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# Research suggests SEC's increasing focus on terrorism may limit financial oversight

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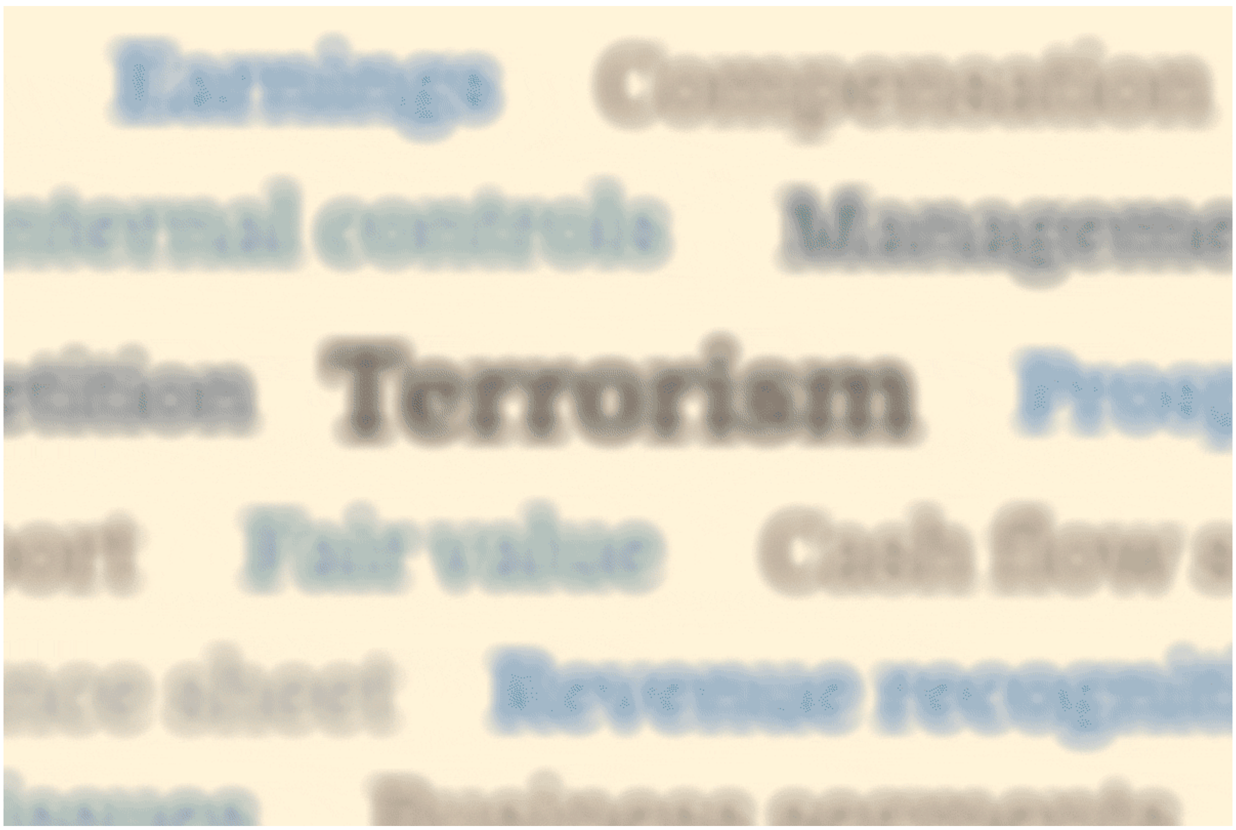


SEC inquiries about potential terrorist ties have grown substantially in recent years, and according to new research from Duke University's Fuqua School of Business, the increase could reduce the quality of the agency's financial reporting oversight. Credit: Ryan Gaucher/Duke University's Fuqua School of Business

When Iranian authorities started seizing Barbie dolls from Tehran toy shops in 2012, Mattel Inc. execs faced concerns not only about the dolls' attire—miniskirts and swimsuits considered immodest in an Islamic country—but also questions from the U.S. Securities and Exchange Commission (SEC) about Mattel's ties to Iran.

U.S. businesses are restricted from business in Iran, which U.S. authorities have designated a state sponsor of terrorism (SST). The number of SEC inquiries about potential terrorist ties has grown substantially in recent years, and according to new research from Duke University's Fuqua School of Business, the increase could reduce the quality of the agency's financial reporting oversight.

