SEC Ruling, Investor Confidence and Firm Valuation

Gang Bai
Southwestern University of Finance and Economics

Yan Hu
University of La Verne

Daniel Hsiao
Texas A&M University Commerce

Prior studies suggest that a firm is valued higher when the shareholders are better protected. By examining the firms' responses to the SEC Order No. 4-460, we find significant positive abnormal returns to those firms with correct certification. Those firms with timely certification are rewarded with higher valuation. Consistent with the notion that large outside blockholders have strong incentive to monitor managers, we find that outside blockholders play an important role in ensuring the accuracy and timeliness of financial reports. The equity-based compensation package may align the managerial interest with shareholders' as a whole, but not necessarily with outside shareholders'.

Keywords: SEC Order 4-460, abnormal returns, blockholder ownership, firm valuation

INTRODUCTION

Prior finance research suggests that the legal protection of investors plays an important role in the development of the financial markets and the valuation of firms. Especially, La Porta et al. (2002) found that firms with better legal protection of shareholders were rewarded with higher firm valuation. In response to the wave of many accounting scandals and collapses of Adelphia, Enron, WorldCom, and other high-profile firms since the late 1990s, on June 27, 2002, the Securities and Exchange Commission (SEC hereafter) issued an Order No. 4-460 (the Order hereafter) which requires the filing of sworn statements pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934. The Order 4-460 requires the principal executive officer (CEO) and the principal financial officer (CFO) of the 947 (or 945 per SEC) largest companies to, under oath, personally attest that the companies' most recent periodic reports are materially truthful and complete, or explain why such a statement would not be filed (SEC, 2002). The importance of this critical stewardship role of reliable financial reporting is highlighted in regulators' attempts to instill responsibility later on through Sarbanes-Oxley Act of 2002 (SOX) in Section 302 for CEO and CFO certification requirements and the SEC's trend of naming individuals, including CFOs, in their enforcement actions (Bishop, DeZoort, and Hermanson, 2017; Crabtree and Mahr, 2012). The statements are due on the first date that a company's Form 10-K or Form 10-Q is due on or after August 14, 2002. For a calendar-

year-end company, it is due on August 14, 2002. The Order 4-460 aimed at providing material information of companies to investors and thereby restoring their confidence.

Managers face with greater litigation risks for misconducts while investors benefit from the Order 4-460 by obtaining more accurate and timely financial information, and by having less probability to be expropriated by the misbehaved management. The broader goal from the SEC is "improving investor confidence in the reliability of a company's financial disclosure and system of internal control over financial reporting" (SEC, 2002). In other words, the purpose from this regulation should result in different levels of protections for various investors, so that investors may regain their confidence in the quality of financial reporting (Crabtree and Mahr, 2012; Li and Luo, 2017). Based on the later provision of SOX, it is stated that CEOs and CFOs who willfully submit an incorrect certification to a SOX compliance audit can face fines of up to $5 million and up to 20 years in jail (SOX 2002). Therefore, it can be expected that the investors are willing to pay more for the equity of those firms whose financial reports are certified by the corresponding CEOs and CFOs.

Companies may react differently to the Order because of the differences of the ownership structure and managerial incentives. If large investors (board members) are also the insiders (top management), the certification cannot provide any new information to them. The certification adds little to no value to them but reveal their private information to the market and outside investors. Therefore, it is expected that those firms will submit the certification later than other firms. For those firms, in which outside blockholders have larger shareholdings or in which corporate governance are better, we expect that the managers are well monitored and the financial reports of these firms are already reliable, therefore, these companies are able to and willing to certify reports earlier than others.

In this study, we aim to investigate two research questions. First, will the regulation, in our study, the Order 4-460 be effective to disclose more companies' information to the shareholders, and thereafter increase their confidence? In particular, this paper tests the following research questions: (1) targets on whether firms filing in time with correct format would have positive abnormal stock returns? whereas (2) focuses on whether firms with late filing or without filing, or firms with changed statement format would have no or even negative abnormal stock return. Furthermore, (3) aim to whether outside ownership of blockholders relate to the timeliness of submission. Second, we investigate what types of firm-specific characteristics affect the magnitude of abnormal returns and the submission timelines. In particular, we examine the effect of equity-based compensation of CEO and corporate ownership.

