The Buffering Effect of Brands for Companies Facing Legislative Homogenization: Evidence from the Introduction of Sarbanes-Oxley

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Broad Questions:

- How does regulation affect the allocation of resources within firms?
- How does regulation affect firm efficiency?
- How can firms protect themselves from the uncertainties of regulatory change?

We use the laboratory of Sarbanes-Oxley (SOX) legislation to investigate these questions within the context of firms' marketing decisions.

Specific Questions:

- After SOX, how do firms adjust the allocation of resources between value creation and value appropriation strategies?

- How do these changes affect marketing efficiency?

- Was there a characteristic that buffered firms from the negative consequences of SOX?

SOX and the Costs of Taking Risk:

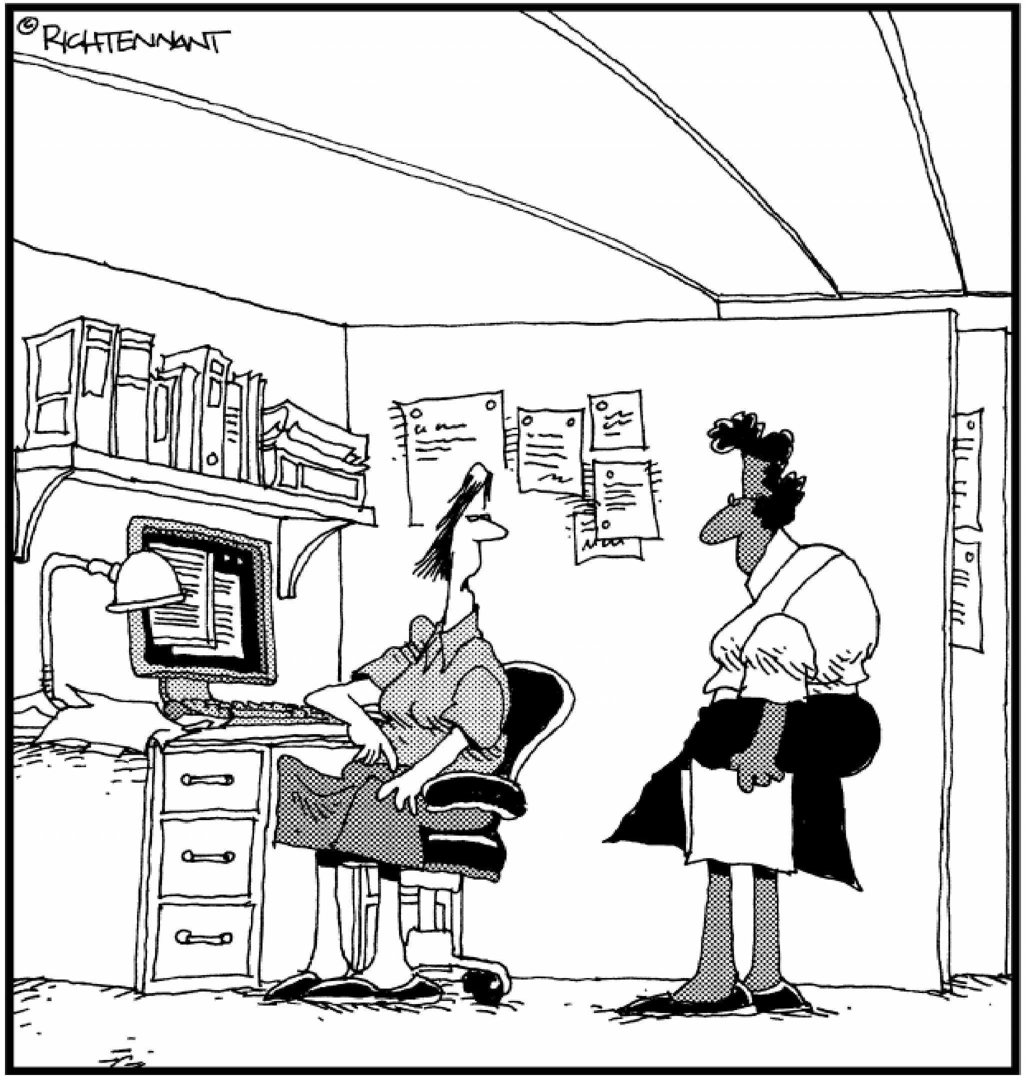
- SOX requires the CEO and CFO to certify the correctness of firms financial statements and face potential criminal charges for misstatements.
  - Riskier projects with greater asymmetric information increase the probability of perceived misconduct and potential criminal liability when the outcomes are poor
- Section 404 requires corporations to evaluate and disclose the adequacy of their internal controls.
  - Riskier projects require a greater commitment of resources to internal control systems
- In related changes, the NYSE and Nasdaq changed listing standards to increase the role of independent directors.
  - Greater reliance on independent directors potentially imposes a sub-optimal board structure with higher costs of acquiring information about projects, particularly risky projects.

