

SEC Disclosure Regulation of State Sponsors of Terrorism and Financial Reporting Oversight

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April 10, 2020

ABSTRACT

We examine whether SEC Division of Corporation Finance (DCF) effort to regulate disclosures regarding state sponsors of terrorism (SST) negatively impacts financial reporting oversight. Using comment letter questions about SST as our effort measure, we find the likelihood that the DCF fails to identify a financial reporting error increases when the comment letter references SST. Consistent with SST disclosure regulation crowding out financial reporting oversight, we find comment letters referencing SST are less likely to mention accounting, non-GAAP and MD&A issues. The SST effects we document do not represent a general risk factor phenomenon as we do not observe similar effects for comment letters referencing non-SST risk factors. We find that temporal increases in SST comments coincide with a labor mix shift at the DCF towards (away from) lawyers (accountants). Path analysis reveals that accountants (lawyers) are more (less) likely to detect financial reporting errors and comment on financial reporting topics, with mention of SST issues in a comment letter indirectly exacerbating these effects.

Keywords: Comment Letters; Financial Reporting Regulation; Independence; SEC; Terrorism;

*Corresponding Author. We appreciate helpful discussions with James Hansen and Shelly Luisi from the SEC Division of Corporation Finance, Jim Cox, Katherine Schipper, Caleb Rawson (discussant), Rodrigo Verdi and workshop participants at Duke University, Harvard University, the Southeast Summer Accounting Research Conference hosted at Georgia Tech and the 2020 FARS Midyear Meeting. We would like to thank Jonathon Weber of Marathon Studios for providing payroll data at www.FederalPay.org.

1. Introduction

A fundamental area of research considers the effectiveness of the Securities and Exchange Commission (SEC) in enforcing securities laws (Jackson and Roe 2009; Correia 2014; DeHaan et al. 2015; Kedia and Rajgopal 2011). The SEC Division of Corporation Finance (DCF) reviews filings made under the Securities Acts of 1933 and 1934 in order to enhance compliance with applicable accounting and disclosure requirements and issues comment letters to registrants when deficiencies are identified (SEC 2020). Existing research documents that DCF comment letter reviews improve investor perception of accounting numbers (Bens et al. 2015) and increase transparency of qualitative disclosures (Bozanic et al. 2017a). In this paper, we investigate whether DCF effort to regulate disclosure regarding business activities with countries designated as state sponsors of terrorism (SST) limits the DCF's ability to review audited financial statements for compliance with accounting standards (hereafter, financial reporting oversight).¹

Two factors motivate our investigation. First, qualitative disclosures describing registrant business dealings with SST countries have become an increasingly important topical area of inquiry. In their 2018 SEC reporting update summarizing where the DCF is allocating review resources, Ernst and Young (EY) noted that 12% of all comment letters contained questions related to SST (EY 2018). This percentage was slightly above questions on intangible assets (11%) and business combinations (8%), in line with tax questions (12%) and slightly below revenue recognition (13%) and segment reporting (15%). Moreover, this percentage has grown substantially relative to the 2% of comment letters that mention SST in 2005, which is the first year comment letters became publicly available.

¹SST is a designation applied by the United States Department of State to countries which the Department alleges to have repeatedly provided support for acts of international terrorism.

Second, some suggest SEC efforts to regulate SST disclosure may be misguided. For example, the Division of Investment Trade Organizations and Mary Jo White, the 31st Chairperson of the SEC, have suggested that regulating SST disclosure may fall outside of the SEC's core competence and that SEC involvement may be politically motivated (Preston and Strongin 2008; White 2013). Under this view, if the DCF lacks the relevant expertise to regulate SST disclosure and/or SST regulatory efforts are undertaken as a result of political pressure, scarce DCF review resources may be inefficiently used. In the presence of budget constraints, efforts to regulate SST disclosures may come at the expense of financial reporting oversight.

Whether SEC effort regulating SST disclosures affects the quality of financial reporting oversight is ultimately an open empirical question. Providing evidence requires measures of both SEC effort and financial reporting oversight quality.² Regarding the former, the ideal research design would directly measure effort by DCF employees in the regulation of SST disclosures. Because private effort is not observable, we follow existing research and utilize information from comment letters to proxy for SEC effort (Cassell et al. 2013; Heese et al. 2017; Ege et al. 2019). For each firm receiving a comment letter, we measure effort expended on SST disclosure regulation using an indicator variable that equals one if a comment letter contains an SST comment, and zero otherwise.

We also use comment letters to operationalize financial reporting oversight. Because each comment letter identifies the fiscal periods under review, we can ascertain whether the financial reports under review are subsequently restated, indicating the existence of a financial reporting error. To determine whether the SEC detected a financial reporting error during its review, we manually identify and compare topics raised in the comment letter with the topics of

²Since the DCF is a division within the SEC, we use the terms SEC effort and DCF effort interchangeably.

the restatement. We then create an indicator variable equal to one if the SEC detected a financial reporting error during the comment letter review, and zero otherwise (Kubic 2019). If DCF effort regarding SST negatively influences financial reporting oversight quality, we would observe a negative association between the incidence of an SST comment in the comment letter and the SEC's detection of a financial reporting error.

Regression results reveal that DCF error detection rates decrease by 44% to 65% when SST issues are discussed in the comment letter, depending on the specification. These findings are consistent with efforts to regulate SST disclosure limiting the quality of financial reporting oversight. Of course, DCF effort is not exogenous and endogeneity concerns limit our ability to draw causal inferences. For example, suppose a firm engages in complex, global transactions that result in both a firm interacting with a country designated as SST and increased difficulty in detecting financial reporting errors. To the extent our empirical specifications do not capture business transaction complexity, unobserved heterogeneity would explain the empirical associations we document.

To help mitigate omitted variable bias and other endogeneity concerns, we examine the sensitivity of our results to a variety of estimation techniques. Following Oster (2019), we conduct a bias correction for unobservables. We also utilize alternative fixed effects combinations to control for time-invariant but unobservable firm-specific factors. To minimize measurement error in DCF error detection, we analyze a subsample of reviews known *ex-post* to contain an error, which is the set of observations where the DCF could have detected an error if they had asked the appropriate question. In addition, we use three different matching techniques to address the concern that SST is not randomly assigned. Finally, we consider a 2SLS instrumental variable estimation using global terrorism data from the National Consortium for

the Study of Terrorism and Responses to Terrorism. Under all specifications we consider, we find that DCF effort directed at SST is inversely related to financial reporting oversight quality.

If this inverse relationship reflects a binding DCF budget constraint, efforts spent on SST disclosure regulation must come at the expense of financial reporting oversight. To formally assess this possibility, we examine the association between SST comments and financial reporting comments. We find a negative relation between DCF effort and accounting-related comments, non-GAAP disclosure comments, and MD&A disclosure comments. This evidence is consistent with a substitution effect in which DCF effort regarding SST is crowding out efforts to monitor accounting numbers and other disclosures directly related to those numbers.

Because terrorism-related issues represent one of many risk exposures a company may face (Campbell et al. 2014), an alternative interpretation of our results is that we are documenting a general risk factor phenomenon rather than an effect of terrorism *per se*. We therefore repeat our analysis by removing all instances of SST and replacing our measure of DCF effort directed at SST with a measure of effort toward regulating non-SST risk-factors. Unlike SST comment letters, we find that comment letters dealing with non-SST risk factors are not associated with error detection rates and do not crowd out financial reporting questions.

Collectively, the evidence suggests DCF efforts directed at SST disclosure lowers financial reporting oversight quality and crowds out financial reporting comments. To understand why this may be the case, we obtain the identities of each individual employed by the DCF by filing a Freedom of Information Act (FOIA) request. We cross-reference this listing with federal payroll data (www.federalpay.org) to identify the occupation of each individual. We find that over time, the occupational mix of the DCF has shifted towards (away from) lawyers (accountants). This shift coincides with both a temporal increase in SST comment

letters and incidences of global terrorism. Given these findings, one explanation for our results is that, because accountants are more adept at detecting financial reporting errors relative to lawyers (Kubic 2019), the available amount of expertise for detecting financial reporting errors may be increasingly limited due to heightened SST disclosure regulation.

To formally test this explanation, we conduct a path analysis to assess how the number of lawyers and accountants on a review team is associated with error detection and financial reporting comments. We observe a direct effect whereby both error detection and the mention of accounting and non-GAAP comments are increasing (decreasing) in the number of accountants (lawyers). The effects of accountants and lawyers also operate indirectly through SST comments, but in very different ways. The mediating effects of SST reveals that increases in the number of lawyers further dampens error detection and exacerbates crowding out of financial reporting topics, while the opposite is true for accountants.

Our findings make four contributions to the literature. First, some have criticized the SEC an ineffective regulator (Goldschmidt 2002; Thomsen 2009), pointing towards political influence and limited resources as reasons for such ineffectiveness (Levitt 1997; White 2013; Heese 2018; Gunny and Hermis 2019; Ege et al. 2019; Bonsall et al. 2019). Our results suggest a focus on SST disclosure issues has negative implications for financial reporting. However, we do not consider any potential benefits for regulating SST disclosure and therefore cannot speak to whether the allocation of review resources toward SST disclosures is in any way suboptimal.

Second, terrorism disclosures have received relatively little attention in the literature, except for recent work by Nguyen (2017) and Potter (2018). Nguyen (2017) shows that a shift to counter-terror investigation resulting from 9/11 dampens the regulation of wire fraud and insider trading. Our paper complements this work by examining the detection of financial reporting

errors as a different externality that arises from the SEC’s focus on terrorism (Dechow et al. 1995; Hobson et al. 2012). Third, our study adds to the literature on corporate social responsibility reporting (Christensen et al. 2018) by examining terrorism disclosures. While most papers document benefits to expanding the boundaries of financial reporting oversight, we show a potential cost. Expanding the boundaries of financial reporting oversight to include terrorism may induce negative externalities by reducing the DCF’s ability to effectively regulate accounting information and non-SST disclosures in periodic filings.

Finally, our study adds to the literature on SEC comment letters, which generally documents benefits of the comment letter review process (Heese et al. 2017; Johnston and Petacchi 2017; Duro et al. 2018; Brown et al. 2018; Bozanic et al. 2017b). Our evidence suggests there is variation in the effects on financial reporting quality depending on whether the comment letter review process contains a focus on SST, and by the occupation of the review team members.

2. Background and Hypotheses Development

The SEC’s mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. The SEC’s Division of Corporation Finance (DCF) supports this mission through the review of registrant filings and “concentrates its resources on critical disclosures that appear to conflict with Commission rules or applicable accounting standards and on disclosures that appears to be materially deficient in explanation or clarity” (SEC 2020). During a review, the DCF comments on registrant filings to elicit compliance with applicable disclosure and accounting requirements. The firm responds to these inquiries, typically within 10 days, and depending on the nature of the initial inquiries and the firm responses, there may be additional correspondence between the DCF and the firm.

Big 4 accounting firms analyze and report on the disclosure areas receiving the most DCF comments to provide clients with insight on where the DCF is allocating review effort. Recently, these reports show an increasing focus on disclosures involving nations designated as State Sponsors of Terrorism (SST). For example, in EY's 2018 SEC reporting update, registrant business activities with nations designated as SST is revealed as a "top 10" issue (EY 2018).³ Specifically, EY finds that 12% of all SEC comment letters referenced SST issues. This percentage is slightly above questions related to intangible assets (11%) and business combinations (8%), in line with tax questions (12%) and slightly below revenue recognition (13%) and segment reporting (15%). Moreover, this percentage has grown substantially relative to the 2% of comment letters that mentioned SST in 2005 (Table 2, Panel A).

SEC involvement in the regulation of SST disclosures is a controversial issue. Some have suggested that regulating SST disclosure falls outside of the SEC's mission and is politically motivated. Regarding the former, the Securities Industry and Financial Markets Association stated that the "SEC's mission is not foreign policy and national security matters" and that the "SEC should leave foreign policy and national security matters to the government agencies charged with, and possessing significant experience in, carrying out those matters...(Preston and Strongin 2008)." Regarding the latter, Mary Jo White, the 31st Chair of the SEC, acknowledged that "from time to time, the SEC is directed by Congress or asked by interest groups to issue rules requiring disclosure that does not fit within our core mission" and highlighted the importance of independence from "those who seek to effectuate social policy or political change through the SEC's power of mandatory disclosure (White 2013)." Consistent

³ The list of nations designated as state sponsors of terrorism at any given date has varied over time as nations were added and removed. Since 1996, at one point or another, seven different nations (Cuba, Iran, Iraq, Libya, North Korea, Sudan and Syria) have been designated as state sponsors of terrorism.

with political pressure underpinning the SEC focus on SST, the Organization for International Investment noted, “there is no basis for the SEC's decision to highlight this particular issue rather than any of the other myriad issues that one could argue might be equally important to investors, from a company's environmental policies to its labor practices to its charitable contributions” (Malan 2008).