Using the same methodology as Billett, Flannery and Garfinkel (1995), we examine whether there are abnormal announcement returns following the sworn statement. Based on a sample of 833 companies that have stock price data in Center of Research in Security Prices (*CRSP*) and statement submitting date, we find that only those companies whose CEO and CFO have filed and certified their statements as exact SEC required ("clean" statements) have significant abnormal stock returns after submitting the statement. In those "clean" statements, we find that the difference of standardized prediction errors (SPE) between early statements and late statements is statistically significant, which indicates that for those companies whose executives certify early, the certification shows a stronger signal to the investors and the general public. The signal implies that these companies have better internal corporate governance and their financial reports are more reliable. Therefore, there is a higher market valuation of these firms.

We also examine which firm-specific characteristics affect the timeliness of submitting the statements. The logistic model shows that the percentage ownership held by all outside blockholders is significantly negatively related with the submitting time. We use the percentage ownership of outside blockholding as the proxy of ownership composition, and the conclusion will be more convincing if there are other related data available, such as board composition. The result suggests that large outside blockholders have strong incentives to monitor managers. In those firms, top executives are less likely to expropriate and the financial reports are more reliable and contain updated information.

The main contribution of this paper is that it provides further evidence on the effects of legal protection and ownership structure on corporate valuation. We use the issue of Order 4-460 to examine the relation between timely certification and firm valuation, and gain a better understanding of such association. We also investigate the effect of equity-based compensation of CEO and outside blockholder ownership on the

accuracy and timeliness of financial reports. Our empirical results support the investigation on these research questions.

Our study is rather different from prior studies in the examination on the market reaction of passage of Sarbanes-Oxley Act in the following ways, such as in Jain and Rezaee (2006), Zhang (2007), and Li, Pincus and Rego (2008). Our research specifically focuses on the sole event by the issuance of SEC Order 4-460 pursuant to the Securities Exchange Act of 1934, precisely dated on June 27, 2022. However, the above studies aim on the political-driven events surrounding the entire formation process of SOX legislation, and often time they were with multiple contemporaneous legislative events for windows across several days (Zhang, 2007; Li, Pincus and Rego, 2008). They may be coincided with other congressional ongoing activities and actions against fraudulent companies (Zhang, 2007; Li, Pincus and Rego, 2008). Second, their studies examined all public traded firms, by assuming that firms were affected in equilibrium during the legislative process (Jain and Rezaee, 2006); whereas our research mainly places the focus on 975 firms that have been identified by SEC Order. Therefore, our study would contribute to the capital market research in the critical issuance of SEC rule without other contemporaneous noise.

The paper proceeds as follows. Section 2 discusses the hypotheses and methodology. Section 3 describes the data and Section 4 presents empirical results. Section 5 concludes and discusses future research direction.

HYPOTHESIS AND METHODOLOGY

Order 4-460 and Firm Valuation

The effect of the regulation, in our study, the Order 4-460 on firm valuation is uncertain. On the one hand, if the statement is a signal of confirming that the recent financial reports of the company are reliable, investors will have lower risks with those certified financial reports and they are willing to pay more for the equity of these firms. The timely certification signals that the company has better internal corporate governance. That is, under this effect managers take more active roles in financial reporting to ensure the quality. (Li and Luo, 2017). Therefore, the market response should be positive and the market value of the firm would increase. On the other hand, if investors know that the firm is in trouble, the sworn statement will have little effect and the market value of the firm will not change much. Late filling and without filing do not provide the signal that the financial reports are reliable, we expect the market response will not be positive. This leads us to the first two hypotheses:

H₁: *firms filing in time with correct format would have positive abnormal stock returns;*

H₂: *firms with late filing or without filing, or with changed statement format would have no or even negative abnormal stock return.*

We use the same methodology as Billett, Flannery and Garfinkel (1995) to examine whether there are abnormal returns around the certification. We define "Day 0" as the statement submission day and utilize a one-day event window. For each of 833 companies that have stock price data in CRSP, we run a daily market model regression (using the CRSP equally weighted market data) for the certifying firms over the period [-200, -50]. We then compute the fitted return for the submission day, which implies a prediction error (PE_{jt}). Then, the standardized prediction error is calculated in this way: $SPE_{jt} = PE_{jt}/S_{jt}$, where

$$S_{jt} = \left(V_j^2 (1 + \frac{1}{151} + \frac{(R_{mt} - \overline{R}_m)^2}{\sum_{i=1,151} \quad (R_{mi} - \overline{R}_m)^2} \right)$$

V_j^2 is the residual variance of firm j's market model regression.
$R_{m,t}$ is the market return on day *t*.
$\overline{R}_m$ is the mean market return during the estimation period.

