Firms violating non-accounting securities laws more likely to breach GAAP

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Firms who breach non-accounting securities laws are more likely to subsequently violate accounting rules.

New research published in the *Journal of Business Finance & Accounting* shows a link between non-compliance with securities laws—such as insider trading, stock manipulation and providing false or misleading information about securities or the company's operation—and future Generally Accepted Accounting Principles (GAAP) violations.

The team from Australian National University, Lancaster University and Sungkyunkwan University, Seoul, studied US firms who faced enforcement action from the Securities Exchange Commission (SEC) for breaching non-accounting related laws.

As well as finding a greater number of firms with accounting violations following on from securities laws breaches, they also found that non-compliant firms are more likely to report multiple accounting restatements, demonstrating more severe and systematic problems.

Firms are more likely to breach securities laws if they are larger, younger, performing poorly, and audited by non-Big auditors.

"We found that firms that violate securities laws are more likely to go on to breach GAAP compared to those without non-accounting violations," said report co-author Dr. Xiu-Ye Zhang, of Australian National University.

"Importantly, when we looked at the rates of accounting restatements both before and after the noncompliance, it was only afterwards that there were GAPP violations—showing that once firms violate non-accounting laws, they also start to breach GAAP, suggesting how important non-compliance with securities laws is as a leading indicator that GAAP violations may follow."

Their findings suggest systemic internal control issues within firms exposed by securities non-compliance are more likely to be followed-up with GAAP breaches than would be the case for firms who initiate no such misconduct.

Co-author Professor Steve Young, of Lancaster University Management School, said: "The accounting and compliance systems of a firm are built on a common culture, such as ethical values and integrity from the very top. Therefore, a culture of non-compliance in one area may correlate with problems in other areas, such as financial reporting. Our study shows that non-compliance with securities laws typically involves top management.

"Another factor is that firms seeking to circumvent securities laws often revert to manipulating financial data to camouflage such behaviour. Because non-compliance with laws and regulations typically involves misrepresenting economic reality—such as a firm's performance of value—the accounting system reflects these factors as accountants receive misleading information.

"Our results support the view that accounting outcomes are influenced not only by a firm's control over financial reporting, but also by controls over other business decisions. Weaknesses in compliance control may also indicate weaknesses in accounting control—highlighting the importance of considering a firm's internal control mechanisms as a whole, rather than isolating accounting from the rest of a business."

More information: Sunhwa Choi et al, Noncompliance with non-accounting securities regulations and GAAP violations, *Journal of Business Finance & Accounting* (2019). DOI: 10.1111/jbfa.12377

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