John H. Schnatter Institute for the Study of Free Enterprise

RESEARCH SUMMARY

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

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How do corporations respond to changes in their regulatory environment? How does it affect their spending on two critical activities:

1. Value creation (researching and developing new products) and
2. Value appropriation (extracting profits from existing products)?

Corporations balance their expenditures between planning for the future (value creation) and making sales today (value appropriation). Excessive research and development may result in too many costs without enough benefits, while too little innovation may reduce their competitive advantage in the future.

Analyzing corporate behavior change following the passage of the 2002 Sarbanes-Oxley Act, Thomaz, Bargeron, Hulland, and Zutter found that, on average, corporations shifted their spending away from value creation and towards value appropriation. This shift led to reduced marketing efficiency—the proportion of sales to marketing expenditures decreased. However, companies with strong brands were shielded from the efficiency reduction.

BACKGROUND

In the wake of a series of accounting scandals (Enron, WorldCom, and Adelphia), the United States Congress attempted to restore investor confidence and prevent future scandals by passing the Sarbanes-Oxley Act of 2002 (SOX). The act targets U.S. companies with asset values greater than $75 million. Two elements of the act increased the costs of risky investments:

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1. The chief executive and chief financial officers must certify the correctness of the firm's financial statements (and potentially face related criminal charges); and
2. Corporations must evaluate and disclose the effectiveness of internal control systems to avoid or identify misstatements about investments.

The increased costs of risky investments has been confirmed by prior research which found that risk-taking in U.S. firms decreased after SOX. Using financial accounting and stock data, the authors explore the increased cost of risky investment by analyzing the trade-off between value creation (R&D) and value appropriation (advertising) before and after the passage of the act.

FINDINGS

This study provides evidence that legislative changes such as Sarbanes-Oxley can significantly affect corporate marketing policies and result in less efficient expenditures.

In the post-SOX environment, U.S. corporations are trading away their future (investments in research and development) for immediate gains (sales from advertising). This response may jeopardize their future and their stakeholders' (shareholders, suppliers, employees, and customers) future wellbeing.

- On average, corporations shifted their emphasis away from riskier R&D investments and towards safer marketing activities.
- Increased corporate marketing expenses across industries led to decreases in marketing efficiency—the proportion of sales to marketing costs.
- However, firms that invested in building their brand prior to SOX maintained more of their marketing efficiency.

In the future, Sarbanes-Oxley may make U.S. corporations vulnerable to innovative foreign competitors that can leverage their size without having to comply with the law.