Since the DCF is a budget-constrained entity, inefficient effort in regulating SST disclosure, either due to lack of requisite expertise or because of political pressure to unduly focus on SST, may come at the expense of regulatory oversight in other areas such as financial reporting. Whether and to what extent financial reporting oversight suffers ultimately depends on the degree to which the budget constraint is binding. SEC Chairpersons have suggested budget constraints hinder the SEC’s ability to fulfill its mission (Donaldson 2004; White 2014), and consistent with binding budget constraints, Ege et al. (2019) shows that unexpectedly high capital market transaction volume reduces the quality of DCF comment letter reviews.

Despite this evidence, the possibility remains that increased DCF focus on SST disclosures may not come at the expense of financial reporting oversight quality due to DCF support from the Office of Global Security Risk (OGSR). The OGSR is a subdivision within the Division of Corporation Finance (DCF) that exists specifically to enhance reporting compliance with required disclosures related to business activities in or with SST. If the OGSR provides sufficient support to the DCF as part of the comment letter review process, we may not observe any negative ramifications for financial reporting oversight. We therefore state our hypothesis in null form:

H1: There is no association between DCF effort to regulate SST and the quality of DCF financial reporting oversight.

3. Research Design, Data and Hypothesis Testing

3.1. Research Design

The ideal research design would measure the effort expended by DCF employees on SST disclosure oversight. Unfortunately, we cannot directly observe the effort of individual DCF employees, so we follow the extant literature and use comment letter activity to proxy for DCF employee effort (Cassell et al. 2013; Heese et al. 2017; Ege et al. 2019). We utilize reference to SST in a comment letter as our proxy for DCF effort and create an indicator variable, *SST CL*, that equals one if a comment letter contains and SST comment, and zero otherwise.

We also use comment letters to operationalize financial reporting oversight quality by examining whether the DCF identifies a financial reporting error as part of the review. Thus, to empirically test H1, we include *SST CL* as an additional explanatory variable in the linear probability model of DCF error detection used in Kubic (2019) as follows:

$$\begin{aligned} Error\ caught_{c,i} = & \alpha_0 + \alpha_1 SST\ CL_{c,i} + \alpha_2 Team\ Size_{c,i} + \\ & \sum_m \alpha_m Firm\ Characteristics_{c,i} + \sum_n \alpha_n Audit\ Characteristics_{c,i} + \\ & \sum_k \alpha_k Filing\ Characteristics_{c,i} + \delta_{c,b} + \varepsilon_{c,i} \end{aligned} \quad (1)$$

where *Error Caught* is an indicator variable equal to one if the DCF identifies a financial reporting error as part of a comment letter conversation, *c*, and zero otherwise. A comment letter conversation begins with the initial letter from the SEC to the registrant, *i*, and ends when the SEC closes the review. An error is considered to be “caught” by the SEC if the restatement of a financial filing under review occurs during the comment letter review process or within 135 days and the topic identified in the comment letter is the same topic that is restated. We use the Kubic (2019) mapping of comment letter topics to restatement announcements. To validate the measurement of *Error Caught*, we manually review overlapping comment letter reviews and

restatement announcement to ensure the restatement relates to a question in the comment letter.⁴

SST CL indicates that a firm's comment letter conversation contained an SST comment.

Observing $\alpha_1 < 0$ would reject the null hypothesis proposed in H1 and suggest that DCF effort with respect to SST comes at the expense of financial reporting oversight quality by decreasing the chance a financial reporting error is caught.

In Equation (1) we control for the extent of human capital deployed by the DCF through the size of the review team assigned to the filing (*Team Size*). Review team size is assessed by manually counting the number of unique DCF staff referenced in the initial comment letter sent to the registrant. We control for characteristics of both the registrant (*LN marketcap*, *firm age*, *loss*, *bankruptcy rank*, *earnings growth*, *M&A*, and *high volatility*) and the auditor of the registrant (*Big 4 auditor*, *auditor tenure*, *auditor change*, and *material weakness*) measured using the most recently available data before the start of the comment letter conversation. We also control for characteristics of the registrant's recent filings, including the number of 8-Ks filed in the 30 days prior to the comment letter conversation (*recent 8Ks*), whether the comment letter conversation refers to a previously amended filing (*ref amended filing*) and the readability (*FOG*) and extent of litigation terms (*litigation words*) in the most recent annual report prior to the comment letter conversation beginning. Precise definitions of all regression variables are in Appendix A.

As a collection, the control variables are designed to capture factors likely associated with the amount of unobservable effort expended by the DCF toward reviewing the registrant as well as the potential difficulty of uncovering a financial reporting error. Finally, we note that the

⁴ Similar to Kubic (2019), we find that a manual classification of errors caught by the SEC closely matches classification based on mapping AA comment letter topics to AA restatement announcement topics. Thus, we use the AA topic classification matching summarized in Appendix B.

eleven regional branches of the DCF are organized to focus on specific industries, with budget allocations for each branch determined annually. However, branch budgets are not publicly available (Blackburne 2014). To capture branch budgetary issues and heterogeneity in filing volume across industries that might influence busyness in a given year and impact available review resources (Ege et al. 2019; Gunny and Hermis 2019), we control for branch-year fixed effects ($\delta_{c,b}$). The year component of this fixed effect is the SEC calendar year that contains the date of the initial letter in a comment letter conversation.

3.2. *Data*

The comment letter sample derivation is detailed in Table 1, with the unit of observation being a comment letter conversation. Our sample begins with the 30,863 comment letter conversations pertaining to recurring reviews of quarterly (10-Q) or annual (10-K or 20-F) financial filings available in the Audit Analytics Comment Letter database from SEC fiscal year 2005 (which begins November 1, 2004) through SEC fiscal year 2016 (which ends September 30, 2016).⁵ We begin in SEC fiscal year 2005 as this is the first year in which comment letters are available. We end in fiscal year 2016 to allow sufficient time to measure restatements after the completion of a review. After removing comment letter conversations missing requisite control variables, we are left with 17,818 sample observations, representing 5,927 unique firms.

We tabulate the number of comment letters each fiscal year as well as the number of comment letters containing a question regarding SST in Panel A of Table 2. Overall, 4.2% of comment letters in our sample contain SST questions, with the proportion has been steadily rising over our sample period from just over 2% in 2005 to just over 8% by the end of the sample

⁵ Our focus on comment letters pertaining to recurring reviews follows the extant literature studying comment letters. Other filings beyond what we examine, such as Form F-1, S-1, S-3, etc. can receive SST comments. These filings are not examined here as we have limited ability to measure financial reporting quality and in turn cannot construct the dependent variable in Equation [1].

period. EY reports that this trend has continued beyond our sample period as well, reaching 12% by 2017/2018, consistent an ever-increasing focus on SST by the SEC (EY 2018).

Identifying SST comment letters is done via the Audit Analytics Database. However, Audit Analytics does not characterize specific SST comments in any way. To gain insight on the sources of information that underpin DCF inquiry, we read each of the 755 SST comment letters in our sample and categorize the information source that the DCF references. As summarized in Table 2 Panel B, we identify 1,300 information source references, with the median comment letter referencing two unique sources. The most common source is an existing disclosure within a filing, which is commented upon in 80.5% of SST comment letters. For example, the DCF commented to Logitech International, a maker of keyboards and other computer peripherals, the following regarding an existing 10-K disclosure: “We also note the disclosure on page 5 and elsewhere in your form 10-K that you operate in regions including the Middle East and Africa. As you know, Iran, Syria and Sudan, countries located in those regions, are designated by the U.S. Department of State as state sponsors of terrorism and are subject to U.S. economic sanctions and controls. Your Form 10-K does not include disclosure about contacts with those countries.”

The DCF also references various non-filing sources such as the media, which is the second most referenced source and appears in 26.8% of SST comment letters. For example, to the toy manufacturer Mattel Inc. and the food maker Kraft Heinz Foods, the DCF commented, respectively: “We note a 2012 news article that shops in Iran were selling Barbie Dolls” and “We are aware of an August 2010 news article indicating that Heinz ketchup is available in Cuba.” Other information sources referenced by the DCF include registrant websites, a disclosure made

by an affiliate of the registrant, non-registrant websites, and publicly available information on regulatory enforcement by other government agencies and intellectual property.

Of the financial statements under review in the full sample of 17,818 comment letter conversations, 11.8% (2,100/17,818) are eventually restated (Table 1). Table 2, Panel C reveals that 3.2% of total sample (26.8% of the known error subsample) contain errors that are caught by the DCF comment letter review, implying that 8.6% of the total sample (73.2% of the known error subsample) contain errors that are identified through other means outside the DCF review. The correlation matrix in Panel D of Table 2 reveals a negative and statistically significant association ($\rho = -0.028$, $p < 0.01$) between SST comments (*SST CL*) and financial reporting error detection (*Error Caught*). While this correlation suggests a potential rejection of H1, other factors are associated with both SST comments and financial reporting error detection. For example, the DCF is less (more) likely to catch financial reporting errors of (issue SST comments to) large firms, suggesting firm size as a potential confounding effect. This may occur if larger firms are both more complex and have a more global footprint relative to smaller firms. To consider such confounding factors, we turn to the multiple regression specification summarized in Equation (1).

3.3. Empirical Analysis

Table 3, Panel A reports the results of estimating Equation (1), first without control variables in Column 1, and then with the full set of control variables in Column 2. The negative and statistically significant coefficient ($\alpha_1 = -0.0247$, $p < 0.01$) on *SST CL* in Column 1 replicates the inverse bi-variate correlation previously discussed and provides an interpretable effect size. The coefficient estimate implies that the probability of detecting an error decreases by 2.47%

when an SST comment is made. Relative to the unconditional error detection rate of 3.2%, this represents a decrease in error detection of 77.2% ($0.0247/0.032$).

In Column 2 we observe that, in the presence of controls, we still observe a negative and statistically significant coefficient ($\alpha_1 = -0.0143$, $p < 0.01$). This finding rejects H1, but with a smaller effect size of 44.7% ($0.0143/0.032$) based on a comparison to the unconditional mean error detection rate. The presence of control variables allows for additional calibration of economic effect size. For example, consistent with Kubic (2019), the coefficient on team size is positive and statistically significant ($\alpha_2 = 0.00462$, $p < 0.01$). This implies that an SST question in a comment letter conversation has an effect size that is 3.10 ($0.0143/0.00462$) times greater than adding one more member to the review team. Additionally, the presence of an SST comment has roughly the same effect size as an auditor change in terms of detecting financial reporting errors.

One concern when interpreting SST effects in Columns 1 and 2 is that the estimate captures the probability of error detection (*Error Caught* = 1) versus non-detection (*Error Caught* = 0), and the instances of non-detection can take many forms. The non-detection observations can result from instances where financial reporting errors exist and are identified by parties other than the SEC (8.6% of sample observations, equal to $2,099/17,818 = 11.8\%$ total errors less 3.2% detected), instances where financial reporting errors exist but are never detected by any party, and instances where no financial reporting errors exist. Because it is not possible to isolate observations where financial reporting errors exist but are never detected versus situations where no reporting errors exist, measurement error in the dependent variable could be responsible for the inverse relationship between *Error Caught* and *SST CL*. We therefore conduct two further subsample analyses. In Column 3, we remove foreign filers because they are much less likely to have restatements relative to domestic filers (Srinivasan et al. 2015).

Given foreign filers may be more geographically proximate to nations designated as SST relative to domestic filers, the negative association between *SST CL* and error detection may simply capture whether the firm is a foreign filer.⁶ The coefficient on *SST CL* remains negative and statistically significant ($\alpha_1 = -0.0198$, $p < 0.01$), implying error detection rates decrease by 58.2% ($0.0198/0.034$) when compared to unconditional error detection rate for this subsample of 3.4%.

