to the disclosure, 15 of 22 *Value Line* forecasts predicted an earnings increase for the forthcoming year, while 7 forecasts predicted a decrease. After disclosure of the error, there were 5 predicted increases and 17 predicted decreases. A chi-square test produces a χ^2 (1 df) of 8.29 ($p < 0.01$). This indicates that disclosures about these accounting disputes changed expectations about reported earnings. Of course, we cannot be certain whether the changes in analysts' forecasts reflect revisions in expectations of targets' future accounting methods or revisions in expectations of underlying cash flows.

4.2 SHARE RETURN REACTIONS TO SEC ENFORCEMENT ACTIONS

We computed the cumulative abnormal returns for the period beginning with the start of the disputed accounting and ending with settlement for 34 sample firms with daily *CRSP* returns data. This period averages 52 months. We find cumulative abnormal returns of −5.7% in the year prior to the initiation of the disputed reporting ($t = -.59$). Target firms experienced cumulative abnormal returns of −24% ($t = -1.88$) in the period beginning one year prior to first disclosure of the disputed reporting and ending three days before that disclosure. This supports the view that the target firms underperformed the market despite the positive income effects of the disputed accounting. These results are similar to those reported in Kinney and McDaniels [1989], where sample firms underperformed the market prior to their restatements of quarterly earnings, and Kellogg [1984], where sample firms underperformed the market prior to the initiation of accounting-based class-action lawsuits.[12]

We also computed average abnormal returns for three 15-day intervals beginning nine days before and ending five days after the first disclosure date, the SEC investigation date, and the settlement date, respectively. Trading suspensions, delistings, bankruptcies, and mergers eliminated 13 of 58 targets at the SEC investigation date and 25 at the settlement date.

Table 9 reports the abnormal returns for days {−9 to +5} around day {0}, the first financial press disclosures of the disputed accounting in the *Wall Street Journal* or the *Funk and Scott's Index*. The sample firms' cumulative abnormal returns decreased 12.9% on days {−1, 0}, significant at the 0.001 level.[13] This indicates that the market views information about the disputed accounting as having implications for the targets' future economic prospects. The magnitude of this share price decline seems to reflect the disputed accounting's relatively large income effect.

Table 9 also indicates that targets' average abnormal returns decreased by more than 7.5% ($t = -3.75$) over days {−1, 0} before the disclosure of SEC investigations. An issue of interest is whether the market is reacting to the investigation announcement as opposed

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[12] On the other hand, negative returns may indicate that firms with share price declines are more likely to become enforcement targets. Market-based indicators of financial problems are likely to attract the interest of SEC analysts who review the firms' financial statements. Also, auditors are more likely to qualify annual reports or force the restatement of quarterly reports if they are aware of market-based indicators of financial distress. As noted earlier, auditor qualifications and "internal investigations" in conjunction with the annual audit represent 25 of the first disclosures of the 58-firm market sample. Such activities are likely to capture the attention of the SEC's reviewers and increase the likelihood the firms will be selected as enforcement targets. We used the Scholes and Williams [1977] approach to adjust for nonsynchronous trading.

[13] In three cases—Equity Funding Corp., Flight Instruments Corp., and American Biomaterials Corp.—the target ceased trading as of the disclosure of reporting violations. We searched the *Wall Street Journal* and *Moody's Manuals* but could not find any evidence that the firms' securities retained any value after the trading suspension. However, to be conservative, we assumed only a 50% decrease in share price. Target firms' share values drop more than 10% on days {−1, 0}, even with these three firms eliminated from the sample. Alternately, if we eliminate the five target firms whose first disclosure is associated with auditor qualifications or resignations, the decrease in shareholders' returns for days {−1, 0} continues to be −12.6%.

TABLE 9

Average Abnormal Returns Around the First Disclosure, SEC Investigation Initiation, and Settlement Dates Associated with the Financial Reporting Violations Addressed in AAERs No. 1 to No. 224 (Issued Between April 1982 and April 1989)

Day	First Disclosure Date (N = 58)[a]		Disclosure of SEC Investigations (N = 45)[b]		Settlement of Investigations (N = 33)[c]	
	Mean	t-Statistic	Mean	t-Statistic	Mean	t-Statistic
−9	−0.015	−1.88	−0.004	−1.10	−0.003	−0.26
−8	0.006	0.88	−0.007	−1.36	0.022	1.70
−7	−0.001	−0.16	−0.000	−0.00	−0.011	−1.50
−6	−0.001	−0.33	−0.007	−1.65	0.004	0.54
−5	−0.014	−1.27	−0.017	−0.96	0.007	0.86
−4	−0.004	−0.74	0.009	1.07	−0.001	−0.04
−3	0.000	0.04	0.012	1.52	−0.007	−0.91
−2	−0.002	−0.38	0.006	0.97	0.001	0.16
−1	−0.029	−2.42*	−0.025	−2.17*	−0.003	−0.31
−0	−0.100	−3.97**	−0.050	−3.28**	−0.009	−1.19
+1	−0.011	−0.82	−0.014	−1.48	0.008	0.95
+2	0.012	1.90	−0.008	−1.29	−0.001	−0.21
+3	0.004	0.50	0.003	0.33	0.013	1.11
+4	0.086	0.92	0.010	1.61	0.004	0.77
+5	−0.006	−0.73	0.000	0.09	−0.003	−0.53

[a] For 54 of the 58 firms in the market sample, day {0} is the date of press disclosure in the *Wall Street Journal* or a publication followed in the *Funk and Scott's Index*. In the other four cases, day {0} is the press release disclosure date that was disclosed in registrants' Form 8-Ks. These four press releases preceded the actual Form 8-K filings.

