

BCLS Notes

Beyond the Classroom Lecture Series

Volume 3 Number 1 Spring 2007

BCLS Notes are
produced for the benefit
of our students by the
Faculty of School of
Business, Public
Administration, and
Information Sciences,
Long Island University



Copyright © 2005-2007 by Long Island University

Sarbanes-Oxley Act & Current Regulatory Relief: Market Reaction to Outside Directors Appointment

Hatice Uzun, PhD

School of Business, Public Administration and Information Sciences
Long Island University, NY 11201

The Sarbanes –Oxley Act

The **Sarbanes-Oxley Act of 2002** also known as the **Public Company Accounting Reform and Investor Protection Act of 2002** and commonly called **SOx** or **Sarbox** ;(July 30, 2002). Named after sponsors Senator Paul Sarbanes and Representative Michael G. Oxley .The legislation is wide ranging and establishes new or enhanced standards for all U.S. public company boards, management, and public accounting firms. The Act contains 11 titles, or sections, ranging from additional Corporate Board responsibilities to criminal penalties, and requires the Securities and Exchange Commission (SEC) to implement rulings on requirements to comply with the new law.

The recent fraud scandals at Enron, WorldCom, Sunbeam, Tyco, and others have led to more attention being directed toward corporate governance reforms that aim to improve the quality of monitoring and protection of shareholders. Investor confidence was shattered after these fraud cases were reported, and as fraud at large brokerage houses such as Merrill Lynch and Solomon Smith Barney became apparent in the second quarter of 2002, action from regulatory agencies became essential. A particularly important regulatory response to these events was the passage of the Sarbanes-Oxley Act on July 30, 2002, which is widely regarded as “the most sweeping federal law concerning corporate governance since the adoption of the initial federal securities laws in 1933 and 1934,” (Ribstein, 2002). Another important response to the securities

fraud cases came from both the New York Stock Exchange and National Association of Security Dealers (NASDAQ) requiring various corporate governance provisions for companies whose stock is traded on the NYSE or listed on NASDAQ. Both the Sarbanes-Oxley Act (SOX) and the NYSE and NASDAQ proposals impose several governance provisions on publicly traded firms in the United States. However, a significant stipulation of SOX is the call for improved oversight and monitoring capabilities of a firm's independent directors.

One of the primary purposes of the Sarbanes-Oxley Act is to correct systematic weaknesses in corporate governance structures. Specifically, it tightens up rules on disclosure and establishes guidelines for boards of directors in publicly-traded firms. One of the goals of SOX is to increase the degree of the board independence, most notably on the audit committee. A common measure for board independence is the proportion of outside directors on the board, and SOX has mandated changes to corporate governance requirements. These requirements include increasing the ratio of outsiders on the board of directors and increasing the ratio of outsiders on the board's audit committee. In addition to audit committee independence, SOX provision (SEC.407) requires public companies to appoint and disclose financial experts to the audit committee. The idea behind this requirement is to encourage boards to appoint independent directors with financial expertise to the audit committee. Theoretically, this will lead to an increase in the quality of financial reporting and monitoring as these directors should use their expertise to protect investors. Thus, the primary occupation of the outside directors and appointment to the audit committee are also important factors to protect shareholders.

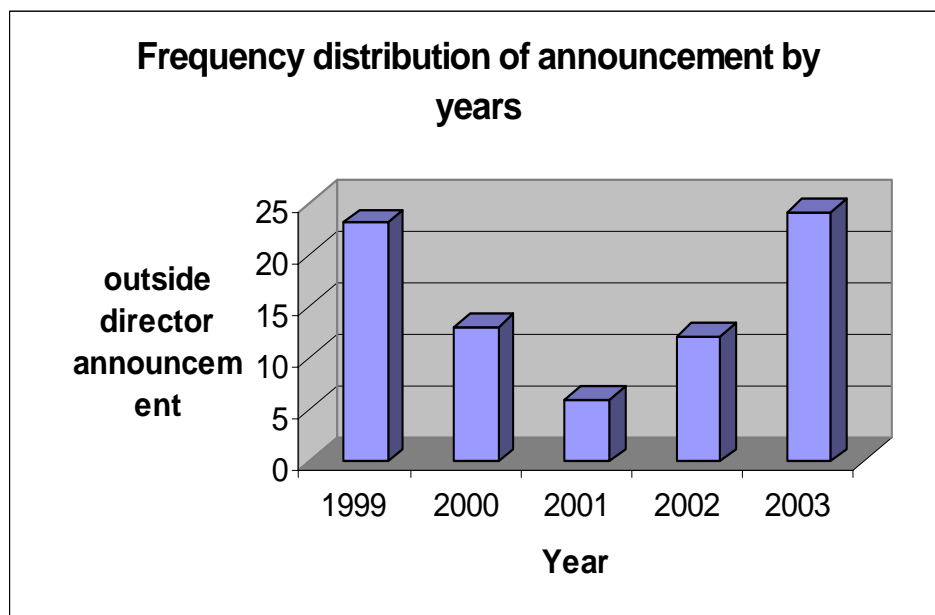
Since this Act was passed, empirical study on outside director appointment announcements has yet to be examined in the financial literature. One of the purposes of this study is to examine the stock market reaction to the appointment of outside directors both before and after the passage of the Sarbanes – Oxley Act. Previous studies, such as Rosenstein and Wyatt (1990) and Brickley, Coles, and Terry (1994), document a positive market reaction to the announcement of independent director appointments using announcements from the 1980s. However, more recent studies, including DeFond, Hann, and Hu (2005) report mixed results based on director characteristics.