In Column 4, we remove all observations where an error is not present. Doing so helps alleviate the concern that the DCF expends more effort on SST when firms have no financial reporting issues. That is, effort expended on financial reporting issues may be low, but adequately so, because the firm complies with all financial reporting requirements. If such firms are less likely to have a restatement, there would be no error for the DCF to catch and we would observe a negative association between *SST CL* and error detection. This resulting subsample of known errors isolates those observations where the error is by definition detectable. In this subsample, the DCF identifies an error in the comment letter process in 26.8% of observations. Estimating Equation (1) for this subsample also reveals a negative and statistically significant coefficient on *SST CL* ($\alpha_1 = -0.118$, $p < 0.01$) suggesting that effort directed at SST appears to dampen the DCF's ability to identify financial reporting errors by 44.0% ($0.118/0.268$) relative to the unconditional error detection rate.

If SST issues distract DCF attention from financial reporting errors, perhaps the distraction is not economically meaningful if errors missed are not severe. To assess this issue, in Column 5 we repeat the analysis in Column 4 but condition into a sample of only severe errors

⁶ Empirically, we find that both foreign filers and firms with operations in countries that border nations designated as SST per review of Exhibit 21 data are more likely to have SST comment letters ($p = 0.133$, $p < 0.01$ and 0.182 , $p < 0.01$, respectively). We do not consider geographic location of sample firms in Equation (1) because this is generally static during our sample, and in subsequent analysis we accommodate this issue and other unmeasured time-invariant firm-specific factors via the inclusion of firm fixed effects.

(Scholz 2014; Hobson et al. 2012; Palmrose et al. 2004).⁷ In this subsample the unconditional error detection rate is 36.9%, which is slightly higher than the error detection rate for all errors and implies that the DCF is more successful at identifying more severe errors. Even among this subsample, we observe a negative and statistically significant coefficient on *SST CL* ($\alpha_1 = -0.239$, $p < 0.01$) suggesting that interest in SST by DCF comment letter review teams reduces the ability to detect severe financial reporting errors by 64.8% ($0.239/0.369$) relative to the unconditional mean. This finding is important given more severe errors likely have larger ramifications for investors (Hobson et al. 2012; Hennes et al. 2008).

3.3.1. *Omitted Variable Bias*

As a collection, the results in Panel A of Table 3 reject H1. We find a reduction in error detection rates ranging from 44.0% to 64.8% relative to the unconditional mean, depending on sample construction. These inferences assume that the inclusion of control variables in the linear probability model sufficiently mitigates confounding effects. However, interpreting the negative association between error detection and the mention of SST issues in comment letter conversations as evidence of lower quality financial reporting oversight is premature if our models are not sufficiently specified, either due to an omitted variable or incorrect functional form on existing control variables.⁸ The plausibility of an omitted variable bias is evident from both the attenuation of the SST effect when estimating Equation (1) without controls (Column 1: $\alpha_1 = -0.0247$, $p < 0.01$) versus with controls (Column 2: $\alpha_1 = -0.0143$, $p < 0.01$) and the substantial

⁷ We define severe errors as those corrected via Form 8K Item 4.02 or errors with an adverse effect on either revenue or expenses (AA variables adverse = 1 and core = 1).

⁸ Another interpretation of this negative association is that the SEC is not focusing on accounting issues by internal mandate rather than attempting, but failing, at detecting accounting errors (Cox 2006). We cannot disentangle whether distraction is by *ex-ante* mandate or occurs *ex-post* after effort is applied. In either case, focus on SST in the comment letter process appears to curb financial reporting oversight.

amount of unexplained variation in error detection rates for the models that do contain controls variables (adjusted R^2 values ranging from 2.4% to 12.6%).

One common technique to empirically capture unobservable but constant firm-specific factors is to include firm fixed effects. However, doing so here is not possible in conjunction with branch-year fixed effects because firms are assigned to the same DCF branch via the firm's industry affiliation. We can, however, replace branch-year fixed effects with firm and year fixed effects, and doing so does not change our inferences.⁹

Another approach is to construct bias-adjusted coefficients following recent work by Oster (2019). If a correlated but omitted variable is responsible for the associations we document, we may be unduly rejecting H1. The bias adjustment in Oster (2019) is derived by comparing the coefficient on *SST CL* and resulting R^2 of a “short” regression without control variables (i.e. Column 1 of Table 3 Panel A) versus an “intermediate” regression that contains measurable control variables (i.e. Column 3 of Table 3 Panel A). The bias-adjustment derivation also requires an assumption about the importance of observables relative to unobservable variables (δ) and an assumption about the explanatory power of a regression that contains both observable and unobservable variables (R^2_{max}). Following (Oster 2019), we assume that observable and unobservable variables are of equal importance ($\delta = 1$) and that the inclusion of omitted, unobservable variables would result in R^2_{max} equal to 1.3 times the R^2 of the intermediate regression.

When applying these conditions via the *psacalc* command in STATA provided in Oster (2019), we obtain a bias-adjusted *SST CL* coefficient of -0.0110, which is less than *SST CL*

⁹ When including firm and year fixed effects instead of branch-year fixed effects, the coefficient on *SST CL* is -0.0144 ($p < 0.05$), -0.023 ($p < 0.01$), -0.169 ($p < 0.01$) and -0.202 ($p < 0.05$) in Columns 2, 3, 4, and 5, respectively.

coefficient we originally observed of -0.0143 in Column 2 of Table 3 Panel A. Re-estimating our subsample results in Columns 3, 4 and 5 of Table 3 Panel A yields bias-adjusted *SST CL* coefficients of -0.017, -0.085 and -0.212, respectively. That the bias-adjusted estimates are smaller than the original estimates implies that our estimations are overstated. However, assuming an R_{max}^2 equal to 1.3, the unadjusted R^2 implies that in order for the omitted variable bias to render our original *SST CL* results statistically insignificant, unobservable factors would have to be between 3.5 and 6.1 times larger than observable factors. Such an unobservable factor is difficult for us to articulate.

3.3.2. *Matching*

To further address the concern that SST and non-SST observations differ on unobservable dimensions, we follow Gallemore et al. (2019) and examine the robustness of our *SST CL* effect in Column 2 of Table 3 Panel A to three matching procedures. SST assignment is not random, and the objective of matching is to increase the similarity of SST and non-SST on observable dimensions, which is assumed to minimize unobservable differences. Matching also relaxes functional form assumptions that underpin linear regression models. We present the results in Table 3 Panel B.

First, we use coarsened exact matching (Iacus et al. 2012; Blackwell et al. 2009) which separates data into evenly spaced strata and then matches on observable characteristics. The analysis is then conducted on the uncoarsened, matched data, dropping unmatched observations (Blackwell et al. 2009). Increasing the number of strata makes it more difficult to match but improves the quality of the match. We match on firm, audit, and filing characteristics for observations within the same branch-year pairing, using three evenly spaced strata, and ensure

results are robust to using four or five strata.¹⁰ The coarsened exact match *SST CL* estimate is -0.0157 ($p < 0.01$), which rejects H1.

Second, we use one-to-one propensity score matching (Shipman et al. 2016), which substantially reduces our sample size to only 1,251 observations as there are far fewer SST than non-SST observations. When implementing propensity score matching, we estimate a logistic regression determinant model of SST CL using firm, audit and filing characteristics as well as branch-year fixed effects as in Equation (1). We then match SST observations with non-SST observation based upon fitted values, without replacement. The propensity score matched *SST CL* estimate is -0.0326 ($p < 0.01$), also rejecting H1.

Finally, we use entropy balancing, which achieves covariate balancing by reweighting treated and untreated observations (Hainmueller 2012). We find the entropy balanced *SST CL* estimate to be -0.0142 ($p < 0.01$), which rejects H1 consistent with the other matching techniques. In all matching cases, we do not observe a meaningful decrease in magnitude relative to the -0.0143 *SST CL* obtained from the linear probability model estimation.¹¹

3.3.3. 2SLS Instrumental Variable Estimation

In addition to matching, another approach to mitigate endogeneity concerns is the use of an instrumental variable (Larcker and Rusticus 2010; Heese et al. 2017). As an instrument for terrorism-related comments (*SST CL*), we measure the number of global terrorism attacks reported by the National Consortium for the Study of Terrorism and Responses to Terrorism

¹⁰ When matching on firm, audit and filing characteristics within branch-year pairing, using 3 strata reduces the sample by 43%, 4 strata reduces the sample by 71% and 5 strata reduces the sample by 91%. In all cases, the coefficient on SST remains negative and statistically significant at the 1% level.

¹¹ We include control variables to accommodate the possibility that our matching between treatment and control is insufficient. Estimating the results without control variables yields very similar *SST CL* estimates equal to -0.0173 ($p < 0.01$), -0.0326 ($p < 0.01$) and -0.0137 ($p < 0.01$) for coarsened exact, propensity score and entropy balanced matching, respectively.

(START) Global Terrorism Database. The START Global Terrorism Database identifies global terrorism attacks each day since 1970, totaling over 190,000 attacks since inception.¹² Figure 1 plots the percentage of SST comment letters against the number of global terror attacks for each SEC fiscal year. SEC effort in regulating SST disclosure appears to closely track actual instances of terrorism globally ($\rho = 0.89$, $p < 0.01$), potentially consistent with the DCF responding to the heightened potential of terrorism exposure to SEC registrants.

To incorporate the global terrorism data into our empirical specifications, we measure the number of terrorist attacks in the 90 days before the start of each comment letter conversation (*Recent Terror*). Measurement of terrorism at the conversation level in this manner is designed to capture the intensity of global terrorism while the DCF is conducting its review. In our sample, the variable *Recent Terror* has a mean of 1,745, a standard deviation of 1,154, and ranges from a low of 327 to a high of 4,517.

In Panel C of Table 3, we present the two-stage least squares estimation, where in the first stage *SST CL* is modeled as a function of *Recent Terror* and full controls as in Equation (1). The only difference relative to Equation (1) is that we replace branch-year fixed effects with branch fixed effects as there is not significant within-year variation in our instrument. Figure 1 suggests this is the case as the relationship between SST comment letters and terrorism has a substantial time component. In the second stage, we find the *SST CL* coefficient is negative and significant ($p = 0.028$), consistent with our previous results in Panel A and Panel B of Table 3.¹³

¹² START is a university based research center headquarter at the University of Maryland focus on supporting academic research on terrorism (<https://www.start.umd.edu/about/about-start>).

¹³ The coefficient magnitude in Column 2 of Panel C is not comparable to the result in Panels A and B since we have a binary outcome variable (*Error Caught*), a binary endogenous regressor (*SST CL*) and a continuous instrument (*Recent Terror*). See Angrist and Pischke (2008) sections 4.6.1 and 4.6.3.

Regarding instrument validity, we note that our terrorism instrument satisfies the relevance criterion that requires the instrument (*Recent Terror*) to be correlated with the endogenous regressor (*SST CL*). Specifically, the first-stage F-statistic is 14.1, exceeding the thresholds recommended by Stock et al. (2002). The exclusion criterion requires that recent terrorist attacks be uncorrelated with our outcome measure, DCF error detection, other than through its association with DCF effort. For example, if the number of recent terrorist attacks for some reason increases the likelihood that firms engage in difficult-to-detect financial misreporting, then our instrument would be invalid. It is not obvious why this would be the case, but since we only have a single instrument, we are unable to conduct a test of overidentifying restrictions related to the exclusion criterion.

4. Additional Analysis

4.1. Crowding Out of Financial Reporting Oversight

The results thus far suggest a robust inverse relationship between SST comments in comment letter conversations and financial reporting oversight quality. If this effect is due to the DCF facing a binding budget constraint, it implies that financial reporting errors are missed because DCF effort is directed at SST and not at financial reporting. While we cannot measure effort directly, we can indirectly assess this issue by investigating the extent to which financial reporting questions are also asked during comment letter conversations.

To provide initial insights, in Figure 2 we plot the percentage of comment letters containing an SST comment against comments on core financial reporting topics, which we define as the sum of comments about accounting, Non-GAAP or MD&A disclosure. We consider these three types of comments as accounting disclosures pertain to the numbers that are eventually restated, non-GAAP disclosures are associated with earnings management (Black et

al. 2017), and MD&A disclosures describe the reported financial numbers and are associated with restatements (Hoberg and Lewis 2017; Purda and Skillicorn 2015). Figure 2 reveals a clear inverse relationship over the sample period consistent with effort directed toward SST crowds out efforts to oversee financial reporting.

