

Taking the Oath: Investor Response to SEC Certification Under Sarbanes-Oxley

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Abstract

This study investigates the market response to the requirement that the principal executive and financial officer of an SEC registrant each state under oath that the firm's annual and quarterly financial reports are materially accurate and complete pursuant to the Securities Exchange Act of 1934. We hypothesise that investors should recognise the importance of these changes in financial reporting and, thus, respond at or around those events that should reveal the most information about those changes, specifically, the SEC order to certify (27 June 2002), the passage of the Sarbanes-Oxley Act (25 July 2002), and the first certification filing by a registrant. We find that investors did respond on the identified dates, and in the ways hypothesised. We conclude that investors responded to certification and / or Sarbanes-Oxley.

JEL Classification: G14, K22, M41

Keywords: Securities and Exchange Commission, SEC certification, Sarbanes-Oxley, stock market response, securities regulation.

"In a mad deadline rush, top executives from scores of large companies filed with federal securities regulators forms swearing that their latest financial results are accurate."

Schroeder (2002).

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1. Introduction

This paper examines the stock market response to the SEC requirement that a company's principal executive officer and principal financial officer each certify under oath that, to their knowledge, the company's annual and quarterly financial reports are materially accurate and complete pursuant to the Securities and Exchange Act of 1934. The passage of the Sarbanes-Oxley Act of 2002 (hereafter, Sarbanes-Oxley or the Act), perhaps the most significant change in accounting and reporting since the 1930s, effectively mandated the certification requirement into law.

We focus on the stock market response that occurred in three key stages, first, as an SEC order to require sworn statements of certification by the senior officials of SEC registrants with revenues in excess of US\$1.2 billion, proposed on 12 June 2002 and effective as of 27 June, second, as a provision of Sarbanes-Oxley, passed on 25 July 2002, and, third, as an actual certification filing. The response to certification, however, may also reflect a market reaction to other provisions of the Act, and so our tests, particularly around the passage of the legislation, are not able to isolate a certification-only effect.

The SEC order identified 947 firms required to certify, of which 695 had a due date of 14 August 2002,¹ with certifications by most of the remaining companies due before year end.² Of the 14 August companies, 631 met the deadline and 64 did not, although many of the latter received a filing extension. Uncertainty regarding the certification process was evident with regulators, who were slow to confirm compliance such that only 334 certifications were recorded as meeting the requirement as of the end of the next day.³ The Wall Street Journal (21 August) reported that only 16 firms failed to certify by 20 August.

Due to its far-reaching implications for CEO / CFOs and others such as auditors and attorneys, we hypothesise that investors should recognise certification and passage of Sarbanes-Oxley, which effectively mandated certification for all firms, as significant return-relevant events. If, as we posit in section 3, certification and the related regulations changed the expected costs and consequences of financial reporting, then investors should impound these effects in the distribution of stock return around each of the aforementioned stages, that is, the adoption of the certification order (27 June 2002), the passage of Sarbanes-Oxley (25 July 2002), and the first certification filing by a registrant subject to the order. Investor response to these implications, at a minimum, should be reflected as a change in stock return volatility, specifically, unsigned excess return, although we also examine investor response using signed excess return and test hypotheses about why investors should respond not just at the time of these events but, also, differentially due to regulation-specific factors.

¹ Specifically, the 695 companies were those whose next fiscal quarter ended on or after 30 June 2002 or whose fiscal year ended on or after 16 May 2002, regardless of whether they actually filed their 10-Q or 10-K before or after 14 August 2002. Certification filings were not permitted under EDGAR. However, of the firms in our sample, 91.5% filed their Forms 10-K, 10-Q, or 8-K under EDGAR on days -1, 0, or 1, relative to the day of a CEO certification filing (and 72.2% filed on the same day as the certification).

² Also, due before year end, were firms not on the SEC list but those required to certify under the SEC rules for all firms as mandated by Sarbanes-Oxley. See SEC (2002a; 2002b).

³ As reported in McKinnon and Spors (2002).

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