[b] Thirteen firms that were trading at the first disclosure date had suspended trading at the time of the disclosure of the SEC investigation. This reduces the trading sample at the time of the investigation disclosure from 58 to 45.

[c] Only 33 of the 58 market-sample firms were trading as of the settlement date. Five firms had merged and the other 20 had trading suspended due to bankruptcy or lack of a market for their securities.

*Statistically significant at the 0.05 level.

**Statistically significant at the 0.01 level.

to the impact of the disputed accounting on earnings. Twenty-five of 45 announcements of SEC investigations also represent the first disclosure of the disputed accounting; thus it is unclear whether this test captures the market's reaction to new information about disputed earnings as opposed to news about the investigation. To isolate the investigation effect, we focus on the cumulative returns for the 20 firms that had previously disclosed the disputed accounting. The cumulative abnormal return for days $\{-1, 0\}$ for these 20 firms is -6.0% ($t = -2.38$). This implies that the market reacts negatively to the SEC's investigation, *even with prior knowledge* of the error. This incremental market effect of investigations may be related to negative publicity and the impact of the SEC's position on future third-party lawsuits. At a minimum, the ability of SEC investigations to affect targets' market prices indicates that the agency possesses a viable sanction because managers have market-based incentives to avoid investigations.

Table 9 also presents the abnormal returns around the settlement. None of the abnormal returns in this 15-day period is statistically significant. The limited market activity is not surprising considering that the settlements tend to occur several years after the first disclosure date.

4.2 CROSS-SECTIONAL TESTS

We test the income effect of the disputed accounting, the type of account affected, and the presence of fraud as possible explanations for the magnitude of abnormal returns, using short windows, the days $\{-1, 0\}$ and $\{-9, 0\}$. The regression model follows:

$$CAR_i = a_0 + b_1 INC_i + b_2 WC_i + b_3 FRD_i + e_i \tag{1}$$

where INC_i = dollar income effect of the disputed accounting as provided by the SEC, scaled by the registrant's latest annual reported net income. If the correction affects quarterly net income, the SEC's proposed correction is scaled by net income reported to date in the fiscal year; $WC_i = 1$ if the correction requires reducing working capital in the disclosure year and 0 otherwise; $FRD_i = 1$ if the SEC's action is motivated by the antifraud sections of the 1934 Securities Act and 0 otherwise; and e_i is an error term.

In the first row of table 10, the dependent variable is the abnormal returns for days $\{-1, 0\}$ relative to the first disclosure of the alleged violation. The eventual income effect of the disclosure violation is

TABLE 10

Cross-Sectional Association Between the Cumulative Abnormal Returns, Income Effect, Current Assets, and the Disclosure of Potential Fraud

$$CAR_i = a_0 + b_1 INC_i + b_2 WC_i + b_3 FRD_i + e_i$$

Variable and Expected Sign	a_0	INC[b] +	WC −	FRD −	ADJ R^2	N
Days $\{-1, 0\}$[a]						
Coefficient	0.11	0.13	−.05	−.04	.109	58
t Value	0.18	1.93*	−.80	−.84		
Days $\{-9, 0\}$						
Coefficient	0.15	0.16	−.19	−0.88	.210	58
t Value	1.79	1.77*	2.20*	−1.22		

*Statistically significant at the 0.05 level (one tail).

[a] Days are relative to the first disclosure of the error; thus, day {0} is the first disclosure in the financial press.

[b] INC_i equals the income effect in dollars of the error as estimated by the SEC in the *AAERs* scaled by the registrant's latest annual reported net income.

WC_i equals one if correction of the questionable accounting requires the write-down of current assets in the disclosure year and equals zero otherwise.

FRD_i equals one if fraud is involved and zero otherwise.

e_i is a regression error term.

positively correlated ($t = 1.93$) with the abnormal returns. This implies that information about the accounting errors affects the market's expectations about the future earnings of the target company. While the signs for the indicator variables representing working capital reductions and fraud are negative as hypothesized, they are not statistically significant at conventional levels.

