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The Sarbanes-Oxley Act and CEO tenure, turnover, and risk aversion

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ABSTRACT

Using a sample of CEO turnover from 1999 to 2005, we find that CEOs become significantly more risk averse following the passage of the Sarbanes-Oxley Act, SOX. Their increased risk aversion may serve as an explanation for why CEO tenure is not significantly shortened and forced CEO turnover is not more likely post-SOX, as we document in this paper. In addition, we provide evidence that financial restatements have some effects on CEO tenure and the probability of forced CEO turnover. This may be due to intensified monitoring activities by the board and the financial press in the post-SOX era, but we cannot contribute all of it to SOX. In some occasions, SOX seems to weaken the effect of board monitoring on CEO tenure and the effect of firm performance on CEO risk aversion. Though the increased monitoring level post-SOX contribute to the increased CEO risk aversion, little impact is found from the SOX-mandated accuracy and transparency of financial reporting.

1. Introduction

Responding to the emergency situation caused by high profile corporate scandals at the turn of the century, the U.S. Congress passed the Sarbanes-Oxley Act (SOX hereafter) in July 2002. This act mandates numerous changes in financial disclosure and corporate governance. At about the same time, various U.S. stock exchanges passed similar rules on financial disclosure, auditor independence, corporate responsibility, and criminal responsibility. The mandated provisions in SOX and the stock exchange rules[1] have been reported by popular media to lead to significant changes in management behavior, corporate governance, and the business environment.[2] SOX focus on corporate governance and the roles that managers and directors play in corporate governance. As a result, SOX may, by holding board members more accountable, change the relationship between boards and CEOs, and thereby indirectly affect CEO tenure, CEO turnover, and CEO risk aversion.

Current research on SOX covers a wide range of topics including firm value or market reaction to the passage of SOX (Chhaochharia & Grinstein, 2007), financial reporting (Jain & Rezaee, 2004), costs of public listing and the tendency to go private (Engel, Hayes, & Wang, 2007), the impact on compensation and earnings management (Cohen, Dey, & Lys, 2005; Cohen, Dey, & Lys, 2007; Carter, Lynch, & Zechman, 2006), executive loans (Cullinan, Du, & Wright, 2006; Kahle & Shastri, 2004), and the effects on corporate boards (Linck, Netter, & Yang, 2009).

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[1] Because the NYSE and NASDAQ proposals are very close to the passage of SOX in time, we do not separate the three events in our study. For simplicity, we generalize the effects of the three as the effects of SOX, and we focus our discussion on SOX provisions.

[2] Popular media reports on the effects of SOX are widespread. Major reported changes include the adversarial relationship between managements and boards, corporate risk taking behavior, fewer foreign listing on NYSE and NASDAQ (see "Stunting Corporate Growth" in The Washington Post, January 1, 2005; "Capital Punishment" in the Wall Street Journal, November 4, 2006), time spent on compliance, financial costs, constrains to innovation ("Stunting Corporate Growth" in The Washington Post, January 1, 2005), more independent outside directors, fewer corporate fraud ("The SEC's Fuzzy Math" in the Wall Street Journal, March 23, 2006), and increased investor confidence ("Compliance Survey: Public Companies Highlight Automation as Key to Realizing Business Value from Compliance Investment; Respondents Also Find Link Between Sarbanes-Oxley and Reduced Corporate Fraud" in PR Newswire US, October 3, 2006); "Shareholders See Scandals and Sarbanes-Oxley Leading to Boardroom Shake-up" in PR Newswire US Business Wire, December 16, 2003).

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To the best of our knowledge, little research has been done on CEO turnover and succession in the context of SOX. This study is designed to fill the void. While SOX may not directly regulate CEO turnover, given the mandated changes in corporate governance and the corresponding changes in the business environment, CEO turnover cannot be isolated from SOX. In particular, the mandated changes promulgated by SOX increase the responsibility of directors as monitors. Part of a director's monitoring role relates to evaluating CEO performance and making decisions that affect CEO tenure. SOX might influence how directors and other stakeholders involved in firm governance handle performance issues related to the CEO. For example, when somewhat similar regulations to SOX were passed in Great Britain, these regulations increased the incidence of CEO turnover (Dahya, McConnell, & Travlos, 2002).

In this paper, we document the changes in CEO tenure, turnover, and risk aversion post-SOX by investigating how SOX affects these three aspects of corporate governance. In particular, we examine whether SOX increases CEO risk aversion, shortens CEO tenure, and increases the likelihood of forced CEO turnover. We further investigate how these changes are related to the provisions in SOX. Since SOX targets board composition, financial reporting, and management personal responsibilities, we examine whether such mandatory requirements of SOX and the consequent intensified monitoring from multiple parties shake the position of a CEO.