Under the null hypothesis of no certification effect, the *SPE*s should be distributed asymptotically as $N(0,1)$.

Ownership Composition and Timeliness of Submission

Ownership composition may affect the timeliness of submitting the statements. Large outside blockholders have strong incentives to monitor managers. In those firms with large outside blockholders, top executives are less likely to expropriate and the financial reports are more likely to be reliable and to contain updated information. This leads to our third hypothesis:

H$_3$: *Outside blockholder ownership is negatively related to the submitting time.*

To test above hypothesis, we use the percentage ownership of outside blockholding as the proxy of ownership composition and control for those firm specific characteristics that can potentially influence the market response to the sworn statement. Those variables control for firm performance, firm leverage, firm size and agency cost.

Firm size is measured as the natural log of the total asset (*Size = Ln(total asset)). Leverage* is the ratio of long-term debt and total asset (*Leverage = long-term debt / total asset). CEO_option* is the equity-based compensation of CEO (*CEO_option = new options (Black-Scholes model) / (salary+bonus+new options)).* If options have a large percentage in a CEO's total compensation, CEO's incentive is closely aligned with the shareholders' and closely tied with the firm performance. *MarketBook* is measured as the ratio of market value and book value (*MarketBook = (book value + market value of equity − book value of common stock − deferred tax)/book value)*. Firms with higher *MarketBook* ratio tend to have more growth options (relative to asset in place), which will make them more difficult for outsiders to evaluate. The information in a sworn statement may therefore result in a greater revaluation for the firm with high *MarketBook*. The performance confirmation may increase the firm's stock price. '*Block*' is the percentage held by all outside blockholders. It is from Blockholder database. The outside blockholders may play a significant role in monitoring and disciplining managers. For companies with higher outside ownership, it is most likely that the managers are well monitored, and the agency cost is smaller and the financial reports are more accurate and timely.

DATA DESCRIPTION

The SEC requires top officials of 947 (or 945 per SEC) largest U.S. companies to submit sworn statements attesting to the accuracy of the companies' most recent annual and quarterly financial reports. Those are companies with revenues greater than $1.2 billion during their 2001 fiscal year. We search the statements of these companies in their 8-K, 10-K and 10-Q filings from June 28, 2002 to Dec. 30, 2002. To ensure the accuracy of the data, we use both EGARD and LexisNexis Academic databases. For those companies which don't have statements recorded in those databases, we also check records from their websites. We then compare the statements filed by CEO and CFO with the SEC required forms and manually collect the delivery (submission) and filing dates of those statements. In this way, we get the initial sample of 894 companies. Only those firms which have data in Center of Research in Security Prices (CRSP) are useful for the research. This selection results in a sample of 833 companies. Of the 833 announcements, 816 are filed and certified as exact SEC required ("clean" statements), 5 stated the reason that they can not certify as SEC required ("problem statements") and 12 are filed with incorrect format ("others": only one executive signed, or signed by neither CEO nor CFO, or not in format as SEC required).

Accounting data of those companies are obtained from *Compustat.* The blockholder data are from the fiscal year-end of 2001, preceding the sworn statement date. Executive compensation data are obtained from *ExecuComp*. We label an executive as a firm's CEO if the *ExecuComp* 'CEOANN' field is labeled as "CEO". To make sure that the executives are the ones who certified the financial reports, we exclude those executives who began to work as CEO after the company submitted the statement and those who left the company before the company submitted the statement. On this basis, our sample includes 495 companies.