Market Reaction to the Appointment of Outside Directors

In order to test the market reaction to outside director appointments following the Sarbanes-Oxley Act of 2002, *Lexis Nexis* was used to collect announcements of firms appointing an outside director to the board both before and after the SOX passage during period 1999 - 2003. The key words used in the *Lexis Nexis* search are the following: director, outside, and appointed. Firms must have returns available on CRSP to be included in the final sample. Information on the number of outsiders elected to the board, the number of directors currently on the board, the proportion of outsiders on the board prior to the announcement, whether or not the CEO is also the chairman of the board, and whether or not the new outside director will expand the board or is a replacement of a former director were also collected. Using COMPUSTAT, firm characteristics for each observation was collected in the sample.

Frequency distributions for the sample are presented in Table 1 by year.

Table 1



Using standard event study methodology, shareholder response to outside directors' appointments is analyzed. Primarily, the results show that for four different event windows the difference between market reactions to independent director appointments is not statistically significantly different between pre-SOX and post-SOX announcements. Results from multiple regression analysis show that the market reaction pre-SOX is higher when the outsider is expanding the board, but is lower in cases of CEO/chairman duality and if the outsider is appointed to the audit committee. However, post-SOX CEO/chairman duality has a positive impact on the abnormal returns. This difference in the influence of CEO/chairman duality is significantly different between samples.

Business Application and Current Regulatory Relief

The results show that the market response to the announcement of an appointment of an outsider to the board of directors is negative but not significant both before and after the passage of the Sarbanes-Oxley Act. These differences are not significant between samples. It appears that the Sarbanes Oxley Act did not influence shareholders' response to outside director appointments.

Section 404 of Sarbox requires company management to develop and processes to monitor internal controls over financial reporting- accuracy of financial statement - and it also requires auditors to test managements' assessment of company's internal controls. This section has been criticized by business groups, law-makers and others for being too expensive and irrational. In response to those criticisms, the Committee on Capital Markets Regulation made some recommendations to ease the regulation. Some of the recommendations are following:¹

- Revise section 404 to raise the bar on what constitutes a "material weakness" in internal controls. Grant auditors more judgment and less liability in assessing internal controls.
- Exempt small companies from part of section 404 if SEC actions do not go far enough.

¹ Wall Street Journal December 1,2006

- Do not apply section 404 to foreign companies that meet comparable standards at home

Currently, those recommendations are under consideration by policymakers.

Appendix A: Definition of Variables

OUTSIDE DIRECTORS: one who is not affiliated with the firm in any way except in terms of his her directorial duties. Definition of variable is taken from Rosenstein and Wyatt (1990) paper.

BOARDSIZE: the number of members on the board of directors prior to the announcement

PROP OUTSIDE: proportion of outsider on the board prior to the announcement of outside directors' appointment to the board.

DUALITY: a dummy variable set equal to "1" if the CEO is also the board chair, otherwise is zero.

OCC FINANCE: a dummy variable set equal to "1" if outside director is from a finance profession otherwise it is zero. We follow the definition of finance profession from Rosenstein & Waytt (1990) paper.

OCC CORP: a dummy variable set equal to "1" if outside director has general corporate experience. We also follow Rosenstein & Waytt (1990) paper.

EXPAND: a dummy variable set equal to 1 if the new director expands the board size, zero if director is a replacement.

AUDIT: a dummy variable set equal to "1" if outside director sits on the audit committee otherwise it is zero.

References

Brickley, James A., Jeffrey L. Coles, and Roy L. Terry (1994) Outside Directors and The Adoption of Poison Pills, *Journal of Financial Economics* 35,371-390.

DeFond, Mark L.,Ham Rebecca N. and Hu Xuesong (2005) Does the Market Value Financial Expertise on Audit Committees of Board of Directors? *Working Papers, SSRN*.

Ribstein, Larry E. (2002) Market vs Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002, *Journal of Corporation Law*, 28, 1-67

Rosenstein, Stuart, and Jeffrey G. Wyatt (1990) Outside Directors, Board Independence, and Shareholder Wealth, *Journal of Financial Economics*, 26,175-92.