Table 10, second row, reports the cross-sectional results for days $\{-9, 0\}$; abnormal returns are positively correlated ($t = 1.77$) with the income effect of the error and negatively correlated with indicator variables for working capital accounts ($t = -2.20$). The lack of statistical significance of the fraud variable may reflect uncertainty, at early disclosures, about whether cases involve fraud as opposed to merely an accounting dispute. In fact, the magnitude of the income effect of the reporting violation is not generally known at the time of first disclosure.[14]

5. *Conclusion*

The stated goals of the SEC's accounting-based enforcement activities are to anticipate emerging reporting problems and to maintain the credibility of the disclosure system. The agency's actions on emerging issues include releases dealing with disclosures of the risks associated with financial instruments, the potential for client fraud, and tighter standards for auditor independence. The agency's positions predate similar FASB and AICPA statements by several years. In protecting the disclosure system from some registrants' attempts to "erode" accounting principles, the agency is most likely to pursue alleged disclosure violations dealing with premature revenue recognition or overstatements of current assets. The income effects of these financial disclosure violations are material, and their disclosure affects financial analysts' expectations of targets' future earnings. After the disclosure of alleged reporting violations, enforcement targets' managers often suffer negative consequences including job losses and lawsuits.

The SEC's auditing enforcement actions appear to take the form of admonitions to auditors to apply *GAAP* and *GAAS* conscientiously. Among 58 firms with available data, auditor qualifications and the client's internal investigations in conjunction with the annual audit seem to be leading indicators of enforcement activity. However, when auditors do not expose the reporting violations, the agency typically censures them or bars them from SEC practice. While the agency has

[14] We found estimates of these income effects on the first disclosure date for 14 of the 58 firms in the market sample. The focus on days $\{-1, 0\}$ is consistent with Abdel-khalik [1984].

censured auditors of all sizes, smaller auditors are more likely to be censured and to receive the most severe penalties.

Consistent with prior studies on accounting disputes and restatements, we find that in the years prior to disclosure the enforcement targets substantially underperform the market despite the reporting "benefits" of the disputed accounting. In addition, the enforcement targets experienced a two-day −13% market return associated with the first disclosure of the alleged reporting violation. The declines in enforcement targets' market returns are positively associated with the relative income impact of the accounting dispute. Moreover, the market reacts negatively to news of an SEC investigation even when there was prior public disclosure of the violation. This implies that threat of an investigation represents a viable sanction that is available to the SEC in its goals of maintaining the credibility of financial statements and preventing the erosion of accounting principles.

APPENDIX A

Summary of the Accounting and Auditing Enforcement Releases (AAERs) Included in the Primary Sample

AAER No. 1: Equity Funding Corporation—AMEX

The complaint alleges that Equity Funding engaged in reporting fraud from its initial public offering in 1964 to the fraud's disclosure in 1973. Under the direction of top management, the firm created false insurance receivables and booked $120 million of fictitious assets and earnings. The auditor, Wolfson & Wolfson (later acquired by Seidman & Seidman), did not attempt to confirm major receivables.

AAER No. 1: Mattel Inc.—NYSE

The complaint alleges that Mattel fraudulently overstated 1971 income through the use of falsified accounting entries and records. The errors included (1) recognition of sales when the right to return exists; (2) failure to write down obsolete inventory; (3) deferral of tooling and royalty expenses; and (4) overstatement of income resulting from insurance payments. Without these errors, the reported income of $12.1 million for 1971 would have been a loss.

AAER No. 1: Penn Central Corp.—NYSE

The complaint alleges that operating income for 1969 was overstated by at least $63 million due to improper recognition of gains on "sham" sales and bogus dividends. Penn Central reported a $30 million gain on "sales" of amusement parks that did not transfer the risk of loss to the buyer. Penn Central recognized a gain of $21 million on an exchange of Madison Square Garden Stock, but the exchange did not affect Penn Central's ownership interest. Also, Penn Central recognized income of $11.7 million as a result of *intercompany* dividends.

AAER No. 1: Talley Industries—NYSE

The complaint alleges that Talley overstated income for 1969 by more than 100% by understating cost of goods sold as a result of overstating inventories. Talley's inventory valuation relied on sales contracts that were not binding.

AAER No. 4: Clabir Corporation—NYSE

The complaint alleges that the company used an "unorthodox accounting method" that inflated the company's earnings in the 1981 third quarter. *GAAP* (*SFAS No. 12*) requires that firms carry marketable securities at the lower of cost or value; however, on the basis of a verbal offer, the firm carried its marketable securities at an amount 10% above market for the quarter ending October 31, 1981. This allowed Clabir to report pretax earnings of $3.6 million (rather than $1.5 million under proper application of *GAAP*). Clabir wrote the marketable securities down to market as of the fiscal year-end of January 31, 1982.

AAER No. 10: Aetna Life and Casualty Company—NYSE

The SEC alleges that the company recognized current income and assets arising from net operating loss carryforwards (*NOLs*) thus violating *GAAP* (*APB No. 11*) which states, "the tax benefits of loss carryforwards should not be recognized until they are actually realized, except in usual circumstances when realization is assured beyond any reasonable doubt. . . ." Aetna considered the realization of the benefits resulting from *NOLs* to be certain and disclosed its position clearly. The Commission did not dispute that Aetna acted in good faith but ruled that it had not met the "assurance beyond any reasonable doubt" test. Aetna's premature tax loss credit recognition increased operating income by $26,000,000 (of the $491,000,000 total) in 1981 and $203,000,000 (of the $372,000,000 total) in 1982.

