The SEC's Use of Voluntary Disclosure for the Oversight of Mandatory Disclosure

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May 24, 2023

The Comment Letter Process

1. SEC regularly reviews companies' filings to ensure that investors have access to high-quality disclosures (SEC 2019).

2. SEC identifies disclosures that may be materially deficient in **explanation** or inconsistent with accounting standards. Company response letters often include information not previously available and may also include additional schedules or exhibits

3. Public interest in CL correspondence is driven by the fact that the SEC can get answers to questions that analysts and investors might struggle to get answers to on their own (Cunningham and Leidner 2022).

Motivation

1. When conducting these reviews, the DCF reviewers suffer from a classic asymmetric information problem – they do not have access to the **same information** as corporate managers.

2. How does the SEC formulate the questions?

Motivation

"Please revise this section to include substantive disclosure on prospective developments and strategies that may affect your company. Your current disclosure on pages 24 and 25 lists factors that broadly affect your segments, but there is an absence of disclosure addressing management's views about the trends and uncertainties that you reasonably expect will have material impacts on your operations. We note that management expressed opinions regarding specific expectations for organic revenue growth, foreign exchange impacts, operating margin outlook, seasonality and pension expense, in your earnings call on February 20, 2015."

SEC Comment Letter to BARNES GROUP INC filed on April 1, 2015

Research Questions

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2. Under what circumstances is the SEC more or less likely to use earnings conference calls to monitor annual reports?

3. How do CLs that refer to earnings conference calls affect firms' voluntary disclosures in future calls and the price discovery of associated earnings announcements?

Conference call

Earnings conference calls possess three key features that make them unique:

- happen right after earnings announcements. The information delivered during conference calls has high relevance.
- information delivered during conference calls has high credibility.
- the interactive component of conference calls may lead managers to offer more information than initially planned.

Conceptual Framework

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- Over **97%** of the DCF staff indicate that they are willing to "put in the extra effort to get a job done." (Office of Personnel Management 2014).

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Reasons for NOT using conference calls:

- SEC is resources constrained.
- Blurs the boundary between mandatory and voluntary disclosures, and **increases** firms' estimates of voluntary disclosure costs to be more in line with those of mandatory disclosure costs

Hypothesis Development

Given the potential benefits and costs mentioned above, we state our H1 in the null form:

H1: The DCF reviewers do not use voluntary disclosures from conference calls to assist in their monitoring of mandatory disclosures.

Hypothesis Development

Next Question: Under what circumstances is the SEC more or less likely to use earnings conference calls to monitor annual reports?

- DCF reviewers employ a risk-based approach

- Use conference calls when the costs of doing so (to themselves) are likely lower and/or the expected benefits to investors are likely higher

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H2b: The DCF reviewers' initial perception of a firm's mandatory disclosure quality or their perception of their interaction with a firm during the review process will not prompt them to use voluntary disclosures from conference calls to assist in their monitoring of mandatory disclosures.

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H2a: Great uncertainty and negative tone in mandatory disclosures will not prompt the DCF reviewers to use voluntary disclosures from conference calls to assist in their monitoring of mandatory disclosures.

H2b: The DCF reviewers' initial perception of a firm's mandatory disclosure quality or their perception of their interaction with a firm during the review process will not prompt them to use voluntary disclosures from conference calls to assist in their monitoring of mandatory disclosures.

H2c: High media attention, more corporate events, and abnormal return and trading volume around earnings announcements will not prompt the DCF reviewers to use voluntary disclosures from conference calls to assist in their monitoring of mandatory disclosures.

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H2b: The DCF reviewers' initial perception of a firm's mandatory disclosure quality or their perception of their interaction with a firm during the review process will not prompt them to use voluntary disclosures from conference calls to assist in their monitoring of mandatory disclosures.

H2c: High media attention, more corporate events, and abnormal return and trading volume around earnings announcements will not prompt the DCF reviewers to use voluntary disclosures from conference calls to assist in their monitoring of mandatory disclosures.

H2d: Resource constraints will not reduce the DCF reviewers' incentives to use voluntary disclosures from conference calls to assist in their monitoring of mandatory disclosures.

Hypothesis Development

Our third and final research question: How do comment letters in which the reviewers make reference to earnings conference calls affect firms' voluntary disclosures in future conference calls and the informativeness of those calls?

- Regulatory oversight **blurs** the boundary between voluntary and mandatory disclosures.
- Firms might **scale back** their future voluntary disclosures.
- Reducing voluntary disclosure may have **negative** market consequences.