To assess this relationship more formally, we simply re-estimate Equation (1) but change the dependent variable as follows:

$$\begin{aligned} Core\ Comment_{c,i} = & \alpha_0 + \alpha_1 SST\ CL_{c,i} + \alpha_2 Team\ Size_{c,i} + \\ & \sum_m \alpha_m Firm\ Characteristics_{c,i} + \sum_n \alpha_n Audit\ Characteristics_{c,i} + \\ & \sum_k \alpha_k Filing\ Characteristics_{c,i} + \delta_{c,b} + \varepsilon_{c,i} \end{aligned} \quad (2)$$

where *Core Comment* is one of the three following variables; 1) the count of unique accounting topics mentioned in a comment letter conversation (*Acct Comments*), 2) the incidence of a non-GAAP comment in comment letter conversation (*non-GAAP*), or 3) the count of unique MD&A topics in a comment letter conversation (*MD&A comments*). The test variable of interest is *SST CL* as previously defined and the remaining covariates are exactly as in Equation (1). Results are reported in Table 4.

Column 1 reports the results for accounting related questions, Column 2 reports the results for Non-GAAP questions, and Column 3 reports the results for MD&A questions. On average, comment letters contain 2.7 (1.1) unique accounting (MD&A) topics, and 17% of comment letters contain a non-GAAP comment. The multiple regression coefficients on *SST CL* in each of the three columns is negative and significant at the 1% level.¹⁴ This evidence is consistent with effort toward SST crowding out financial reporting oversight.

¹⁴ These findings are robust to using firm and year fixed effects in place of branch-year fixed effects. The coefficients on *SST CL* are -1.643 (p<0.01), -0.592 (p<0.01) and -0.122 (p<0.01) for Columns 1, 2 and 3 respectively in Table 4 using firm and year fixed effects with standard errors clustered by firm and year.

Moreover, this evidence also makes it difficult to forward alternative explanations for the previously documented inverse association between error detection and SST comments. For example, suppose that business transaction complexity is the unobservable but omitted factor not captured by our existing controls and matching procedures that drives both SST comments and the failure to detect errors. That is, the variable *SST CL* is ultimately proxying for complex business transactions, which are more difficult for the DCF to evaluate from an accounting standard standpoint, thereby making financial reporting error detection more difficult. If *SST CL* is capturing business transaction complexity, we would expect the DCF to ask more accounting questions and seek more MD&A clarification, not less as we observe in Table 4. More generally, we were unable to forward a potential unobservable factor that would explain *both* the inverse relationship between *SST CL* and error detection in Table 3 as well as the inverse relationship between *SST CL* and core financial reporting comment letter topics in Table 4.

4.2. *General Risk Factor vs. Terrorism Risk Factor*

The results thus far are consistent with the SEC's focus on SST crowding out the investigation of core financial reporting issues and reducing financial reporting error detection rates. However, the risk a firm faces when engaging in activities with a country designated as SST represents only one type of risk. As Campbell et al. (2014) note, terrorism represents one of many risk factors that must be disclosed by firms.¹⁵ This implies a potential alternative interpretation of our findings. Facing a budget constraint, a heightened focus on risk factor disclosures *in general* distracts DCF employees from financial reporting oversight such that the results we document are not due to terrorism *per se*.

¹⁵ Risk factor disclosures are mandated as part of Item 1A (Item 3) on form 10-K (20-F). Firms can face risks with respect to SST if, for example, they are subject to fines as a result of their business activities.

Under this alternative interpretation, we would expect comments related to non-SST risk factors to be negatively associated with *both* error detection rates and core financial reporting comments just as we observed for SST comments. To assess this possibility, we remove all SST comment letter observations and re-estimate our error detection analysis in Table 3, Panel A and comment letter topic analysis in Table 4, replacing our indicator for SST comment letters (*SST CL*) with an indicator for whether the comment letter references a non-SST risk factor (*non-SST Risk Factor CL*). *Non-SST Risk Factor CL* is defined using Audit Analytics following Cassell et al. (2013) and appears in 10.6% of comment letter conversation. This proportion falls between the fraction of comment letters containing SST comments in the full sample (2.3%, Table 3 Panel A, Column 2) and the fraction of comment letters containing non-GAAP comments (17.0%, Table 4 Column 3).

The results are presented in Table 5. In Columns 1 through 4, we fail to find a statistically significant relation between non-SST risk factor comment letters and error detection rates, regardless of whether we investigate the full sample (Column 1) or any of the previously assessed subsamples (Columns 2-4). This implies that the effects we document regarding SST are terrorism specific and not a general effect of a regulatory focus on risk factors. In Columns 5 through 7, we find no evidence that investigation of non-SST risk factors crowds out the investigation of accounting issues. In fact, interest in risk factors appears to compliment the investigation of financial reporting issues, as we observe a statistically positive association between non-SST risk factor comment letters and both accounting (coefficient = 0.334, $p < 0.01$) and MD&A comments (coefficient = 0.581, $p < 0.01$).

5. Budget Constraints and DCF Employee Composition

The DCF ultimately deploys human capital to conduct reviews. As such, any budget constraint the DCF faces pertains to the available amount of hours and expertise of DCF employees. One possible explanation for our findings is that DCF employees skilled in detecting financial reporting errors are different from DCF employees who have the skills required for SST disclosure oversight. Kubic (2019) shows that among DCF engagement team members identified in a comment letter, accountants, but not lawyers, are particularly adept at identifying financial reporting errors. Assuming accountants (lawyers) have relatively more expertise for overseeing financial accounting (SST), examining the labor mix at the DCF may provide some insights as to why we observe SST error detection and crowding-out effects.¹⁶

While we can observe DCF examiner names listed on any specific comment letter, information about the complete set of individuals employed by the DCF is not publicly available. To characterize the available DCF human capital each year, we obtain the name of each DCF employee by year through a Freedom of Information Act (FOIA) request.¹⁷ We then combine the names of DCF employees with information on the employee's occupation type from www.FederalPay.org.

DCF employee composition by year is presented in Table 6. In Columns (2) through (8) we provide FOIA data on the overall composition of the DCF. In Column 2, we observe no obvious time trend in the number of DCF employees, with the highest (lowest) headcounts occurring in 2005 and 2013 (2009 and 2012). However, the occupation mix of the DCF has systematically changed, with the percentage of accountants (lawyers) decreasing (increasing) from 51% (36%) of total DCF employees in 2005 to 44% (43%) in 2015. Column 8 reveals the

¹⁶ Lawyers may be better suited to regulate SST disclosures due to the wide range of laws that govern sanctionable firm interactions with foreign nations, such as, for example, the Iran Sanctions Act of 1996.

¹⁷ The response to our FOIA request did not contain sufficient information to identify the specific employees that were assigned to the OGSF each year.

proportion of employees with occupations other than accountant or lawyer remains a relatively stable proportion of overall DCF headcount at about 13%. These other employees are primarily support staff, with the three most frequent occupational titles being (1) administration and program support, (2) information technology management and (3) clerk and assistant.

Columns 2 through 8 in Table 6 report information for employees formally assignment to the DCF, however some DCF employees, such as support staff, may never work on comment letters. To assess trends in DCF employees who worked on comment letters, in Columns 9 through 15 we report the labor mix based on employees who are listed on at least one comment letter during our sample period. We obtain a list of employee names from Intelligize and cross-reference to www.federalpay.org to obtain occupations. Like the overall DCF headcount, we find no discernable time trend in the total number of unique SEC employees listed on comment letters. We also identify similar temporal trends in the mix of referenced DCF employees. Specifically, the proportion of accountants (lawyers) referenced in at least one comment letter decreases (increases) over time from 58% (40%) in 2005 to 49% (50%) in 2015. We note that in some years the number of unique lawyers listed on comment letters (Column 12) slightly exceeds the number of lawyers formally listed in the DCF headcount (Column 5). This appears to capture situations where the DCF utilizes employees from other divisions within the SEC.¹⁸

The results in Table 6 suggest that the labor occupation distribution observed in comment letters mimics the underlying distribution of labor at the DCF. Moreover, as noted earlier, comment letters over time increasingly refer to SST, following the global increase in terrorist attacks (Figure 1). If lawyers indeed have relatively more SST expertise than accountants, it may be the case that *SST CL* represents the effort (lack of effort) by lawyers (accountants)

¹⁸ We have no means to identify the department to which such individuals are assigned. However, we can obtain their occupation by cross referencing their name with SEC payroll data.

toward SST regulation, which in turn drives lower error detection and crowds out the pursuit of financial reporting topics. That is, lawyers and accountants may have both a direct effect on error detection and the pursuit of financial reporting topics and also an indirect effect through their efforts to regulate SST disclosures.

To test this conjecture, we conduct a path analysis where the number accountants and lawyers are the source variables, error detection and core financial reporting comments are the outcome variables, and *SST CL* is the mediating variable. To estimate the path analysis, we replace the number of DCF team members (Team Size) in Equations (1) and (2) with the number of lawyers (mean = 0.81, std = 1.01) and the number of accountants (mean = 2.04, std = 0.96) separately. We report the path analysis results in Table 7.

In Panel A, we see that the number of accountants on a review team is positively associated with error detection, both directly (0.0096, $p < 0.01$) and indirectly through SST comment letters ($0.0003 = -0.0310 * -0.0099$, $p < 0.05$). Conversely, we find that the number of lawyers on a review team are associated with reduced error detection, both directly (-0.0029 , $p < 0.10$) and indirectly through SST comment letters ($-0.0004 = 0.0403 * -0.0099$, $p < 0.05$). These findings imply that pursuing SST disclosures issues enhances (degrades) the effect of accountants (lawyers) on error detection.

Regarding crowding out of financial reporting topics, in Panel B, we find that accounting comments are increasing (decreasing) in the number of accountants (lawyers), with a point estimate of 0.774, $p < 0.01$ (-0.178 , $p < 0.01$). This result is consistent with accountants having relatively more accounting expertise than lawyers. When considering indirect effects, SST comment letters facilitate an increase (decrease) in the likelihood of making an accounting comment for accountants (lawyers), with an effect equal to $-0.031 * -0.565 = 0.018$ ($0.04 * -0.565$

= -0.023). That is, the mediating effects of SST comment letters crowd out accounting comments for lawyers, but not for accountants.

In Panel C, the direct and indirect effects of accountants and lawyers on non-GAAP comments mimics the pattern observed in Panel B for accounting comments. The number of accountants (lawyers) increases (decreases) the likelihood of making a non-GAAP comment both directly and indirectly through SST comments. The effects of accountants and lawyers on MD&A questions in Panel D, however, differs from what we observe for accounting and non-GAAP comments. For MD&A comments, we observe that both accountants (0.305, $p < 0.01$) and lawyers (0.413, $p < 0.01$) directly increase the likelihood of an MD&A comment. This implies that both accountants and lawyers have some expertise with respect to MD&A, perhaps because the MD&A captures a wide range of issues including discussion of both accounting numbers and risk factors. However, the indirect effects of accountants and lawyers through SST comments reveals the same pattern as accounting and MD&A comments. The mediating role of *SST CL* crowds out MD&A comments for lawyers ($-0.033 = 0.04 * -0.835$) but not for accountants ($0.026 = -0.031 * -0.835$).

As a collection, the path analysis reveals two fundamental insights. First, accountants (lawyers) directly play a role in increasing (decreasing) error detection, consistent with Kubic (2019). These differential direct effects for error detection also appear when examining accounting and non-GAAP comments, consistent with accountants (lawyers) having (lacking) expertise in financial reporting oversight. Second, accountants and lawyers also influence these outcomes indirectly through SST disclosure efforts, and the effects differ by occupation. For lawyers, SST comments facilitate decreased error detection and crowding out of comments on

core financial reporting topics like accounting, non-GAAP, and MD&A. The opposite holds true for accountants.

6. Conclusion

Across a variety of specifications, we find consistent evidence that DCF effort to regulate SST disclosures decreases the quality of financial reporting oversight. When a comment letter references SST disclosures, the likelihood that a financial reporting error is detected decreases between 44 to 65% relative to unconditional error detection rates. We also find that comment letters referencing SST are less likely to mention accounting, non-GAAP and MD&A issues. Together, these results are consistent with the DCF facing a binding budget constraint whereby effort to regulate SST disclosure results in less effort directed toward financial disclosure. The SST effects we document do not represent a general risk factor phenomenon as we do not observe similar effects for comment letters referencing non-SST risk factors.