AAER No. 16: Litton Industries—NYSE

The complaint alleges that from 1972 to 1977 Litton delayed in recognizing losses on long-term shipbuilding contracts with the Navy and related subcontractors. *AAER No. 16* reports that *GAAP* (*APB*

No. 45) requires a provision for the estimated loss when estimated costs exceed estimated revenues. Litton recognized $328 million in pretax losses on these contracts in 1978.

AAER No. 16: Gelco Corp.—NYSE

The complaint alleges that Gelco improperly accounted for purchase discounts as current revenue rather than as a reduction of the purchase price. The agency's staff discovered the questionable accounting in its review of a registration statement late in 1979. This questionable accounting treatment increased operating income 9.3% for fiscal 1977 and 4.3% ($1 million) for fiscal 1978.

AAER No. 22: U.S. Surgical—OTC

The complaint alleges that the firm engaged in an irregularity that included (1) falsified purchase orders and other documents, (2) recognition of revenue on unordered products, (3) falsely claimed consignments to European distributors, and (4) capitalized period expenses. The SEC charged overstatement of pretax earnings by $18.4 million from 1979 to 1981. The SEC charged seven top executives with violating the antifraud and accounting provisions of the securities law. A substantial portion of these executives' compensation depended on reported earnings.

AAER No. 30: Doughtie Foods—OTC

The complaint alleges that an inventory overstatement resulted from an irregularity by an officer who desired to make himself appear more productive by understating his division's cost of goods sold. The officer "fooled" the independent auditors by using fraudulent count sheets during the annual audits. By the middle of 1982 Doughtie Foods had overstated inventory by $650,000. Net income was overstated by 15%, 39%, and 7% for Doughtie's fiscal years 1980, 1981, and the first six months of 1982, respectively.

AAER No. 31: Datapoint Corporation—NYSE

The complaint alleges an irregularity included full recognition of sales revenue on unordered merchandise, canceled orders, and partial shipments. Management actively attempted to deceive the auditors. These practices increased 1981 revenue (net income) by $21,000,000 ($5,000,000) thereby increasing the bonuses of top managers.

AAER No. 35: Stauffer Chemical Company—NYSE

The complaint alleges that the company overstated its 1982 earnings by $31.1 million (of a total of $121 million) by overstating sales and inventory. *GAAP* (*SFAS No. 48*) requires a delay in revenue recognition if a right to return exists. More than 40% of the products recognized as sold in 1982 under Stauffer's early-order plan were returned in 1983. Thus, product transfers under the early-purchase program were a consignment arrangement, not sales.

AAER No. 40: Chronar Corp.—OTC

The complaint alleges that Chronar recognized contract revenues over two fiscal years despite a contractual disagreement with customers that resulted in nonpayment. *GAAP* requires that sales not be recognized if major uncertainties exist concerning whether the seller has met relevant contract conditions and the revenue is collectible. The SEC inquiry resulted in a reduction of revenue for the year ending 3/31/83 of $1.8 million, thus changing previously reported net income to a loss of $1,792,000 as opposed to a $8,000 profit. Also, income for the year ending 3/31/84 was $858,000 lower than previously reported. The SEC censured Seidman & Seidman as a result of the audit because neither the audit report nor the notes to the financial statements indicated that uncertainty existed concerning the value of receivables.

AAER No. 42: Oil Tech—OTC

The complaint alleges that Oil Tech recognized revenues from incomplete drilling and failed to write off worthless receivables. *GAAP* requires the completion of major revenue-producing functions before recognizing sales revenue. As a result of the irregularity, income for the 1980 fiscal year was overstated by 44% and income for the first nine months of 1981 was overstated by 93% or $270,000.

AAER No. 44: Florafax Inc.—OTC

The complaint alleges that Florafax violated *GAAP* by improperly recognizing revenue on shipments of flower containers that had not been authorized by florists and other customers. As a result of these accounting practices, operating income was overstated by $331,000 for the 1981 fiscal year. This was approximately 12% of reported income and served to increase executive bonus compensation.

AAER No. 45: Digilog Inc.—OTC

The complaint alleges that Digilog accounted for Digilog Business Systems (DBS) as if it were an independent company despite the fact that DBS was financed and controlled by Digilog who held notes convertible into 90% of its common stock. Digilog also guaranteed the debt of DBS. The SEC argues that the economic substance of this relationship was control of DBS by Digilog. *Accounting Research Bulletin No. 51* states, "the aim [in deciding consolidation policy] should be to make the financial presentation which is most meaningful in the circumstances." Thus, the financial statements of Digilog should have been consolidated to reflect the financial losses of DBS. With consolidation, Digilog would have reported a pretax loss for 1981 of $449,000 as opposed to the reported income of $10,591. In consolidation with DBS, Digilog would have reported a 1982 pretax income of $1,183,000 as opposed to the $2,382,441 actually reported.