Concerns about the Effects of SOX on Risk-Taking

“Sarbanes-Oxley says to every entrepreneur, ‘For God's sake don't innovate. Don't take chances because down will come the hatchet. We're going to knock your head off’”

-- Milton Friedman

The 5th Wave By Rich Tennant



"Thanks to Sarbanes-Oxley, we've got more internal controls than a warehouse full of Imodium."

Academic Evidence:

- Survey evidence suggests CFOs believe SOX adversely affects corporate risk taking (Graham, Harvey, and Rajgopal, 2003)
- Stock option compensation and risk-taking in U.S. firms decreased following SOX (Cohen, Dey, and, Lys, 2007)
- Risk-taking by U.S. public firms decreased relative to non-U.S. firms following SOX (Bargeron, Lehn, and Zutter, 2009)
- Stock returns around SOX related announcements vary inversely with firms' growth opportunities (Wintoki, 2007)

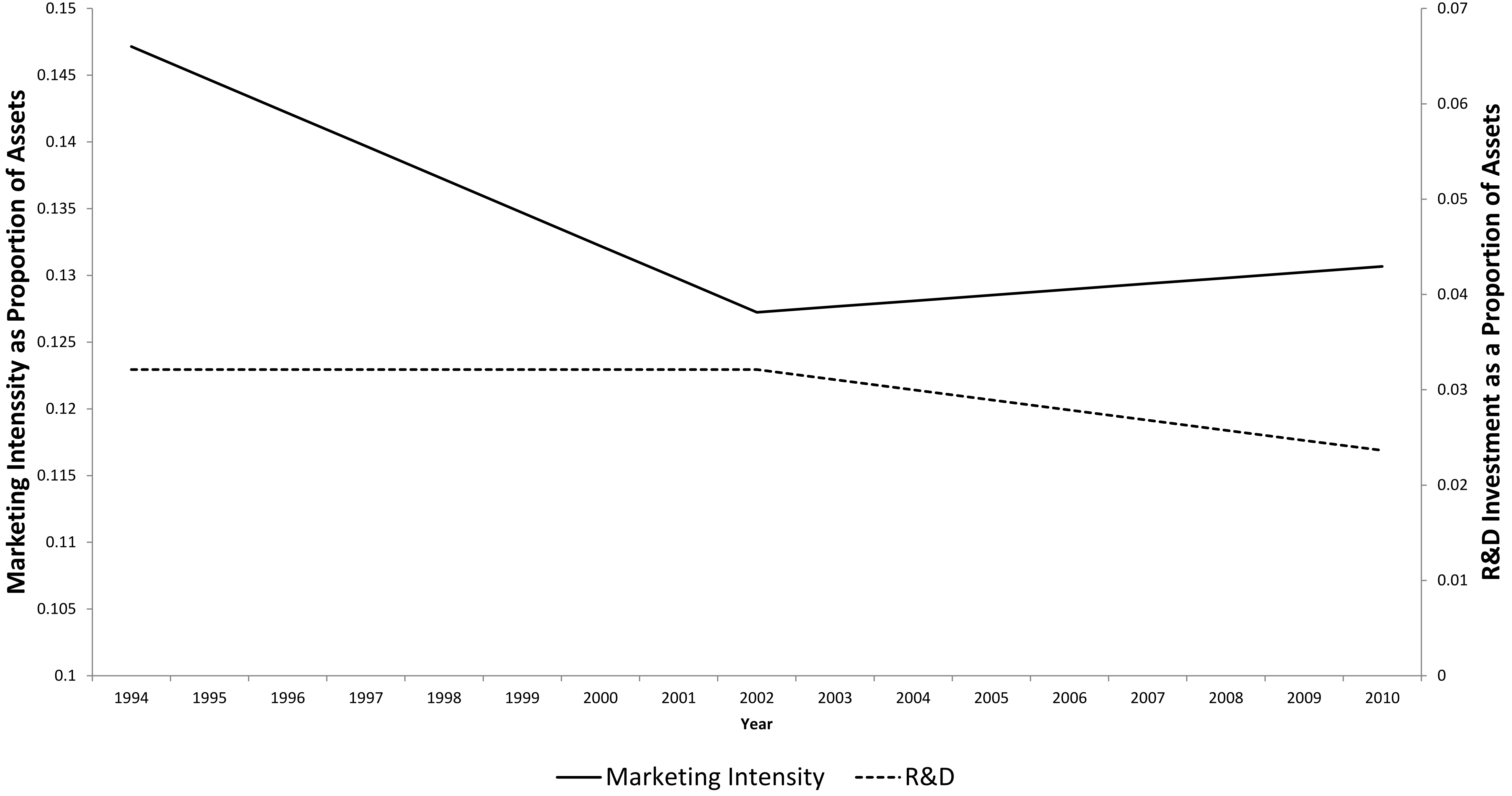
Predictions:

Testable predictions:

- After SOX, firms will shift from risky value creation investments to safer value appropriation investments
- This shift will decrease marketing efficiency (the efficiency of value appropriation strategies)
- Strong branding can insulate firms from a decrease in marketing efficiency

Untested prediction:

- Decreased investment in value creation can damage long-term competitiveness of U.S. firms relative to non-U.S. firms



Marketing Intenssity as Proportion of Assets
0.15
0.145
0.14
0.135
0.13
0.125
0.12
0.115
0.11
0.105
0.1
R&D Investment as a Proportion of Assets
0.07
0.06
0.05
0.04
0.03
0.02
0.01
0
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
Year
Marketing Intensity
R&D

Figure 2

Value Creation vs. Value Appropriation Results:

- In U.S. firms after SOX: we observe a significant shift away from value creation and toward value appropriation

- In non-U.S. firms not affected by SOX: we observe the opposite – a shift toward value creation and away from value appropriation

- In U.S. firms not affected by SOX (below $75 million in assets): we do not observe a shift

Marketing Efficiency Results:

- In U.S. firms after SOX: we observe a decrease in marketing efficiency

- In non-U.S. firms after SOX: we observe the opposite - an increase in marketing efficiency

- The decrease in efficiency for U.S. firms is reduced in high brand equity firms

Conclusions:

- Regulation can affect the allocation of resources in firms: After SOX, U.S. firms emphasized safer short-term value appropriation at the expense riskier long-term value creation.

- The shifts caused by regulation can decrease efficiency: SOX decreased marketing efficiency.

- Firms can insulate themselves from the effects of regulation: High brand value acted as a buffer against the decrease in marketing efficiency

- The results raise the concern that the shift away from investment in long-term value creation could have significant negative consequences for the future competitiveness of U.S. firms.