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Discussion

Discussion of 'Analyzing late SEC filings for differential impacts of IS and accounting issues'

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1. Introduction

This interesting study investigates equity market reaction to the announcement of SEC late filings. Not surprisingly, given the sanctioning power of the SEC and the potential attendant economic costs, and consistent with the extant literature, the authors find that equity markets react negatively to the announcement of SEC late filings for a broad sample of annual 10-K and quarterly 10-Q late filers. More importantly, this study also examines the extent to which the market reacts differentially to the announcement of SEC late filings conditioned on the reason for the SEC late filing as expressed in Form 12b-25, Notification of Late Filing (NT filings). Inter alia, the authors find that the market response is significantly more negative for Information Systems (IS) related reasons for late filing than for other reasons, including problems with Accounting Quality, SOX implementation, Going Concern and, depending on the analysis, even SEC investigations. The authors argue that this result reflects the pervasiveness of IS in corporate financial reporting. In particular, delayed filing due to IS sends a “strong” negative signal to the market, because it potentially indicates pervasive, if not cascading, internal control problems with the corporate reporting and auditing functions of the firm.

In what follows, Section 2 analyzes the case for the differential market reaction to IS filing delays focusing on the authors' maintained hypothesis, aggregation, market reaction tests and other sundry issues. Section 3 briefly concludes with suggestions for potential future research.

2. The case for the differential impact of IS filing delay

2.1. Maintained hypothesis

The study's maintained hypothesis is that late filings due to IS send a more negative signal to the market about the firm's corporate reporting status than other late filing categories because of IS pervasiveness in corporate reporting. The authors also argue that IS generally lack established channels to convey their failures, as opposed to accounting quality for example, so that IS-related late filings likely come as a bigger surprise to investors.

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The maintained hypothesis is debatable to say the least and certainly contradicts my priors. Although the study cites literature indicating the pervasiveness of Information Technology and IS in corporate reporting and auditing, they fail to cite other literatures, such as the restatements literature for example, indicating the rather pervasive nature of poor accounting and auditing quality in corporate financial reporting. Restating firms often restate because of multiple accounting quality and auditing quality reasons [Callen et al., 2006]. A more nuanced reading of the relevant literatures would have given the authors pause and have led to a more neutral (unsigned) maintained hypothesis. As for the "established channels" argument, it lacks documentation and is highly speculative.

2.2. Aggregation

Aggregation is a potential confounding issue. IS filing delay reasons are included in the NT form under the rubric of Technical Problems. But, Technical Problems include concerns other than pure IS (e.g., telecommunications). How are we to know if the filing delay is really due to IS? Furthermore, many of the late filing categories are quite ad hoc. One could argue that any one of the following filing delay categories (or a subset of them) is an accounting quality issue: Accounting Quality, Auditor Related, Going Concern, SOX implementation, SEC investigations. Therefore, in addition to comparing the IS reason for filing delay to each of these other filing delay categories, the authors might also have compared the IS induced filing delay with subsets of these categories. Fortunately, the authors recognize that the aggregation problem could go in the opposite direction in that IS and other reasons for delay might overlap. In an important sensitivity analysis, the authors combine the SOX and the IS reasons for delay. They find that the combined category is highly negatively significant where IS alone is not significant.

2.3. Market reaction tests

This study uses a standard parametric t-test on excess daily returns to measure the market reaction to delayed filing announcements. This test maintains the assumption of normality. While the event study literature has concluded that normality is a relatively innocuous assumption for firms listed on the NYSE, the literature is far less sanguine about this assumption when the sample includes NASDAQ firms or firms listed on other smaller exchanges for that matter [e.g., Campbell and Wasley, 1996]. Unfortunately, this study fails to specify the exchange listing of the sample firms. Yet, firm size data leads me to conclude that many firms in the sample are not listed on the NYSE. An alternative non-parametric approach based on sign and rank tests is easily implemented and has been shown in simulations to yield meaningful results for large and small cap exchanges [e.g., Corrado, 1989].

The study does not control for potential cross-sectional increases in the return variance induced by the event. But, late filing could generally increase firm risk. This can be easily accounted for using a standard adjustment both for parametric and non-parametric event study approaches [Boehmer et al., 1991; Corrado and Zivney, 1992].

The study uses a CRSP value weighted index as its baseline but the literature has shown convincingly that an equally weighted index is far better specified [e.g., Brown and Warner, 1980].

2.4. Other issues

Some of the study's results are counter-intuitive and need to be rationalized or studied further. The fact that the markets do not react significantly (in the multivariate analysis) to the Going Concern category is one such obvious issue. Why 10-Qs yield stronger results than 10-Ks is also counter-intuitive. Is it a sample size issue perhaps?

What did the authors do to eliminate outliers? This is especially crucial considering that only 2.44% of the sample is comprised of firms that cite IS as the filing delay reason.

The authors do not directly control for industry beyond the IC variable. Surely the delayed filing impact is industry dependent.

A large proportion of firms fail to provide a specific reason for filing delay whereas others provide more than one reason. Are the former different from the sample firms? Is there a sample selection bias here? Are firms that only provide one filing delay reason different from firms that provide multiple reasons?

3. Conclusion

This study offers a fairly convincing case that IS induced filing delays convey an especially negative signal to equity markets. The authors are to be commended for a well-researched and comprehensive analysis.

This study also calls for further research. The idea that, absent established channels to convey their failures, IS induced late filings yield more negative surprises to investors is worth investigating. This conjecture is probably difficult to test with archival data. Instead, experimental tests suggest themselves in which the experimenter varies investor familiarity with the information surprise conveyed by delayed filings.

Archival data could be used to extend this study's implications for the future performance of the firm. Specifically, the researcher could explore whether late filers in fact perform worse than firms that file on time and whether IS-troubled late filers perform worse than other late filers.

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