AAER No. 48: Charter Co.—NYSE

The complaint alleges that consistent with its revenue recognition policies for most insurance products, Charter recognized a high percentage (35%) of the total profits to be earned from single-premium deferred annuities at the time of sale. In contrast, the SEC viewed these products as an investment contract, similar to a certificate of deposit. The agency believed that Charter should recognize revenue from single-premium deferred annuities as earned over the life of the investment. The SEC recognized that neither *FASB No. 60* on life insurance accounting nor the *Audit Guide for Stock Life Insurance Companies* prohibited Charter's approach. Rather, the agency cited the more general "substance over form" approach as articulated in *APB Statement No. 4*. In the SEC's view, the substance of the single-premium deferred annuities was an investment, not an insurance contract; thus, the recognition of substantial profit in the year of sale was inappropriate.

AAER No. 49: Zondervan Corp.—OTC

AAER No. 49 reports that Zondervan overstated the value of inventory, other tangible assets, and royalty due. The fraud included misstatements to the independent auditor. The correction of this fraud negated all of reported earnings for 1984.

AAER No. 63: Oak Industries—NYSE

AAER No. 63 charges that Oak's management received reports from its subsidiaries quantifying losses from obsolete, excessive, and defective inventories. Yet, Oak failed to increase its inventory reserves and withheld this information from its independent auditor. Oak's restatement reduced its 1982 net income of $44 million to a loss of $40 million.

AAER No. 65: Pepsico Inc.—NYSE

The complaint alleges irregularities at Pepsico's United Beverages International Unit including failure to write off broken bottles, uncollectible receivables, and obsolete inventory. Executives also falsified expenses. Pepsico's 1982 annual earnings reflected a $79.4 million-dollar charge related to accounting irregularities.

AAER No. 72: Southwest Bancshares—NYSE

The complaint alleges that quarterly earnings targets rather than the quality of its loan portfolio determined loan charge-offs and the level of loan reserves. "Southwest failed to conduct adequate evaluations of its loan loss reserve and charge-off needs as required by *GAAP*." The error affected quarterly but not annual results. The quarterly statements had already been corrected on the advice of its auditor prior to the SEC's investigation.

AAER No. 73: Tonka Corp.—NYSE

The complaint alleges an officer made an unauthorized and improper investment of $2 million in company funds. *AAER No. 73* stressed the importance of maintaining a system of internal accounting control for investments that provide reasonable assurance that assets are properly accounted for and used in accordance with management's authorization. Eventual insurance reimbursement allowed Tonka to avoid a financial loss.

AAER No. 74: Baldwin-United—NYSE

The complaint alleges deficiencies in Baldwin's method of accounting for single-premium deferred annuities. Baldwin recognized income on a "present value" basis which "front loads" income recognition. The SEC pointed out that (1) Baldwin's income and interest assumptions were never realistic and (2) management realized their errors by early 1982 but did not adjust the income recognition pattern. Also, in 1982 Baldwin recognized income from a purchased loss carryforward despite circumstances that made tax realization of that carryforward very remote. The SEC estimated that Baldwin's net income overstatement for 1982 was $164 million.

AAER No. 80: Savin. Corp.—NYSE

AAER No. 80 questions Savin's capitalization of research and development costs associated with a new line of photocopiers because the 8000 series copiers were not an existing product. Thus, capitalization is in conflict with *FASB No. 2*. These *R&D* costs occurred over the four-year period, 1981 to 1984. At minimum, the agency believed that the deferred cost should have been written off in fiscal 1983 when the costs had no more economic benefit due to the discontinuation of the low end of the 8000 series. The understatements of losses were $3 million, $26 million, $38 million, and $7 million for 1981, 1982, 1983, and 1984, respectively. At settlement on November 12, 1985, the firm consented to write off $48.7 million.

AAER No. 90: Interregional Financial Group—NYSE

The complaint alleges that the firm understated its allowance for uncollectible receivables. In fact, the firm had a second set of records that showed the correct amounts. As of 12/3/81 (9/30/82), the allowance was $16.2 million ($33.9 million) when it should have been $57.3 million ($89.3 million). The auditor failed to discover these discrepancies during the audit for 1981 but did discover the problem during the 1982 annual audit.

AAER No. 100: Automatix Inc.—OTC

AAER No. 100 alleges that Automatix's revenue recognition policies were not in accordance with *GAAP* because it recognized revenue on goods that had not been shipped and recorded revenue on equipment shipped on a trial basis.

AAER No. 101: American Express Company—NYSE

AAER No. 101 criticizes Fireman's Fund's income recognition from reinsurance transactions. Fireman's Fund and other insurers swapped groups of pensions resulting from workers' compensation claims. The swap resulted in an accounting gain. The SEC believed that recognition of a gain on the swaps was not appropriate because the risk of loss had not been transferred. These swap transactions increased pretax income $54 million dollars in 1981 and $40 million dollars in 1982. Both American Express and its auditor, Arthur Young & Co., continued to defend this accounting. SEC commissioner Fleischman formally disagreed with the decision citing "conflicting authoritative guidance."