"Comments on terrorism are getting to a critical level of importance in terms of what the SEC is asking companies about," said Bill Mayew, a Fuqua accounting professor and co-author of research, which is forthcoming in the *Journal of Accounting & Economics.* "Investors want to be aware if the companies they invest in are potentially supporting terrorism, but they also want financial statements that are correct. The SEC has to balance both of these issues to protect investors."

## Tracking focus areas at the SEC

Mayew, along with Fuqua Ph.D. alumni Robert Hills of Penn State and Matthew Kubic of the University of Texas at Austin, analyzed the more than 17,800 comment letters from SEC review staff from 2005 to 2016. Comment letters are typically sent after SEC staff reviews a firm's disclosures to gather more information or notify a firm that its filings contain inaccuracies or errors.

Of the 825 comment letters the SEC sent in 2005, only 2.2% included comments related to SST, the analysis showed. By 2016, that number had grown to 8.4%. Terrorism has become as commonplace a topic in comment letters as questions about financial information such as intangible assets, revenue recognition and taxes, Mayew said.

The researchers found that when SEC comment letters included references to terrorism, the letters were less likely to identify the firm's financial reporting errors.

To determine cases in which errors were caught and missed, researchers analyzed comment letters as well as subsequent corrections, or restatements, from the firms that received comment letters.

Among restatements that investors typically care most about—those containing severe errors—the SECs' average error-detection rate was 31.1%, the data showed. The error-detection rate dropped to 10.6% when letters included the topic of terrorism disclosures, the researchers found.

"The inference from our paper is that when the focus turns to terrorism it appears to come at the expense of financial reporting oversight," Mayew said.

The SEC bases some of its terrorism-related inquiries on contents in financial filings, but may also proactively review sources such as the news and websites for the company and its affiliates for information about firms' possible ties to countries on the U.S. Department of State's SST list, which also includes Cuba, North Korea and Syria.

During the same year news coverage piqued the SEC's interest in Mattel, the SEC also contacted Heinz after reports suggested its ketchup was available in both Cuba and Syria. After financial disclosures, news coverage was the most common source the SEC referenced in its questions about SST issues, the research showed.

## An influx of lawyers

The SEC's attention to firms' financial ties to SST countries began at Congress's behest in 2003 after incidents such as the 2001 World Trade Center attacks spurred new counter-terrorism efforts, Mayew said.

The researchers found that this coincided with a shift in the composition of SEC review staff—the number of lawyers the review staff has grown while the number of accountants has decreased, the researchers found. Data showed accountants were more likely to ask accounting questions and detect errors in financial statements while lawyers were more likely to ask questions about terrorism-related activities, which limited the likelihood that the review detected errors.

The data also showed when SEC reviewers asked firms about potential ties to SST, the reviewers were less likely to ask a question regarding core financial reporting, which included topics like accounting policies, disclosures related to a firm's narrative explanation about its financial statements (known as MD&A disclosures), or non-GAAP metrics (metrics that fall outside of those reported under Generally Accepted Accounting Principles).

"Core financial reporting topics are known to be associated with financial misreporting," Mayew said. "Interest in SST crowds out inquiries on core financial reporting topics, likely underpinning why SST questions appear to inhibit the SEC's ability to detect financial misreporting."

## Should the sec review more or less?

Experts inside and outside of the agency have questioned whether the SEC is sufficiently suited to regulate SST disclosure. As long ago as 2008, the Securities Industry and Financial Markets Association publicly opposed the SEC's activities, involvement in what the professional organization called matters of national security. Even a former SEC chair spoke publicly on the importance of the SEC's independence from political persuasion, and that the commission has, at times, been pushed into areas that may not fall within its core mission.

More recently, the SEC has also been called upon to facilitate accountability on how firms address environmental, social, and governance (ESG) factors, and other social issues, such as diversity, equity and inclusion. One such call to action was recently authored by faculty at Duke Law's Global Financial Markets Center, calling on the SEC to integrate ESG disclosures across a number of areas.

"As the SEC considers regulating disclosure in other domains such as ESG, our research demonstrates that careful thought must be placed into how the commission changes its staffing and how that could spill over to other areas like financial reporting," Mayew said. "If you now start making SEC staff members review whether financial filings adequately capture climate change risk or racism, for example, it may be headed down the same path as it has with investigating ties to terrorism."

Provided by Duke University School of Nursing

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