Hypothesis Development

H3a: The DCF reviewers' use of voluntary disclosures from conference calls to assist in their monitoring of mandatory disclosures in annual reports has no effect on firms' future voluntary disclosures.

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H3b: The DCF reviewers' use of voluntary disclosures from conference calls to assist in their monitoring of mandatory disclosures in annual reports has no effect on price discovery around associated earnings announcements.

Data

Sample period: 2004 - 2019.

Data on CLs: Audit Analytics, supplement with hand collections.

Other data: CapitalIQ, Compustat, CRSP, IBES, Seeking EDGAR, Thomson Reuters

Final sample: Consists of 14,562 unique CLs, 761 CL_CCs (CL on conference calls) after restricting our sample to fyears with conference calls and CLs.

Panel B: CL_CCs over time

	CL_CCs (1)	CLs (2)	% firms receiving CL_CCs (3)
2004	3	809	0.371%
2005	3	1,069	0.281%
2006	3	986	0.304%
2007	14	1,165	1.202%
2008	47	1,314	3.577%
2009	61	1,332	4.580%
2010	59	1,073	5.499%
2011	102	1,187	8.593%
2012	87	1,097	7.931%
2013	90	881	10.216%
2014	100	865	11.561%
2015	82	857	9.568%
2016	46	730	6.301%
2017	19	481	3.950%
2018	18	340	5.294%
2019	27	376	7.181%
Total	761	14,562	5.226%

Panel D: Summary statistics of CL_CC characteristics

Variable	N	Mean	Std.Dev	p25	Median	p75
CL_CC first round	761	0.859	0.348	1.000	1.000	1.000
CL_CC rounds	761	1.243	0.583	1.000	1.000	1.000
Presentation	761	0.808	0.394	1.000	1.000	1.000
Q&A	761	0.183	0.386	0.000	0.000	0.000
Business	761	0.097	0.296	0.000	0.000	0.000
Risk Factors	761	0.034	0.182	0.000	0.000	0.000
Properties	761	0.005	0.072	0.000	0.000	0.000
Legal Proceedings	761	0.001	0.036	0.000	0.000	0.000
Market for Registrant's Common Equity	761	0.004	0.063	0.000	0.000	0.000
MDA	761	0.633	0.482	0.000	1.000	1.000
Financial Statements and Supplementary Data	761	0.216	0.411	0.000	0.000	0.000
Changes in and Disagreements with Accountants	761	0.001	0.036	0.000	0.000	0.000
Controls and Procedures	761	0.001	0.036	0.000	0.000	0.000
Executive Compensation	761	0.003	0.051	0.000	0.000	0.000
Exhibit and Financial Statement Schedules	761	0.007	0.081	0.000	0.000	0.000
Other	761	0.016	0.125	0.000	0.000	0.000

The usage of conference calls shows an increasing trend until it reaches a peak of 11.5% in 2014. The usage fluctuates after 2014, but it never drops below 3.9%.

The reviewers are more likely to reach out to conference calls to collect information when they first check firms' annual reports.

Variable	(1)	(2)	(3)
Uncertainty	1.774***		1.419*
	(0.682)		(0.734)
Negative tone		0.948**	0.655
		(0.393)	(0.423)

Variable	CL_CC (1)	CL_CC (2)	CL_CC (3)
Ln(# first CL words)	0.053***		0.039***
	(0.004)		(0.006)
# first CL topics		0.003***	0.001***
		(0.000)	(0.000)

Variable	CL_CC subsequent (1)	CL_CC subsequent (2)	CL_CC subsequent (3)	CL_CC subsequent (4)
#CL rounds	0.014***			0.015***
	(0.002)			(0.002)
Ln (# CL conversation days)		0.006***		-0.001
		(0.001)		(0.001)
First CL extension			0.006**	0.005*
			(0.003)	(0.003)

Variable	(1)	(2)	(3)	(4)	(5)
Ln(# news articles)	0.004***				0.003**
	(0.001)				(0.001)
Ln(# 8Ks)		0.007***			0.005**
		(0.002)			(0.002)
Abnormal return			0.012***		0.007*
			(0.004)		(0.004)
Abnormal volume				0.006***	0.004*

Variable	(1)	(2)	(3)
Busyness	-0.016***		-0.016***
	(0.005)		(0.005)
High CL period		-0.012***	-0.011***
		(0.004)	(0.004)

DCF reviewers are more likely to use disclosures from conference calls when they believe there is material information from these voluntary disclosures that can improve mandatory disclosures.