Table 1 presents the summary statistics of those variables used in our sample. For the full sample, firm size, the natural log of total assets (in millions), has a mean of 8.61, a standard deviation of 1.54, and a

maximum and a minimum of 13.91 and 2.64, respectively. Firm ownership composition, measured as the percentage ownership held by all outside blockholders (*Block*), has a mean of 15.29%, a standard deviation of 13.80, and a maximum of 68.20%. The mean ratio of CEO new option and total CEO compensation is 47.93%, and the standard deviation is 0.29. The mean of leverage ratio is 0.24, with a standard deviation of 0.19. Market to book ratio has a mean of 1.54, a standard deviation of 0.89, a minimum of 0.63 and a maximum 6.87, respectively.

TABLE 1
SUMMARY STATISTICS

	Mean	Std Dev	Minimum	Maximum
CEO_option	0.48	0.29	0	1.00
Leverage	0.24	0.19	0	1.60
MarketBook	1.54	0.89	0.63	6.87
Block	15.29	13.80	0	68.20
Size	8.61	1.54	2.64	13.91

This table provides summary statistics of our sample. The data set is comprised of 495 companies. The descriptive statistics variables include: CEO option share (*CEO_option*: the ratio of CEO new option and total compensation), leverage (*Leverage*: the ratio of long-term debt and total asset), market to book ratio (*MarketBook*: the ratio of market value and book value), firm ownership composition (*Block*: percentage ownership held by all outside blockholders), and firm size (*Size*: Ln(total asset)).

EMPIRICAL RESULTS

In this section, we discuss the empirical results from our univariate and multivariate analysis.

Univariate Analysis

Table 2 reports the average one-day abnormal returns for the full sample, and for each type of certifying companies. Panel A provides the summary information of all the companies in our sample. The first row in Panel A describes the overall sample of 833 companies for which we have stock prices on event day 0 and the period [-200, -50]. The average standardized prediction error (SPE_{jt}=125.22) is significantly different from 0 (*t*-statistic=6.32), consistent with our expectation that the sworn statement enhances investor confidence, thereby increases the firms' market value. The next three rows in Panel A describe average standardized prediction errors by each category. "Clean" certifications constitute the majority of our sample, and generate significant mean standardized prediction returns of 126.58 (*t*-statistics=6.26). The standardized prediction errors for categories "problem statements" and "others" are not significant, which indicates that investors did not obtain any new information of the companies from problematic statements, therefore, there will be no significant change in the firms' market value.

Panel B and C report the average standardized prediction errors for each type of "clean" statements. For those companies whose fiscal year does not end in December, their executives can file the statement anytime on or after August 14, 2002, before the company's Form 10-K or Form 10-Q is due. Therefore, we define those non-calendar year companies whose executives file their sworn statement before and on Aug. 14, 2002, as "early statement" companies. The average standardized prediction errors for "early statement" and "not early statement" companies are 164.51 and 52.72, and both are significant at the 1% level. Using Tukey's Studentized Range Test (HSD), we find that the difference of standardized prediction errors between two groups is significant at the 5% level, which indicates that for companies whose executives submit their statement early, the certification sends out a stronger signal. This signal indicates that these companies have better internal corporate governance and their financial reports are reliable, therefore, there is a higher market valuation of these firms.

For those companies who file the "clean" statement and whose fiscal year ends in December, SEC requires them to file the statement no later than Aug. 14, 2002. Following a similar classification, we divide

them to three categories: “early statement” (statements are submitted before Aug. 2, 2002), “in time statement” (statements are submitted between Aug. 2, 2002, and Aug. 14, 2002), and “late statement” (statements are filed after Aug. 14, 2002). Panel C of Table 2 reports the standardized prediction errors for those types of companies. The average *SPE*s of “early statement” and “in time statement” companies are significant at the 1% (*t*-statistic=3.80 and 4.23), and the average *SPE* of “late statement” companies is not significantly different from 0. The results further imply that the in time certification presents a signal: investors become more confident in the companies if their executives file sworn statements on time. But late statement implies that there may be some problem with the company, and there is no increase in the firm’s market value. The Tukey's Studentized Range (HSD) Test indicates the differences of *SPEs* between two of these three groups are not significant. Such insignificance may be due to the fact the investors are unable to differentiate those timely statements since the submission of calendar-year-end companies is concentrated in the same short period (about 80% companies filed their statements between Aug. 2 and Aug. 14, 2002).