Over time we observe increases in the percentage of comment letters referencing SST disclosures which coincides with both a temporal increase in global instances of terrorism as well as a labor mix shift at the DCF towards (away from) lawyers (accountants). Consistent with accountants possessing more expertise than lawyers for detecting financial reporting errors (Kubic 2019), path analysis reveals that accountants (lawyers) are more (less) likely to detect financial reporting errors and comment on financial reporting topics. Mention of SST issues in a comment letter indirectly exacerbates these effects.

While our evidence characterizes an apparent cost to SST disclosure regulation, we do not consider any benefits. As a result, we cannot draw any conclusion regarding whether effort allocation at the DCF is in any way suboptimal. Efforts to regulate SST disclosures may have societal benefits beyond financial reporting that we are unable to empirically detect. We leave to

future research the consideration of additional costs and benefits related to SST regulation that may also be important when drawing conclusions about SST disclosure regulation by the SEC.

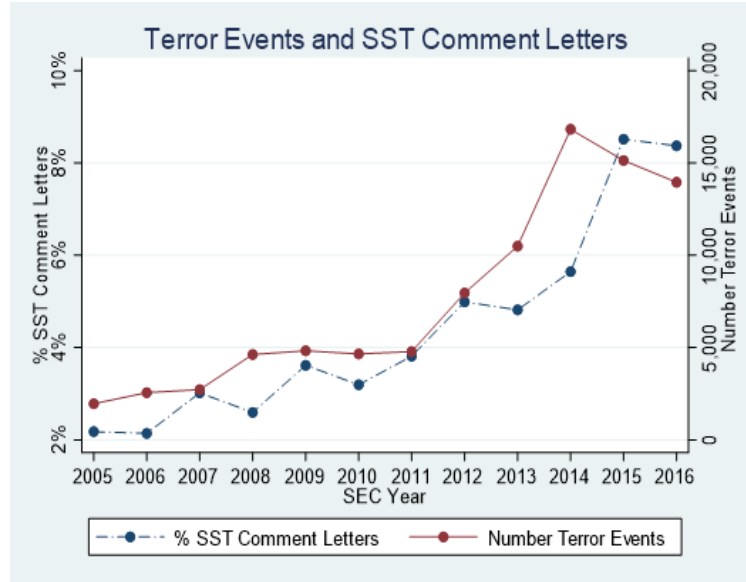
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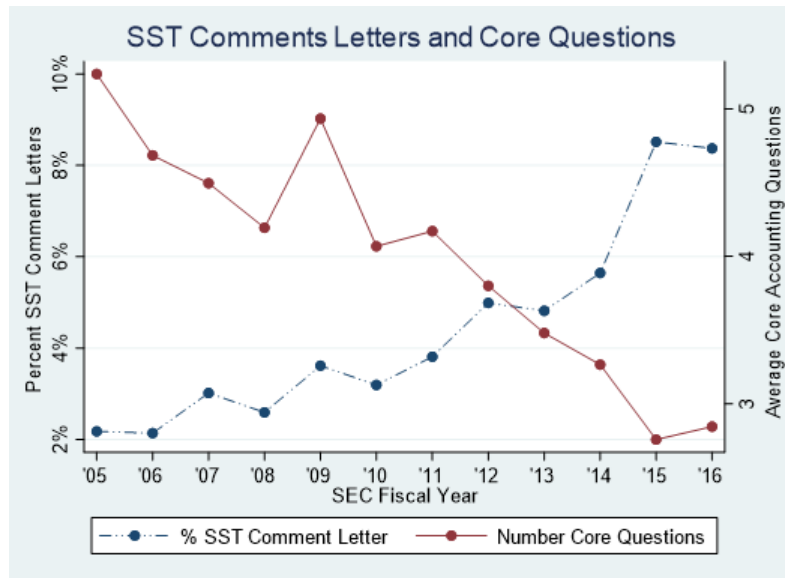
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Figure 1 – SST Comment Letters and Global Terrorism Events



Note: This figure plots the percent of SST comment letters and the number of global terrorism events for each SEC fiscal year from 2005 to 2016. Terror events are obtained from the National Consortium for the Study of Terrorism and Responses to Terrorism (START) Global Terrorism Database (<https://www.start.umd.edu/about/about-start>).

Figure 2 – SST Comment Letters and Core Financial Reporting Questions



Note: This figure plots the percent of comment letters containing an SST comment against the average number of questions pertaining to core financial reporting topics in a comment letter for SEC fiscal years 2005 to 2016. We define core financial reporting topics as the sum of comments relating to accounting, MD&A or non-GAAP disclosure based on classifications from Audit Analytics.

Table 1 – Comment Letter Sample Selection

Comment letter conversations pertaining to recurring reviews in Audit Analytics between 10/1/2004-9/30/2016	30,863
Less observations without Compustat match	-3,242
Less observations without necessary Compustat data to calculate control variables	-5,960
Less observations without necessary CRSP data	-2,525
Less observations without necessary AA data to calculate audit control variables	-963
Less observations without necessary data to calculate other control variables	-355
Equals full sample SEC comment letter conversations*	17,818
Less observations without a restatement	-15,718
Equals known error subsample**	2,100
Less non-severe restatements	-1,016
Equals known severe error subsample**	1,084

* Observations used in full sample regressions

** Observations used in various subsample analysis

Note: We obtain comment letter conversations for recurring reviews from the Audit Analytics Comment Letter database. Recurring reviews pertain to financial filings 10-K, 10-Q and 20-F. Each conversation includes the initial letter from the SEC, the firm's response and all additional rounds of correspondence. The conversation ends when the SEC closes the review. We merge AA comment letter data with Compustat, CRSP, AA auditor data, and WRDS SEC Analytics data. We use the Intelligize comment letter database to collect the names of SEC examiners listed on the comment letters. The restatement subsample consists of comment letter reviews where the firms ultimately restates the period reviewed by the SEC. Non-severe restatements are those restatements that do not meet the following conditions: financial statements were corrected via Form 8K Item 4.02 or errors with an adverse effect on either revenue or expenses (AA variables adverse =1 and core =1).

Table 2 Panel A – SST Comment Letters Over Time

(1)	(2)	(3)	(4)
SEC Fiscal Year	# Comment Letters	# SST Comment Letters	% SST Comment Letters
2005	826	18	2.2%
2006	1,448	31	2.1%
2007	1,358	41	3.0%
2008	1,657	43	2.6%
2009	2,157	78	3.6%
2010	2,098	67	3.2%
2011	1,626	62	3.8%
2012	1,543	77	5.0%
2013	1,557	75	4.8%
2014	1,311	74	5.6%
2015	1,151	98	8.5%
2016	1,086	91	8.4%
TOTAL	17,818	755	4.2%

Note: This table provides annual descriptive statistics on comment letters by SEC fiscal year since 2005, the first year comment letters are available. #Comment Letters (#SST Comment Letters) is the number of comment letter conversations overall (with at least one mention of SST) that begins during the SEC fiscal year. % SST Comment Letters is the percentage of comment letters that begins during a given SEC fiscal year that contain at least one reference to SST.

Table 2 Panel B – Tabulation of Source Material Referenced in SST Comment Letters (N=755)

Source Material Type	N	% of 755 Total SST CL	Source Material Examples from SST Comment Letter Excerpts
Company Disclosure	608	80.5%	"We also note the disclosure on page 5 and elsewhere in your Form 10-K that you operate in regions including the Middle East and Africa. As you know, Iran, Syria and Sudan, countries located in those regions, are designated by the U.S. Department of State as state sponsors of terrorism and are subject to U.S. economic sanctions and export controls. Your Form 10-K does not include disclosure about contacts with those countries." (Logitech International Comment Letter Dated 12/21/2012) "You state on Pages 10, 80, and elsewhere that you operate in the Middle East and Africa - references generally understood to encompass Iran, Syria, and Sudan. We note that Exhibit 21.1 lists Fluor Iran and FD Eurasia as subsidiaries." (Ariba, Inc. Comment Letter Dated 2/4/2010)
Media	202	26.8%	"We note a 2012 news article reporting that shops in Iran were selling Barbie Dolls." (Mattel, Inc. Comment Letter Dated 4/16/2012) "We are aware of an August 2010 news article indicating that Heinz ketchup is available in Cuba, and a March 2012 news article reporting that Heinz ketchup is available in Iran." (Kraft Heinz Foods Corporation Comment Letter Dated 9/27/2012)
Registrant Website	177	23.4%	"Your website includes a link to the website of Priceline Hong Kong. Priceline Hong Kong lists on its website destinations served in Cuba, Iran and Syria." (Booking Holdings Inc. Comment Letter Dated 2/23/2007)
Affiliate	188	24.9%	"A Coca-Cola bottler website indicates that the Coca-Cola company has a distributor in Syria." (Ball Corporation Comment Letter Dated 9/2/2014)
Other Website	88	11.7%	"We are aware of third-party websites showing companies in Iran that carry Cummins products or parts." (Cummins, Inc. Comment Letter Dated 5/16/2012)
Regulatory Enforcement	32	4.2%	"We note that your subsidiary, Moneygram Payment Systems Inc., continues to be identified on the OFAC website as an authorized remittance forwarder to Cuba." (Moneygram International Inc. Comment Letter Dated 5/9/2013)
Intellectual Property	5	0.7%	"It appears from publicly available information that a person identified as a Co-Inventor in certain of your patent applications may be an Iranian national." (Maxlinear Inc. Comment Letter Dated 6/27/2012)
Total Source Items Referenced	1,300		
Mean Source Items Per Comment Letter	1.72		
Median Source Items Per Comment Letter	2.00		

This table reports descriptive evidence on the source material referenced in SST comment letters. We read each SST comment letter and categorize the source material referenced by the SEC in the following categories: company disclosures, media, registrant's website, affiliate, other website, regulatory enforcement, or intellectual property. Mean (Median) Source Items reports the mean (median) number of sources per SST comment letter. Company Disclosure is an indicator equal to one if an SST comment letter mentions registrant filings (including exhibits) or other company disclosures (e.g., conference calls) as a source of information. Media is an indicator equal to one if an SST comment letter mentions news or media reports. Registrant Website is an indicator equal to one if an SST comment letter mentions the registrant's website or information on the website. Affiliate is an indicator equal to one of the SST comment letter mentions that detection arose based on a registrant's significant affiliation with another entity, including joint ventures, significant customer, significant supplier, recent acquisition, or subsidiary. Other website is an indicator equal to one if an SST comment letter mentions a website other than the registrant's website. Regulatory enforcement is an indicator equal to one if an SST comment letter mentions regulatory enforcement actions or investigations. Intellectual Property is an indicator equal to one if an SST comment letter mentions intellectual property (e.g., patents) as a source of information for detection.

Table 2 Panel C – Comment Letter Sample Descriptive Statistics

Variable name	Ind/Cont	Obs	Mean	SD	P25	P50	P75
Comment Letter Variables							
SST CL	I	17,818	4.2%	0.20	0.0	0.0	0.0
Error Caught	I	17,818	3.2%	0.18	0.0	0.0	0.0
Team Size	C	17,818	2.9	1.0	2.0	3.0	3.0
Firm Characteristics							
LN MarketCap	C	17,818	7.0	2.1	5.5	7.0	8.3
Firm Age	C	17,818	21.7	16.0	10.0	17.0	28.0
Loss	I	17,818	26.0%	0.44	0	0	1
Bankruptcy Rank	C	17,818	4.9	2.4	3.0	5.0	7.0
Sales Growth	C	17,818	14.9%	0.44	-2.7%	7.2%	20.8%
M&A	I	17,818	18.5%	0.39	0	0	0
High Volatility	I	17,818	22.5%	0.42	0	0	0
Audit Characteristics							
Big 4 auditor	I	17,818	79.6%	0.40	1	1	1
LN Auditor tenure	C	17,818	2.3	0.9	1.6	2.2	2.8
Auditor change	I	17,818	15.7%	0.36	0	0	0
Material weakness	I	17,818	6.6%	0.25	0	0	0
Filing Characteristics							
Recent 8Ks	C	17,818	0.96	1.12	0	1	2
Ref Amended Filing	I	17,818	5.5%	0.23	0	0	0
FOG	C	17,818	20.2	1.0	19.5	20.1	20.7
Litigation Words	C	17,818	1.0%	0.00	0.7%	0.9%	1.2%

Note: The sample selection procedure for the comment letter analysis is described in table 1. The column Ind/Cont shows whether a variable is an indicator variable ("I") or a continuous/count variable ("C"). Continuous variables are winsorized at the 1 and 99 percentile. Appendix A provides variable definitions.