Less likely to check if they are busy.

Consistent with our hypothesis.

Consequences

$$Voluntary\ disclosure_{it} = \beta_0 + \beta_1 Post\_CL\_CC + \beta_2 Post_{it} + \beta_3 FirmCharacteristics_{it} + Firm\ FE + Year\ FE + \varepsilon_{it}. \quad (2)$$

pre-treatment period as the four quarters prior to the first comment letter commenting on earnings calls and the post-treatment period as four quarters following the letter for our treatment group.

Control firms are matched by industry, year, firm size, and the number of comment letters received in the prior two years (i.e., the two-year window is chosen because each review cycle is three years).

The coefficient of interest is β_1. It captures the effects of the potential impact of CL_CC on firms' voluntary disclosure.

Panel A: Receiving CL_CCs on firms' future CC-related disclosures

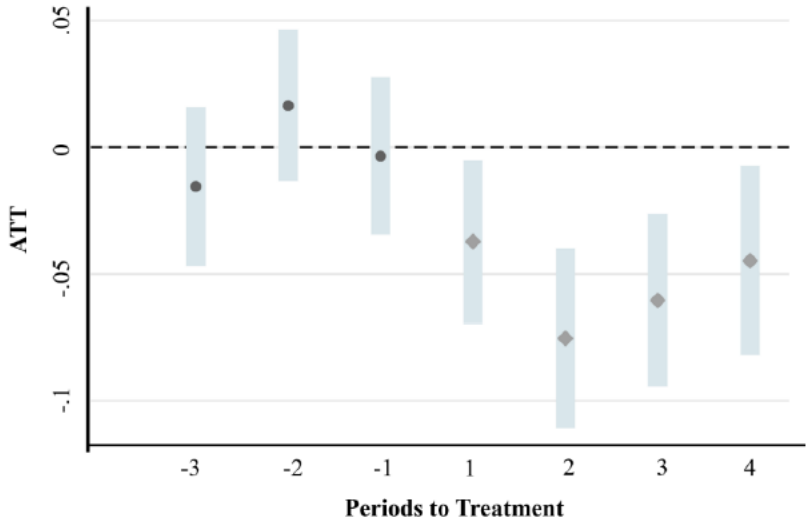
Variable	Ln(Length of earnings call)	Ln(# words)	Ln(# numbers)	Ln(# topics)	CC_composite
	(1)	(2)	(3)	(4)	(5)
Post * CL_CC	-0.042***	-0.043***	-0.033***	-0.032***	-0.175***
	(0.010)	(0.010)	(0.009)	(0.010)	(0.040)
Post	0.011	0.011	0.004	0.012	0.045
	(0.011)	(0.011)	(0.010)	(0.009)	(0.045)

Panel B: Average treatment effects on treated (ATT) before and after the treatment

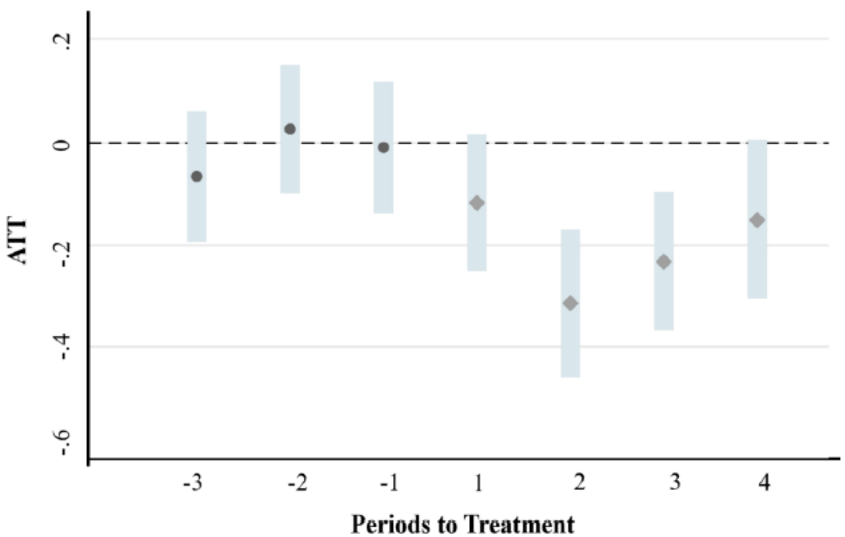
Variable	Ln(Length of earnings call)	CC_composite
	(1)	(2)
Pre-treatment_avg	-0.001	-0.016
	(0.006)	(0.025)
Post-treatment_avg	-0.054***	-0.203***
	(0.014)	(0.058)
q - 3	-0.015	-0.065
	(0.016)	(0.065)
q - 2	0.016	0.027
	(0.015)	(0.064)
q - 1	-0.003	-0.009
	(0.016)	(0.066)
q + 1	-0.037**	-0.117*
	(0.016)	(0.068)
q + 2	-0.075***	-0.314***
	(0.018)	(0.074)
q + 3	-0.06***	-0.231***
	(0.017)	(0.069)
q + 4	-0.045**	-0.150**
	(0.019)	(0.080)