AAER No. 124: Marsh & McLennan Cos.—NYSE

AAER No. 124 criticizes the lack of internal controls over the operations of the firm's investment group. Without any separation of duties, the cash manager both directed and accounted for cash transactions and entered into unauthorized repurchase agreements on long-term government bonds. As of March 1984, top management was not aware that the company had a two-billion-dollar commitment to purchase long-term bonds. Losses on some repurchase agreements were recognized as increases in the price of new investments rather than booked as period expenses. Thus, losses of $55 million and $110 million before tax were not booked in fiscal 1983 and the first quarter of fiscal 1984, respectively.

AAER No. 125: Storage Technology—NYSE

AAER No. 125 alleges that, commencing during 1982 until the first quarter of 1985, the firm did not comply with *GAAP* in reporting sales revenues. *GAAP* requires that revenue recognition be deferred until the major revenue-producing functions are completed and collection (adjusted for an allowance) is certain. STC recognized revenue on the basis of shipment despite uncertainties concerning customers' willingness to accept and pay for the products. Early revenue recognition increased net income for 1982 by $16 million to $64.7 million and increased net income for the second quarter of 1983 by $4.8 million.

AAER No. 128: Continental Illinois Corp.—NYSE

AAER No. 128 questions Continental's use of the term "losses on the sale of loans" to describe the disposition of problem loans at a deep discount as part of a federal bailout. Rather, the SEC believes that the term "loan losses" would properly indicate that Continental's management was responsible for the losses.

AAER No. 132: Wespercorp Corp.—AMEX

AAER No. 132 alleges that Wespercorp prematurely recognized revenue on the manufacture of memory boards, turn-key computer systems, and disk drives prior to shipment or—in some cases—receiving a valid purchase order. *GAAP* requires that revenue not be recognized until the earnings process is virtually complete and exchange has taken place. These restatements lowered quarterly income for the second and third quarter of 1983 by $248 million.

AAER No. 134: First Chicago—NYSE

AAER No. 134 alleges that the firm's loan loss reserve for the year ending 12/31/83 was too low and that it chose not to write off certain large loans despite evidence that the probability of loss was very high. As a result, net income for 1983 was overstated by $46 million (25%). *GAAP* requires recognition of losses inherent in the loan portfolio.

AAER No. 135: Healthdyne Inc.—OTC

AAER No. 134 alleges that Healthdyne's third-quarter report for 1983 was not in accordance with *GAAP* because it recognized revenue without considering that many of its infant-monitoring devices were being returned for credit. As a result, revenues for the third quarter of 1983 were overstated by $1,200,000. The defective monitors were written off in the fourth quarter of 1983.

AAER No. 143: Cardillo Travel Systems Inc.—AMEX

AAER No. 143 alleges that Cardillo attempted to recognize a $203,210 payment from United Airlines to install the Apollo reservations system as income for fiscal 1985. While recognizing the advance as income was critical to avoid defaults on credit lines, the SEC and Cardillo's auditors believed that the $203,210 should be deferred and amortized as income over the life of the Apollo lease.

AAER No. 145: Widcom Inc.—OTC

This release alleges that Widcom prematurely recognized revenue of $643,000 on three telecommunications contracts that allowed the customer full cancellation rights. Under these circumstances revenue recognition is inappropriate because the earning process is not complete. The profits on these contracts constituted close to 70% of fiscal 1985 earnings. Moreover, management of Widcom provided false statements to the auditors concerning these contracts.

AAER No. 146: Texas Commerce Bancshares—NYSE

AAER No. 146 alleges that the company underestimated loan losses by failing to write off certain large loans. *FASB No. 5* implies that losses should be accrued if probable as of the balance sheet date and the amount of the loss can be reasonably estimated. Certain large loans met those criteria in December 1984. An audit by the Controller of the Currency forced those write-offs in April 1985.

AAER No. 151: Allegheny Int.—NYSE

The release alleges that the firm failed to disclose numerous perks given to its former chairman and other executives over the four-year period, 1981 to 1985. The chairman left the firm. To settle, Allegheny agreed to establish an independent audit department reporting directly to the board of directors.

AAER No. 153: Financial Corporation of America—NYSE

The commission charged that from 1980 through 1982 the company prematurely recognized revenue (and income) resulting from "buy/sell" transactions. In the SEC's view these transactions did not transfer risk of loss from the seller to the buyer; thus, the agency cited the "substance over form issue" from *APB Statement No. 4* to challenge FCA's accounting. The commission's staff calculated that income was overstated by $13 million in 1980 and $7 million in 1981.

AAER No. 160: Flight Transportation Co.—OTC

The release charges that the firm's initial public offering overstated revenue for the year ending June 1981 by $15 million. The issue is fraud rather than any ambiguity concerning an accounting treatment. In all, $23.7 million was recovered from the firm and returned to shareholders. Claims exceeded $45 million.