Table 2 Panel D – Comment Letter Sample Pearson Correlations

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
1 SST CL	1.000																	
2 Error Caught	-0.028***	1.000																
3 Team Size	0.033***	0.018**	1.000															
4 LN MarketCap	0.148***	-0.061***	-0.012	1.000														
5 Firm age	0.065***	-0.018**	-0.008	0.324***	1.000													
6 Loss	-0.028***	0.027***	0.055***	-0.351***	-0.156***	1.000												
7 Bankruptcy rank	-0.028***	0.029***	-0.070***	-0.144***	-0.059***	0.314***	1.000											
8 Sales Growth	-0.031***	0.024***	0.008	-0.016**	-0.169***	-0.005	-0.061***	1.000										
9 M&A	0.056***	-0.012	0.042***	0.158***	0.040***	-0.043***	-0.004	0.046***	1.000									
10 High Volatility	-0.031***	0.036***	0.061***	-0.356***	-0.192***	0.335***	0.082***	0.103***	-0.050***	1.000								
11 Big 4 auditor	0.075***	-0.037***	0.014*	0.501***	0.135***	-0.132***	-0.053***	-0.034***	0.073***	-0.172***	1.000							
12 LN Auditor tenure	0.062***	-0.025***	0.004	0.373***	0.457***	-0.153***	-0.049***	-0.141***	0.066***	-0.194***	0.339***	1.000						
13 Auditor change	-0.027***	0.043***	-0.009	-0.209***	-0.076***	0.080***	0.040***	0.054***	-0.047***	0.101***	-0.270***	-0.557***	1.000					
14 Material weakness	-0.009	0.044***	-0.005	-0.152***	-0.069***	0.115***	0.047***	0.035***	-0.030***	0.120***	-0.122***	-0.159***	0.156***	1.000				
15 Recent 8Ks	-0.033***	0.031***	0.001	0.075***	0.057***	0.021***	0.079***	0.039***	0.055***	-0.008	0.032***	0.046***	0.002	0.019**	1.000			
16 Ref Amended Filing	-0.021***	0.082***	0.050***	-0.124***	-0.072***	0.067***	0.035***	0.026***	-0.035***	0.068***	-0.105***	-0.080***	0.059***	0.112***	-0.003	1.000		
17 FOG	0.002	-0.018**	-0.003	0.142***	-0.023***	0.010	0.141***	0.025***	0.117***	-0.023***	0.132***	0.037***	-0.064***	-0.028***	0.049***	-0.026***	1.000	
18 Litigation Words	0.015**	-0.012	0.003	0.203***	0.200***	-0.059***	0.032***	-0.031***	0.051***	-0.040***	0.118***	0.124***	-0.036***	-0.001	0.049***	-0.019**	0.367***	1.000

Note: The sample selection procedure for the comment letter analysis is described in table 1. This table presents Pearson correlations for variables in the comment letter analysis. Continuous variables are winsorized at the 1 and 99 percentile. Appendix A provides variable definitions. ***, **, * represent statistical significance at the 1%, 5%, and 10% levels.

Table 3 – SST Comment Letters and Error Detection Rates

Panel A: $Error\ caught_{c,i} = \alpha_0 + \alpha_1 SST\ CL_{c,i} + \sum_n \alpha_n Controls_{c,i} + \delta_{c,b} + \varepsilon \quad (1)$

	1	2	3	4	5
SST CL	-0.0247*** (-6.83)	-0.0143*** (-3.94)	-0.0198*** (-5.16)	-0.118*** (-3.95)	-0.239*** (-4.27)
Team size		0.00462*** (3.27)	0.00490*** (3.24)	0.0309*** (2.92)	0.0425*** (2.97)
Firm Characteristics					
LN MarketCap		-0.00251*** (-2.85)	-0.00203* (-1.89)	-0.0155** (-2.23)	-0.0245** (-2.05)
Firm age		-0.0000283 (-0.27)	-0.0000669 (-0.61)	-0.000582 (-0.81)	-0.000835 (-0.79)
Loss		-0.000167 (-0.04)	-0.000307 (-0.06)	-0.0171 (-0.60)	-0.0619 (-1.48)
Bankruptcy rank		0.00160** (2.17)	0.00182** (2.21)	0.00396 (0.75)	0.0101 (1.34)
Sales Growth		0.00669 (1.58)	0.00721 (1.56)	0.0340 (1.47)	0.0198 (0.65)
M&A		0.00161 (0.47)	0.000962 (0.26)	-0.0295 (-1.16)	0.0230 (0.53)
High Volatility		0.00562 (1.50)	0.00484 (1.18)	0.0386 (1.50)	0.0298 (0.83)
Audit Characteristics					
Big 4 auditor		-0.00344 (-0.70)	-0.00237 (-0.46)	-0.0893*** (-2.85)	-0.0932** (-2.02)
LN Auditor tenure		0.00474** (2.06)	0.00425* (1.70)	0.0238* (1.70)	0.0155 (0.81)
Auditor change		0.0141** (2.53)	0.0151** (2.52)	0.0489 (1.26)	0.0336 (0.68)
Material weakness		0.0121 (1.66)	0.0143* (1.76)	-0.0700** (-2.02)	-0.0499 (-1.06)
Filing Characteristics					
Recent 8Ks		0.00429*** (3.47)	0.00340*** (2.71)	0.0174** (1.98)	0.00801 (0.60)
Ref Amended Filing		0.0525*** (4.85)	0.0578*** (4.93)	0.200*** (4.82)	0.208*** (4.19)
FOG		-0.000186 (-0.12)	-0.00119 (-0.73)	0.00462 (0.38)	-0.00232 (-0.12)
Litigation Words		-0.312 (-1.06)	-0.227 (-0.71)	1.341 (0.61)	-1.095 (-0.30)
N	17,818	17,818	16,191	2,100	1,084
Unadjusted R-sq	0.1%	3.2%	3.2%	17.5%	24.3%
Adjusted R-sq	0.1%	2.4%	2.3%	11.2%	12.6%
Relative magnitude of SST to team size	N/A	3.10	4.04	3.82	5.62
Mean of Dependent	3.2%	3.2%	3.4%	26.8%	36.9%
Oster bias adjusted SST Coefficient	-	-0.011	-0.017	-0.088	-0.217
Oster δ	-	3.82	5.50	3.50	6.10
Observations	All	All	All less foreign filers	Known Error Subsample	Known Severe Error Subsample
Branch-Year FE	No	Yes	Yes	Yes	Yes

Note: Panel A presents the results of estimating Equation 2. The sample selection procedure is provided in Table 1. The dependent variable in columns 1-4 (5) is *Error Caught (Error Caught Severe)*, which equals one if the SEC Division of Corporate Finance directly identifies an error (severe error) during the comment letter process using the methodology in Kubic (2019). Columns 1-3 use the full sample of comment letter reviews, while columns 4 (5) only uses observations where the comment letter review covers a filing which is ex-post known to contain errors (severe errors). Standard errors are clustered by SEC branch-year. ***, **, * represent statistical significance at the 1%, 5%, and 10% levels.

Panel B: Matching

	Base (Table 3 Panel A Column 2)	Matching Method		
		Coarsened Exact	Propensity Score	Entropy
	1	2	3	4
Error Detection				
SST CL	-0.0143*** (-3.94)	-0.0157*** (-4.31)	-0.0326*** (-3.90)	-0.0142*** (-4.11)
N	17,818	10,207	1,251	17,818
Adjusted R-sq	2.3%	2.7%	0.5%	2.6%
Controls & Branch-Year FE	Yes	Yes	Yes	Yes

Note: Panel B presents robustness results on the main specification of error detection rates in Panel A Column 2. Columns 2 through 4 present results when using coarsened exact matching, propensity score matching, and entropy matching, respectively. When using coarsened exact matching (CEM) in Column 2, we only include observations that match on all controls within the same branch-year pairing using three evenly spaced strata. When using propensity score matching in Column 3, we first estimate a logistic regression determinants model for SST CL based on firm, audit and filing characteristics as well as branch-year fixed effects. We then match SST observations to non-SST observations based on fitted values without replacement. When using entropy balance matching, observations are weighted to adjust for out-of-balance control variables between SST and non-SST observations. The fixed effects are estimated using REGHDFE, which drops singleton observations prior to estimation (Correia 2015). Standard errors are clustered by SEC branch-year. Appendix A provides variable definitions. ***, **, * represent statistical significance at the 1%, 5%, and 10% levels.

Panel C: 2SLS Instrumental Variable Estimation

	First Stage	Second Stage
Dependent Variable:	<i>SST CL</i>	<i>Caught Direct</i>
<i>Recent Terror</i>	0.0000103*** (3.74)	
<i>SST CL</i>		-0.444** (-2.20)
N	17,818	17,818
Adj R-Squared	4.7%	.
First Stage F	.	14.01
Controls	Yes	Yes
FE	Branch	Branch

Note: Panel C presents results using two-stage least squares (2SLS) where recent terrorist attacks (*Recent Terror*) as an instrument for *SST CL*. Using the START Global Terrorism Database, we calculate Recent Terror as the number of terrorism attacks in the 90 day period prior to the start of comment letter conversation. Controls include DCF review team size, firm characteristics, audit characteristics and filing characteristics as in Equation (1). We find the number of recent terrorist attacks predicts the likelihood of a SST comment with a first-stage F-statistic of 14.1. Standard errors are clustered by SEC branch-year. Appendix A provides variable definitions. ***, **, * represent statistical significance at the 1%, 5%, and 10% levels.

Table 4 – SST Comment Letter and Crowding out Core Financial Reporting Topics

$$Core\ Comment_{c,i} = \alpha_0 + \alpha_1 SST\ CL_{c,i} + \sum_n \alpha_n Controls_{c,i} + \delta_{c,b} + \varepsilon \quad (2)$$

	Acct Comments	Non-GAAP	MD&A Comments
	1	2	3
SST CL	-1.597*** (-12.77)	-0.122*** (-8.07)	-0.640*** (-11.68)
Team size	0.420*** (13.16)	0.0246*** (7.13)	0.343*** (18.83)
Firm Characteristics			
LN MarketCap	0.122*** (6.66)	0.0107*** (4.48)	0.00353 (0.35)
Firm Age	0.000629 (0.38)	-0.000141 (-0.60)	-0.00125* (-1.85)
Loss	0.156*** (2.96)	0.000885 (0.13)	0.107*** (3.97)
Bankruptcy Rank	0.0597*** (5.39)	0.00678*** (4.43)	-0.00453 (-0.80)
Sales Growth	0.0296 (0.64)	-0.00412 (-0.70)	-0.00480 (-0.22)
M&A	0.277*** (5.79)	0.0449*** (4.65)	0.0128 (0.51)
High Volatility	0.116** (2.30)	-0.000857 (-0.12)	0.0267 (1.09)
Audit Characteristics			
Big 4 auditor	-0.202*** (-3.27)	0.00798 (0.99)	0.0000604 (0.00)
LN Auditor tenure	-0.00928 (-0.27)	-0.00845* (-1.76)	0.0118 (0.87)
Auditor change	0.0213 (0.32)	-0.0213** (-2.11)	0.0218 (0.80)
Material weakness	0.0865 (0.83)	-0.0155 (-1.23)	-0.0165 (-0.46)
Filing Characteristics			
Recent 8Ks	-0.0190 (-1.06)	0.0102*** (3.62)	0.00454 (0.61)
Ref Amended Filing	0.132 (1.50)	-0.00108 (-0.10)	0.0887** (2.12)
FOG	-0.0264 (-1.38)	-0.000895 (-0.23)	0.00872 (0.99)
Litigation Words	10.92** (2.19)	-1.466* (-1.93)	-0.779 (-0.28)
N	17,818	17,818	17,818
Adjusted R-sq	16.3%	7.7%	23.8%
Fixed Effects	Branch-Year	Branch-Year	Branch-Year
Dependent Variable Mean	2.70	0.17	1.10
Dependent Variable Standard Deviation	0.03	0.00	0.01

Note: This table presents the results of estimating equation 2. The sample selection procedure is provided in Table 1. The dependent variable in columns 1 (3) is number of accounting topics (MD&A topics) in the initial comment letter. The dependent variable in column 2 is an indicator variable equal to one if the comment letter asks a Non-GAAP question, and zero otherwise. The fixed effects are estimated using REGHDFE, which drops singleton observations prior to estimation (Correia 2015). Standard errors are clustered by SEC branch-year. ***, **, * represent statistical significance at the 1%, 5%, and 10% levels.