Regulators' use of voluntary disclosures in their monitoring of firms' mandatory disclosures has a chilling effect on firms' voluntary disclosures.

Panel A: Conference call length (*Ln(Length of earnings call)*)



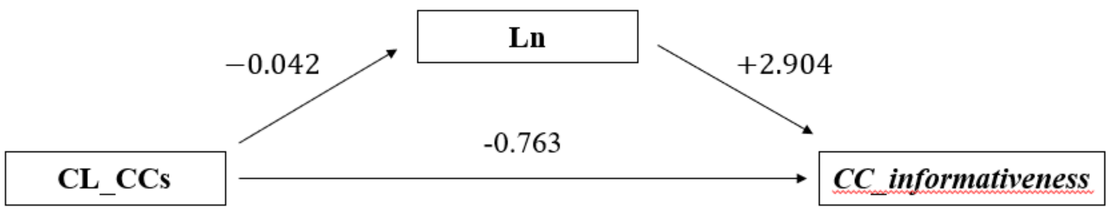
Panel B: The composite measure of conference call disclosures (*CC_composite*)

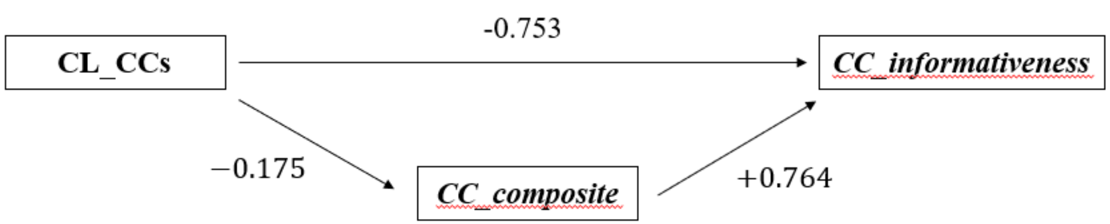


Most of the actions seem to be around the timing of CL on the conference call

Panel A: Receiving CL_CCs on firms' conference call informativeness

Variable	CC_informativeness		
	(1)	(2)	(3)
Ln(Length of earnings call)		2.904***	
		(0.506)	
CC_composite			0.764***
			(0.162)
Post * CL_CC	-0.887*	-0.763*	-0.753*
	(0.419)	(0.413)	(0.407)





We find that conference call informativeness decreases post CL_CC, and the decreases are partly explained by the decreases in the content of the conference call

Closing Remarks

One key challenge of regulatory oversight is information asymmetry between the regulator and the regulated.

In this paper, we rely on a unique setting whereby regulators use firms' voluntary disclosure to facilitate their review process to gain a better understanding of the determinants and consequences of such regulatory practice.

We find that those inquiries reduce firms' incentives to engage in future voluntary disclosures resulting in a worse information environment

Regulators face important tradeoffs when learning about what information known to management via scrutinizing voluntary filings while overseeing mandatory filings.

Questions?

Additional Thoughts

SEC was created because of **market failure (i.e. stock market crash in the 1920s)**, which is an economic inefficiency that results from the free market itself and can potentially be corrected through government regulation.

However, SEC is not perfect and faces its own set of constraints (e.g. budget constraints, capture, and staffing constraints).

We suggest that SEC also faces knowledge constraints.

Some anecdotal evidence

"Management views this information as anecdotal. This data is not material to our analysis of the company's results of operations, nor is it used to forecast sales. We have provided it to respond to analyst inquiries, adding color to the discussion of quarterly sales."

Applied Industrial Technologies Inc