Using a sample of CEO turnovers from the years 1999–2005, we find that CEOs become more risk averse following the passage of SOX; this may explain why we find that CEO tenure is not significantly shortened nor is forced CEO turnover more likely post-SOX. In addition, we provide evidence that financial restatements have some effects on CEO tenure and the probability of forced CEO turnover which may be due, in part, to intensified monitoring activities from the board and the financial press after SOX took effect. We cannot, however, contribute all of this to SOX. In some occasions, SOX seems to weaken the effect of board monitoring on CEO tenure and the effect of firm performance on CEO risk aversion. Though the increased monitoring level post-SOX contribute to the increased CEO risk aversion, little impact is found from the SOX-mandated accuracy and transparency of financial reporting.

We structure the remainder of the paper as follows. Section 2 discusses the major provisions of SOX that might relate to executive turnover and firm performance, surveys the existing literature, and develops our hypotheses. Section 3 describes the data used in our analysis. We present our methodology and results in Section 4, and offer a conclusion in Section 5.

2. Literature review, related provisions by SOX, and hypothesis development

This study is inspired by the research of Dahya et al. (2002) who empirically examine the relation between the Code of Best Practice (the Code hereafter) recommended by the Cadbury Committee and firm performance, as well as the relation between the Code and CEO turnover in Great Britain. They find that CEO turnover increases and the relation between CEO turnover and firm performance becomes stronger following the issuance of the Code. SOX differs from the Code in that SOX belongs to mandatory governance regimes, while the Code belongs to partially mandatory regimes (Anand, 2005). However, the two sets of regulation have similarities. Both were enacted in a similar environment in the aftermath of financial scandals of big corporations and the fallen confidence of investors. In addition, both were designed to improve corporate governance by increasing the number of independent directors serving on the board.

2.1. Effect from intensified monitoring—the board, the institutional owners, and the press

SOX requires more independent directors on corporate boards and empowers the audit committee with the appointment, compensation, and oversight of the work of any registered public accounting firms employed by a firm. In addition, the registered public accounting firms report directly to the audit committee, and the audit committee also has the authority to engage in independent counsel and other advising to carry out its duties. Intuitively, active boards should be more effective in exercising their monitoring roles. Linck et al. (2009) find that SOX significantly increases the monitoring function of corporate boards, including more outside directors, more audit committees meetings, more financial experts, and fewer CEO/Chair dualities. Board meeting frequency may be a proxy for board monitoring effectiveness (Vafeas, 1999). Conger, Finegold, and Lawler (1998) argue that effective board decisions require that directors have "sufficient, well organized periods of time together as a group" (p. 7). Boards that meet more often are more likely to be more effective monitors (Xie, Davidson, & DaDalt, 2003).

SOX created the Public Company Accounting Oversight Board (PCAOB) to oversee the audit of public accounting companies in preparing informative, accurate, and independent audit reports of publicly held companies.[3] Mandatory registration with PCAOB puts U.S. corporations under indirect monitoring of PCAOB via public accounting firms and the audit committees. SOX has specific provisions that require auditor independence, auditor rotation, and prohibits auditing firms from conducting non-audit service for their clients. Further, SOX requires that public accounting firms report to the clients' audit committees in a timely manner, that the audit committee be independent and that at least one member be a financial expert. Corporate managers are also under the scrutiny of their employees through the mandatory anonymous whistle-blowing channel.[4]

If SOX has had its intended effect, corporate boards will become more critical monitors of CEOs. When CEOs fail to provide expected results, boards that are more active monitors may be more willing to make changes at the top and replace the incumbent CEOs. Therefore, we propose board activity changes resulting from SOX mandatory requirements affect the position of a CEO. More active boards are better at firing ineffective CEOs. Further, given the changes in the composition of boards, we expect to see CEO tenure shortened in the post-SOX period and more forced turnovers. As a result, CEOs are likely to become more risk averse after the passage of SOX.

Researchers have documented that institutional investors and the financial press affect CEO tenure and turnover. For example, Parrino, Sias, and Starks (2003) find that both the proportion of institutional ownership and the number of institutional investors decline in the year prior to CEO turnover. Institutional investors tend to intervene in managerial activities to protect shareholder interest. Guercio, Seery, and Woidtke (2008) examine boards' reaction to institutional investor activists' campaigns and find that 31%

[3] One of the duties of PCAOB is to establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers (detailed in Section 103). Section 104 and Section 105 detail the duties of PCAOB to conduct inspection of registered public accounting firms, investigations, and disciplinary proceedings concerning, and to impose appropriate sanctions upon registered public accounting firms and associated persons of such firms.

[4] Due to difficulties of getting the data of employee whistle blowing, we incorporate the effects of whistle blowing on CEO turnover through the dummy variable of post-SOX.