Table 5 – Analysis of Non-SST Risk Factor Disclosures

	Error Detection				Core Financial Reporting Comments		
	DV = Error Caught				Acct Comments	Non-GAAP	MD&A Comments
	1	2	3	4	5	6	6
non-SST Risk Factor CL	0.00168 (0.36)	0.00259 (0.50)	-0.0239 (-0.74)	-0.0564 (-1.07)	0.334*** (3.42)	-0.00293 (-0.31)	0.581*** (11.43)
Team size	0.00458*** (3.12)	0.00500*** (3.17)	0.0321*** (2.94)	0.0490*** (3.24)	0.412*** (12.48)	0.0258*** (7.45)	0.310*** (18.50)
Firm Characteristics							
LN MarketCap	-0.00267*** (-2.92)	-0.00200* (-1.80)	-0.0166** (-2.32)	-0.0224* (-1.81)	0.118*** (6.52)	0.0103*** (4.26)	-0.000849 (-0.09)
Firm Age	-0.0000123 (-0.11)	-0.0000682 (-0.60)	-0.000505 (-0.68)	-0.00103 (-0.97)	0.000847 (0.50)	-0.000157 (-0.65)	-0.00113 (-1.63)
Loss	-0.000137 (-0.03)	-0.000386 (-0.08)	-0.00181 (-0.62)	-0.0598 (-1.42)	0.142** (2.58)	0.000404 (0.06)	0.101*** (3.80)
Bankruptcy Rank	0.00167** (2.18)	0.00189** (2.24)	0.00424 (0.77)	0.0103 (1.34)	0.0622*** (5.47)	0.00653*** (4.16)	-0.00412 (-0.74)
Sales Growth	0.00680 (1.58)	0.00729 (1.57)	0.0351 (1.50)	0.0206 (0.68)	0.0357 (0.77)	-0.00420 (-0.69)	-0.00483 (-0.23)
M&A	0.00119 (0.33)	0.000389 (0.10)	-0.0284 (-1.08)	0.0295 (0.68)	0.292*** (6.00)	0.0478*** (4.71)	0.0162 (0.63)
High Volatility	0.00601 (1.59)	0.00548 (1.32)	0.0366 (1.39)	0.0360 (0.97)	0.123** (2.49)	-0.00151 (-0.21)	0.0266 (1.14)
Audit Characteristics							
Big 4 auditor	-0.00271 (-0.54)	-0.00196 (-0.38)	-0.0885*** (-2.73)	-0.0975** (-2.08)	-0.204*** (-3.33)	0.00914 (1.14)	0.00457 (0.16)
LN Auditor tenure	0.00489** (2.03)	0.00434* (1.68)	0.0263* (1.81)	0.0183 (0.93)	-0.0136 (-0.40)	-0.00974* (-1.93)	0.00734 (0.56)
Auditor change	0.0148** (2.59)	0.0156** (2.55)	0.0552 (1.38)	0.0405 (0.79)	0.00889 (0.14)	-0.0225** (-2.16)	0.0151 (0.57)
Material weakness	0.0131* (1.72)	0.0151* (1.81)	-0.0655* (-1.83)	-0.0459 (-0.95)	0.0900 (0.84)	-0.0139 (-1.05)	-0.0377 (-1.04)
Filing Characteristics							
Recent 8Ks	0.00449*** (3.57)	0.00347*** (2.71)	0.0176** (1.99)	0.00641 (0.46)	-0.0185 (-1.00)	0.0104*** (3.61)	0.00661 (0.90)
Ref Amended Filing	0.0527*** (4.78)	0.0573*** (4.84)	0.199*** (4.70)	0.210*** (4.15)	0.0853 (0.95)	-0.00449 (-0.41)	0.0590 (1.45)
FOG	-0.000305 (-0.19)	-0.00127 (-0.75)	0.00489 (0.40)	-0.00224 (-0.11)	-0.0233 (-1.16)	-0.000627 (-0.15)	0.0106 (1.20)
Litigation Words	-0.337 (-1.11)	-0.246 (-0.76)	0.964 (0.42)	-1.499 (-0.40)	12.65** (2.54)	-1.370* (-1.77)	-0.742 (-0.27)
N	17,063	15,647	2,016	1,054	17,063	17,063	17,063
Adjusted R-sq	2.3%	2.2%	10.4%	11.5%	15.6%	7.8%	25.2%
Observations	All	All less foreign filers	Known Error Subsample	Known Severe Error Subsample	All	All	All
Branch-Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Note: This table presents the results of estimating equation 2 (equation 3) in columns 1-4 (5-7) using non-SST risk factor comment letters as the test variable, rather than SST CL. The sample contains 17,063 observations, which represents the full sample of 17,818 observations less SST CL observations. Columns 1-4 present the test results for the error detection regression (Table 4) where the dependent variable is errors caught direct. Columns 5 - 7 present the test results for the crowd-out regression in Table 4. The dependent variable in columns 5 (6) is number of accounting topics (MD&A topics) in the initial comment letter. The dependent variable in column 7 is an indicator variable equal to one if the comment letter asks a Non-GAAP question, and zero otherwise. Standard errors are clustered by SEC branch-year. ***, **, * represent statistical significance at the 1%, 5%, and 10% levels.

Table 6 – Division of Corporation Finance (DCF) Employee Composition by Year

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)
	DCF Employee Composition - Per FOIA Request							Comment Letter Employee Composition						
SEC Fiscal Year	# Total Employees	# Accts	% Accts	# Lawyers	% Lawyers	# Other	% Other	# Total Employees	# Accts	% Accts	# Lawyers	% Lawyers	# Other	% Other
2005	533	271	51%	191	36%	71	13%	443	255	58%	179	40%	9	2.0%
2006	502	255	51%	177	35%	70	14%	403	230	57%	164	41%	9	2.2%
2007	496	242	49%	182	37%	72	15%	399	222	56%	169	42%	8	2.0%
2008	498	231	46%	199	40%	68	14%	413	219	53%	187	45%	7	1.7%
2009	483	225	47%	191	40%	67	14%	432	223	52%	203	47%	6	1.4%
2010	509	227	45%	215	42%	67	13%	454	225	50%	222	49%	7	1.5%
2011	498	219	44%	211	42%	68	14%	439	213	49%	217	49%	9	2.1%
2012	489	216	44%	211	43%	62	13%	429	213	50%	209	49%	7	1.6%
2013	514	224	44%	227	44%	63	12%	446	214	48%	225	50%	7	1.6%
2014	491	220	45%	210	43%	61	12%	444	211	48%	224	50%	9	2.0%
2015	501	222	44%	213	43%	66	13%	419	201	48%	211	50%	7	1.7%
2016	508	222	44%	216	43%	70	14%	405	198	49%	201	50%	6	1.5%
Average	502	231	46%	204	41%	67	13%	427	219	51%	201	47%	8	1.8%

Note: This table provides descriptive statistics on SEC budget allocations and labor headcounts by SEC fiscal year since the creation of the Office of Global Security Risk in 2005. DCF% is the percentage of the overall SEC budget allocated to the DCF each year. Columns 2-8 (9-15) show the number of DCF employees obtained from a Freedom of Information Act request (employee names listed on comment letters). # Total Employees is the total number of employees. # (%) Accts is the total number of accountants (percentage of accountants to total employees). # (%) Lawyers is the total number of lawyers (percentage of lawyers to total employees). # (%) Other is the total number of non-accountants and non-lawyers (percentage of non-accountants and non-lawyers to total employees). The most common other employees among total DCF headcount are administration and program support and information technology management. The most common other employees listed on comment letters are mining or petroleum engineers.

Table 7 – Path Analysis for Lawyer and Accountant Effects on Error Detection and Crowding out

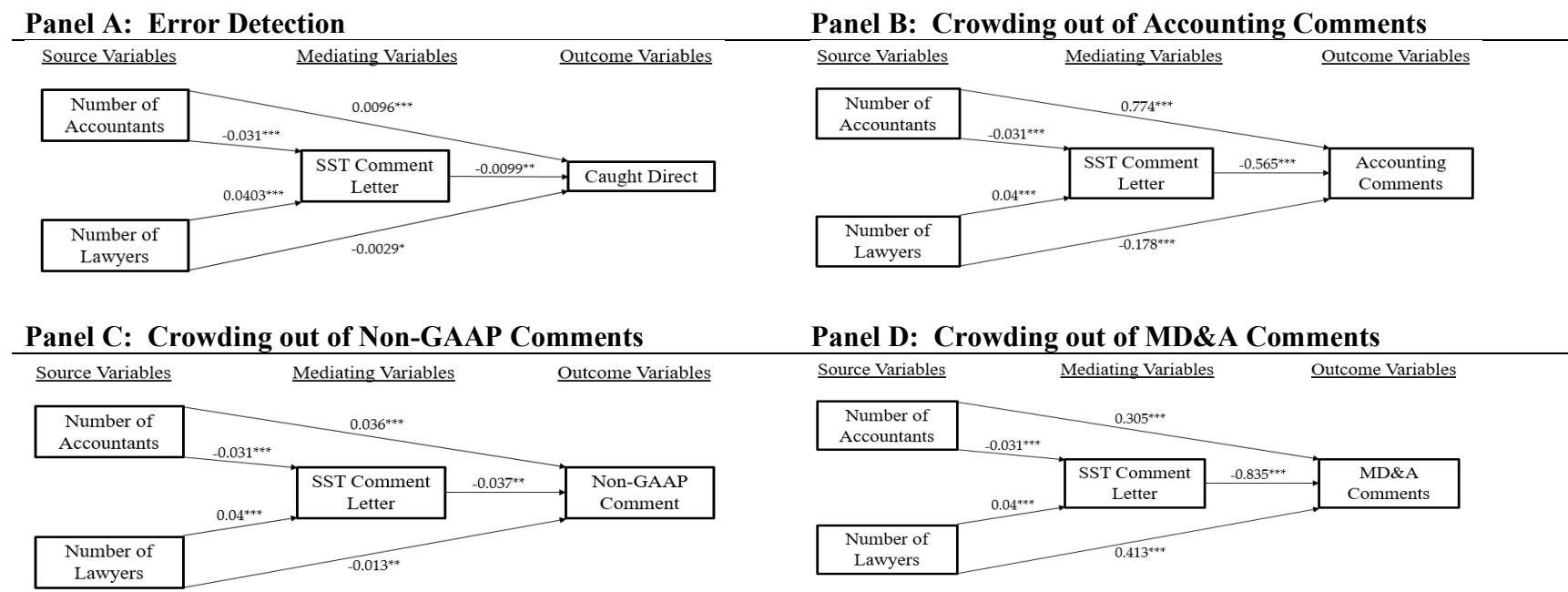


Figure 1 (2) [3] {4} in this table report the results for a path analysis of the relation between the labor mix (Number of Accountants and Number of Lawyers), DCF effort (SST CL), and error detection rates (accounting comments) [Non-GAAP comments] {MD&A Comments}. We estimate a structural equation model to determine the direct effects and indirect effects of labor mix on error detection rates (accounting comments) [Non-GAAP comments] {MD&A Comments} as mediated by DCF effort, in addition to direct DCF effort effects. Standardized path coefficients are presented and ***, **, * indicate significance at the 1%, 5%, and 10% levels, respectively. Standard Errors are clustered at the SEC Branch-Year level. N = 17,818 for each estimation presented, and the Adjusted R² = 0.092 (0.172) [0.099] {0.179} in Panel A (B) [C] {D}. Indirect effects of the Number of Accountants = 0.0003, p<0.01 (0.018, p<0.01) [0.001, p<0.05] {0.026, p<0.01}. Indirect effects of the Number of Lawyers = -0.0004, p<0.01 (-0.023, p<0.01) [-0.001, p<0.05] {-0.033, p<0.01}. Total effects of the Number of Accountants = 0.0099, p<0.01 (0.791, p<0.01) [0.037, p<0.01] {0.331, p<0.01}. Total effects of the Number of Lawyers = -0.0033, p<0.01 (-0.201, p<0.01) [-0.014, p<0.05] {0.379, p<0.01}.