AAER No. 164: Texscan Corp.—AMEX

AAER No. 164 alleges that Texscan materially overstated its net income on interim reports during the 1984 and 1985 fiscal years by (1) recognizing revenue from sales prior to shipment, (2) improperly applying percentage of completion accounting, and (3) improperly accounting for an acquisition. As a result of these errors, net income for 1984 was $1.4 million as opposed to a corrected loss of $200,000.

AAER No. 169: Flexible Computer Corp.—OTC

AAER No. 169 reports that contrary to *GAAP* the firm recognized revenue on the shipment of its computers despite contingencies including (1) customers' receipt of funding from third parties, (2) customers' subsequent resale to a third party, and (3) customers' right to return the product. When the company restated financial results for 1985 and the first three quarters of 1986 the net loss for the nine months ending 9/30/86 increased by $1.8 million to $5 million and the net loss for the year ending 1985 increased by $1.1 million to $8.7 million.

AAER No. 170: Kaypro Corp.—OTC

The complaint alleges that Kaypro's earnings for the second and third quarters of 1984 were false and misleading because it ignored reports of inventory shortages and used an unrealistic estimate of the gross profit percentage to calculate cost of sales until forced to correct these errors by its auditor. The amount missing from its storage area, a circus tent, was eventually determined to be $15.6 million, which caused a loss for the fiscal year ending 8/31/84 of $267,683.

AAER No. 171: The Cannon Group—OTC

The complaint alleges that Cannon materially underamortized firm costs by initially overestimating the anticipated revenues it would receive from certain films. The firm recognized $46 million in revenue from licensing its film library while ignoring that significant substantive terms had not been agreed upon at the time of revenue recognition. As a result of this error, Cannon overstated retained earnings for 12/28/85 by $31.8 million.

AAER No. 181: Columbia Savings & Loan—OTC

This release reports that from 1979 through 1986 the company made false entries that overstated the income generated by mortgage-backed securities. This fraud increased income for the first three quarters of 1986 by $14,058,000 but was discovered during the annual audit for 1986.

AAER No. 183: E. F. Hutton—NYSE

This release alleges that Hutton failed to disclose a reasonably possible contingency as required under *SFAS No. 5*. Starting in 1982, the firm marketed customized securities known as "upper floaters" that protected customers from loss of income due to interest rate declines. In effect, E. F. Hutton was a guarantor with a contingent liability; however, the firm did not disclose this contingent liability to its shareholders until 1986 when it suffered losses to honor its guarantee. Only then did the firm create a $55 million reserve for losses on these "upper floaters."

AAER No. 184: Allnet Communications—OTC

The complaint alleges that Allnet was keeping receivables on the books despite having cut off phone service to those customers. The probability of collection in these cases was remote; thus, *GAAP* required a more timely write-off. Also, the firm did not keep detailed aging analyses of accounts receivable. In the third quarter of 1985, Allnet increases in its reserves for uncollectible receivables by $15 million, but the SEC determined that at least $7.8 million had occurred in prior quarters.

AAER No. 185: AM International—NYSE

The release reports that in 1980 the chief financial officer held the books open for an extra month, allowing the recognition of an extra $500,000 of income. Also, the firm recorded goods out on consignment as sold, allowing for an extra $3 million of income.

AAER No. 189: Endotroncis, Inc.—OTC

The complaint alleges that the firm recognized $3.4 million in sales revenue despite the fact that payment was contingent on customer satisfaction. Revenue on the basis of contingent sales is not consistent with *GAAP*.

AAER No. 194: American Savings and Loan of Florida —NYSE

The complaint alleges that the registrant failed to disclose its exposure to losses on repurchase agreements with ESM Securities in its SEC filings. The collapse of ESM caused an eventual loss of $68,726,000.

AAER No. 196: Electro-Catheter Corp.—OTC

The complaint alleges that the firm inflated the company's profits from 1983 to 1986 by at least $1.4 million by prematurely recognizing revenue upon shipment of its finished goods to a distributor despite the following contingencies: (1) the distributor did not bear the risk of decline in the market value of the goods, (2) Electro-Catheter insured the inventory against theft, fire, etc., (3) the firm bore the cost of leasing the warehouse where the goods were stored, and (4) the distributor would pay the firm only after sale to a final customer. Thus, the SEC believed that the risk of loss had not passed to the customer and revenue recognition was inconsistent with *GAAP*.

AAER No. 197: Windsor Industries—OTC

The complaint alleges that the management of Windsor's Hamilton Corp. subsidiary falsified inventory tags during the 1982 and 1983 physical inventory counts, resulting in income overstatement of at least $2 million. Windsor's president and chief financial officer failed to put in place an adequate control system that would minimize asset misstatements.

AAER No. 202: American Biomaterials Corporation—OTC

The complaint alleges that from 1984 through 1987 the firm failed to report payments made to officers for personal use and misrepresented the prospects of the firm's products to the public. Over $3 million in payments were fraudulently classified and reported.

AAER No. 205: Intex Software—OTC

The complaint alleges that Intex's officers violated the antifraud provisions of the Securities Act of 1934 in their initial public offering by failing to disclose (1) unauthorized personal use of more than $1 million in corporate funds, (2) funds paid to underwriters, (3) inflated revenue and accounts receivable, and (4) uncertainty surrounding the validity of contracts and orders for Intex's products. The firm treated $492,000 received through the sale of options as revenue.

AAER No. 207: Matrix Science Corp.—OTC

The complaint alleges that Matrix increased quarterly earnings in 1986 and 1987 by preinvoicing—recording revenues on orders that were not yet shipped to Matrix's customers. As the amount of preinvoicing increased, frequently months passed between the date an order was recorded and the date when the merchandise was actually shipped to the customer. Preinvoicing increased Matrix's income by $2.126 million for the first six months of 1987.

AAER No. 212: Rocky Mountain Undergarments Co.—OTC

The complaint alleges that the company falsified its inventory and exaggerated its profits in 1985. Top management decided to inflate quantity and cost figures on inventory count sheets for the raw material inventory, and the supplier confirmed bogus inventory on consignment for the auditors. The overstatement of 1985 ending inventory resulted in an overstatement of net income of $607,000 (134% of what net income would have been in the absence of fraud). The SEC also alleged that the firm made numerous misrepresentations to its auditor.

AAER No. 213: DSC Communications—OTC

The release reports that DSC recognized revenue on the basis of product completion rather than delivery and acceptance by the customer. DSC created a pool of inventory to supply its major customer, Sprint, who was not under obligation to pay for the equipment until it was installed at their site. The SEC argued that revenue recognition was premature under these circumstances. Earnings for 1984 were overstated by $18.2 million (30%).

AAER No. 215: Regina Inc.—OTC

The release reports that the firm fraudulently inflated revenue and profits for the year ending 6/30/88 by not recording $12 million in product returns, creating false sales invoices of $5 million, recognizing $6 million of revenue on unshipped "sales," and understating cost of sales. Including these fraudulent transactions, reported income for the year was only $11 million.

AAER No. 224: Matthews & Wright Group—AMEX

The release charges that late in 1985 the firm fraudulently predated municipal bond transactions in order to obtain favorable tax treatment. The scheme involved $768 million in checks written to nonexistent checking accounts. Moreover, the bond proceeds were used for purposes that differed from those stated on the bond offering. The eventual penalties included the loss of the firm's brokers' license.

APPENDIX B

Initial Public Offerings Among AAERs No. 1 to No. 224 (Issued Between April 1982 and April 1989)

AAER	Company	Auditor
1(196–3)	Omni Rx Health System	*Seidman & Seidman
1(227–2)	Western Properties	*Laventhol & Horwath
1(227–3)	Co-Build Companies	*Laventhol & Horwath
1(292–2)	Geon Industries	*Arthur Andersen & Co.
12	Security America	*Coopers & Lybrand
33	Barden Corp.	*ND*#
36	Bell & Beckwith (Toto Ltd., Japan)	Todman & Co. (CPA)
40	Chronar	Seidman & Seidman
42	Oiltech	*Holben & Savane
47	BTK Industries	*ND*
61	Balance Computer	*ND*
64	Crime Control	*Coopers & Lybrand
66	Cymaticolor Corp.	*Winter & Co.
69	American Davy	*David Rogers
79	Horizon Tech, Inc.	*ND*
81	Flight Transport	*Fox & Co.
92	Diversified Technologies	*Ron Harrington
99	Time Energy Systems	*Main Hurdman, KMG
107	Gemcraft, Inc.	Kenneth Leventhol
111	Citel Inc. & Tricomp Sensors	*Main Hurdman, KMG
115	Quantum Financial Services	*Huber, Erickson & Butler
119	Computer Input Services, Inc.	Laventhol & Horwath
122	Berk & Co., Inc.	Touche, Ross & Co.
131	Psych Systems, Inc.	Alexander Grant & Co.
142	Endo-Lase, Inc.	*ND*
145	Widcom, Inc.	Arthur Andersen
153	Financial Corp. of America	Peat Marwick Mitchell
156	Universal Money Centers	Laventhol Horwath

AAER	Company	Auditor
160	Flight Transport Corp.	Fox & Co.
162	Computer Store, Inc.	*ND*
163	Video Station, Inc.	*ND*
172	Computer Input Services	*Stephen Grossman
176	Colonial X-Ray Corp.	*ND*
186	Petrofab Int., Inc.	Price Waterhouse
187	American Biomaterials Corp.	Peat Marwick Mitchell
188	Stereo Village	*ND*
190	Cali Computer System	Peat Marwick Mitchell
195	Advanced Biotherapy Concepts	*D. M. Lamoreaux
204	Colonial International Import	*Larry Dixon
210	Elana, Inc.	*ND*

* An asterisk indicates that the auditor was censured by the SEC.
# *ND* indicates that the auditor was not disclosed in the *AAERs*, *Who Audits America*, *Compact Disk Disclosure*, or the *Moody's Manuals*.

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