Appendix A – Definition of Variables

Variable	Description	Source*
Comment Letter Variables – Presented in alphabetical order		
Acct Comments	A count of the number of unique accounting topics identified within a given comment letter. This variable sums across all unique instances of subtopics within the accounting category in Audit Analytics.	AA
Errors Caught	An indicator variable equal to one if the DCF directly identifies an error during the comment letter process using the methodology in Kubic (2019). See Appendix B for details.	AA
MD&A Comments	A count of the number of unique MD&A topics identified within a given comment letter. This variable sums across all unique instances of subtopics within the accounting category in Audit Analytics.	AA
Non-GAAP Comments	A count of the number of unique non-GAAP topics identified within a given comment letter. Non-GAAP has no subtopics in Audit Analytics, and as a result this variable is a binary indicator of the presence of a non-GAAP comment.	AA
Non-SST Risk Factor CL	An indicator variable equal to one if a comment letter poses a question regarding the risk factors, and zero otherwise. Following Cassell et al. (2013), we identify risk factors disclosures using the AA data field ISS_RISKFACT_KEYS.	AA
# Accts	The number of examiners listed on the first comment letter of a comment letter conversation who are accountants.	HC/IN/PAY
# Accts – FOIA	The total number of DCF employees for a given SEC fiscal year who are accountants. Data is reported in Table 6 and are not used in any of the regression analyses.	HC/FOIA/PAY
# Lawyers	The number of examiners listed on the first comment letter of a comment letter conversation who are lawyers.	HC/IN/PAY
# Lawyer - FOIA	The total number of DCF employees for a given SEC fiscal year who are lawyers. Data is reported in Table 6 and are not used in any of the regression analyses.	HC/FOIA/PAY
SST CL	An indicator variable equal to one if a comment letter poses a question regarding the registrant's involvement with state sponsors of terrorism. We classify an observation as having a SST comment letter question if the AA data field ISS_OTHRDISC_KEYS contains code 248 - Terrorist Nation Sponsor Reporting Issues.	AA
Team size	The number of DCF examiners listed on the first comment letter of a comment letter conversation.	HC/IN
Other Variables – Presented in alphabetical order		
Auditor Change	An indicator variable set to 1 if the auditor changed in the three years prior to the start of a comment letter conversation, and 0 otherwise.	AA
Bankruptcy rank	As defined in Cassell et al. (2013), the decile rank of the Company Altman Z-Score, where poorest financial health is assigned a value of 10. The method for calculating Z-score follows Cassell et al. (2013) and Altman (1968) and is equal to $1.2 * \text{NetWorkingCapital} (\text{ACT-LCT}/\text{AT}) + 1.4 * (\text{RE}/\text{AT}) + 3.3 * \text{EBIT} ([\text{PI} + \text{XINT}]/\text{AT}) + 6 * \text{MarketValueEquity} (\text{CSHO} * \text{PRCC_F})/\text{LT} + 1.0 * \text{SALE}/\text{AT}$, where variables are constructed as of the fiscal year immediately prior to the start of the comment letter conversation.	Compustat

Variable	Description	Source*
Big 4 Auditor	Indicator variable equal to 1 if the firm's Auditor is a Big 4 firm (Deloitte, E&Y, KPMG, or PwC), and 0 otherwise in the fiscal year immediately prior to the start of the comment letter conversation.	AA
Firm Age	Number of years the firm has been listed on Compustat as of the fiscal year immediately prior to the start of the comment letter conversation.	Compustat
FOG	Following Li (2008), the FOG score of the most recent annual filing immediately prior to the start of the comment letter conversation.	WAS
High Volatility	As defined in Cassell et al. (2013), an indicator variable set to abnormal stock return volatility in the top quartile, and 0 otherwise, where volatility is measured immediately prior to the start of the comment letter conversation.	CRSP
Litigation words	Following Loughran and McDonald (2011), the percentage of litigation words in the most recent annual filing immediately prior to the start of the comment letter conversation.	WAS
LN Auditor Tenure	The natural log of the number of consecutive years the auditor has audited the company as of the fiscal year immediately prior to the start of the comment letter conversation.	AA
LN MarketCap	The natural log of market capitalization (CSHO*PRCCF) as of the fiscal year immediately prior to the start of the comment letter conversation.	Compustat
Loss	Indicator variable equal to 1 if the firm reports a loss before extraordinary items (IB < 0), and 0 otherwise as of the fiscal year immediately prior to the start of the comment letter conversation.	Compustat
M&A	As defined in Cassell et al. (2013), an indicator variable set to 1 for non-zero acquisitions (AQP), and 0 otherwise as of the fiscal year immediately prior to the start of the comment letter conversation.	Compustat
Material Weakness	As defined in Cassell et al. (2013), an indicator variable set equal to 1 if the internal control audit opinion (under SOX 404) is a material weakness in year t, and 0 otherwise as of the fiscal year immediately prior to the start of the comment letter conversation.	AA
Recent Terror	The number of terrorist attacks in the 90-day period prior to the start of the comment letter conversation	START
Recent 8Ks	The number of 8Ks filed in the 30-day period prior to the start of the comment letter conversation.	WAS
Ref amended filing	An indicator variable equal to one if the comment letter review references a previously amended filing (LIST_FORM_DATES), and 0 otherwise.	AA
Sales Growth	The percentage change in annual sales (SALE) in the most recently completed fiscal year immediately prior to the start of the comment letter conversation.	Compustat

* Source of the variables includes Audit Analytics (AA), CRSP, Compustat, Freedom of Information Act request (FOIA), WRDS SEC Analytics Suite (WAS), Payroll data from www.FederalPay.org (PAY), Intelligize (IN), National Consortium for the Study of Terrorism and Responses to Terrorism Global Terrorism Database (START) and hand collected examiner data (HC).

Appendix B – Comment Letter to Restatement Mapping (following Kubic (2019))

Restatement Key and Title		AA Comment Letter Codes
1. Revenue Error		
6	Revenue recognition issues	176 Accounts receivable & cash reporting issues; 212 Revenue recognition issues; 816 Percentage of completion; 935 Fair value measurement, estimates, use (incl. VSOE)
2. Expense Error		
1	Depreciation, depletion or amortization errors	190 Depreciation, depletion or amortization reporting issues; 207 PPE fixed asset (value/diminution) issues;
7	Expenses (payroll, SGA, other)	192 Expense (payroll, SGA, other) recording issues; 187 Deferred, stock-based and/or executive comp issues
20	Inventory, vendor and/or COGS	202 Inventory, vendor and/or cost of sales issues
23	Capitalization of expenditures	180 Capitalization of expenditures issues; 1016 Research and Development issues
3. Compensation		
17	Deferred, stock-based and/or executive comp issues	187 Deferred, stock-based and/or executive comp; 0.927 Director compensation and options incentives--Benchmark; M.907 Executive compensation plan disclosure issues
39	Stock-based SFAS 123 only	189 Deferred, stock-based SFAS 123 only (subcategory)
48	Stock options backdating only	188 Deferred, stock-based options backdating only
69	Pension and other post-retirement benefit issues	206 Pension and related Employee Plan issues
4. Liabilities, Allowances, and Reserves		
12	Liabilities, payables, reserves and accrual estimate failures	205 Liabilities, payables, and accrual estimate issues; M. 262 Contingencies and Commitments (MD&A) disclosure issues
14	Accounts/loans receivable, investments & cash issues	176 Accounts receivable & cash reporting issues; 283 Loans receivable, valuation and allowances issues; 931 Investments (SFAS 115) and cash and cash equivalents issues
21 (excl. 42)	SFAS 5, legal, contingency and commitment issues (Exclude Leases – code 42)	203 Contingencies & Commit, legal, (FAS 5 or IAS 37) accounting issues; 284 Loss reserves (LAEs, Reinsurance) disclosure issues; M. 262 Contingencies and Commitments (MD&A) disclosure issues
71	Asset retirement issues	254 Asset retirement obligation (FAS 143) issues;
5. PPE/Intangible Assets/And Leases Error		

3	PPE intangible or fixed asset (value/diminution) issues	207 PPE fixed asset (value/diminution) issues; 208 PPE issues - Intangible assets and goodwill; 935 Fair value measurement; M.261 Oil, Gas and Mining Reserve reporting
22	Gain or loss recognition issues	1012 Gain or loss recognition issues
42	Lease, leasehold and FAS 13 only	204 Lease, leasehold (FAS 13 (98) and IAS 17)
46	Intangible assets, goodwill only	208 PPE issues - Intangible assets and goodwill; 935 Fair value measurement
6. Debt/Derivative Errors		
4	Debt, quasi-debt, warrants & equity (BCF) security issues	185 Debt and/or equity classification issues; 186 Debt, quasi-debt, warrants & equity (BCF) security issues; 935 Fair value measurement; 924 related party disclosure
8	Financial derivatives/hedging (FAS 133) acct issues	185 Debt and/or equity classification issues; 186 Debt, quasi-debt, warrants & equity (BCF) security issues; 194 Financial derivatives/hedging (FAS 133) acct issues; 935 Fair value measurement, estimates, use (incl. VSOE)
26	Debt and/or equity classification issues	185 Debt and/or equity classification issues; 186 Debt, quasi-debt, warrants & equity (BCF) security issues; M.220 Loan covenant violations/issues
27	Y - Loan covenant violations	185 Debt and/or equity classification issues; M.220 Loan covenant violations/issues
7. Statement of Cash Flow Presentation		
19	Cash flow statement (SFAS 95) classification errors	181 Cash flow statement (FAS- 95) classification; 176 Accounts receivable & cash reporting issues; M.1734 Liquidity issues (MD&A)
8. Other Classification and Presentation Issues		
9	EPS, ratio and classification of income statement issues	191 EPS, ratio and classification of income statement issues
29	Balance sheet classification of assets issues	179 Balance sheet classification of assets issues; 180 Capitalization of expenditures issues;
35	Comprehensive income issues	182 Comprehensive income (Equity Section) issues
9. Acquisition or Divestiture		
5	Proforma financial information reporting issues	O.209 Proforma financial information reporting issues
10	Acquisitions, mergers, disposals, re-org acct issues	177 Acquisitions, mergers, and business combinations; 178 Asset sales, disposals, divestitures, reorganization; 200 Investment in subs./affiliate; O.209 Proforma financial information; O.932 Reorganization and restructuring; 935 Fair value measurement

45	Acquisitions, mergers, only	177 Acquisitions, mergers, and business combinations; 935 Fair value measurement
10. VIE Consolidation and Off Balance Sheet Arrangements		
13	Consolidation issues incl Fin 46 variable interest & off-B/S	183 Consolidation (Fin 46, variable interest, SIV, SPE & off-B/S);
11. Subsidiaries and Other Issues		
11	Foreign, related party, affiliated, or subsidiary issues	195 Foreign (affiliate or subsidiary) issues; 196 Subsidiary issues-- US or foreign (subcategory);
24	Intercompany, investment in subs./affiliate issues	201 Intercompany accounting issues; 200 Investment in subs./affiliate issues; 196 Subsidiary issues-- US or foreign (subcategory);
28	Restatements made while in bankruptcy/receivership	O.210 Restatements made while in bankruptcy/receivership
36	Fin Statement, footnote & segment disclosure issues	278 Fin statement segment reporting; 195 Foreign (affiliate or subsidiary) issues; 196 Subsidiary issues; 201 Intercompany accounting issues; 183 Consolidation
37	Consolidation, foreign currency/inflation	184 Consolidation, foreign currency/inflation issue
43	Intercompany only subcategory	201 Intercompany accounting issues
44	Foreign, subsidiary only issues	195 Foreign (affiliate or subsidiary) issues
12. Tax Errors		
18	Tax expense/benefit/(FAS 109) issues	214 Tax expense/benefit/deferral/other (FAS 109) issues; 897 Tax rate disclosure issues

** In addition, we classify observations as caught direct if the restatement occurs during the comment letter period or within 135 days and the restatement announcement includes one of the following phrases: comment letter; SEC comments; routine review; comment(s) (from | received from | raised by) the SEC; letter from the SEC; following a review by SEC; in response to (a comment | comments); initiated by the SEC; received (a letter | letters) from the SEC; staff's review of; requested by the commission. We use the text "SEC" and Securities and Exchange Commission" interchangeably.