TABLE 2
UNIVARIATE ANALYSIS

	Number of Observations	Mean SPE	Standard Deviation	t-Statistic
Panel A: Abnormal returns by type of Statement				
All Statement	833	125.22	572.01	6.32^{***}
“Clean” Statement	816	126.58	577.22	6.26^{***}
“Problem” Statement	5	150.6	356.06	0.95
Others	12	22.54	64.77	1.21
Panel B: Abnormal returns by “Clean” companies whose fiscal year end is not in Dec.				
Early Statement	114	164.51	584.63	3.00^{***}
Not Early Statement	116	52.72	146.58	3.87^{***}
Difference of Mean SPE:		F-value: 3.99^{**}		
Panel C: Abnormal returns by “Clean” companies whose fiscal year end is in Dec.				
Early Statement	43	185.01	319.63	3.80^{***}
In time Statement	533	112.95	615.85	4.23^{***}
Late Statement	13	70.58	210.49	1.21

***, ** and * Significant at the 1%, 5% and 10% levels, respectively.

833 companies are included in our sample. “Clean” statements are those filed and certified as exact SEC required. “Problem” statements are those stated the reason that they cannot certify as SEC required. “Others” are those statements filed with incorrect format (only one executive signed or not in format as SEC required). In the “clean” companies whose fiscal year does not end in December, those companies whose executives file their sworn statement before and on Aug. 14, 2002 are defined as “early statement” companies, and others are defined as “not early statement” ones. In the “clean” companies whose fiscal year ends in December, companies with statements filed before and on Aug. 2, 2002 are defined as “early statement” companies, those with statements filed from Aug. 5, 2002 to Aug. 14, 2002 are defined as “in time statement”, and those with statements filed after Aug. 14 are defined as “late statement”.

Multivariate Analysis

In the primary specification,

$$SPE_{ij} = \alpha_0 + \alpha_1(CEO_option_{ij}) + \alpha_2(Leverage_{ij}) + \alpha_3(MarketBook_{ij}) + \alpha_4(Block_{ij}) + \varepsilon$$

We test the cross-sectional relation between the firm specific characteristics and the abnormal statement returns for three groups of companies: Group 1, companies filing the sworn statement in the correct format required by SEC; Group 2, companies who filed the statement and stated the reason that they cannot certify reports as SEC required (); Group 3, companies who filed statements with incorrect format, such as only one executive signed, or not signed, or not in format as SEC required.

Table 3 reports the multivariate analysis results. Since there are only a few companies in last two groups (n=9 and n=3), we only report the results of the first group of companies. From table 3, we find that only the coefficient estimate of market to book ratio is significant and positive, which indicates that with the financial reports confirmed by CEO/CFO, companies with higher market to book ratio have greater revaluation.

TABLE 3
MULTIVARIATE ANALYSIS

$$SPE_{ij} = \alpha_0 + \alpha_1(CEO_option_{ij}) + \alpha_2(Leverage_{ij}) + \alpha_3(MarketBook_{ij}) + \alpha_4(Block_{ij}) + \varepsilon$$

	Dependent variable = standardized prediction errors
Intercept	98.33**
	-2.02
CEO_option	-63.31
	(-1.17)
Leverage	-97.93
	(-1.18)
MarketBook	49.62***
	-2.86
Block	-0.97
	(-0.86)

***, ** significant at the 1% and 5% level, respectively. The t-statistics are given in parenthesis below each estimate.

This table reports results of regressing the standardized prediction errors on CEO option share (*CEO_option*: the ratio of new option and total compensation), the leverage (*Leverage*: the ratio of long-term debt and total asset), market to book ratio (*MarketBook*: the ratio of market value and book value), firm ownership composition (*Block*: percentage ownership held by all outside blockholders).

To examine the relation between the firm-specific variables and the timeliness of submitting sworn statement, we run regression with following logistic model,

$$log\frac{P(early = "no")}{P(early = "yes")} = \alpha_0 + \alpha_1(CEO_option_{ij}) + \alpha_2(Leverage_{ij}) + \alpha_3(MarketBook_{ij}) + \alpha_4(Block_{ij}) + \alpha_5(Size_{ij}) + \varepsilon$$

Using this model, we examine whether firm specific characteristics have an effect on shareholder protection, which is measured by the timeliness of submitting the sworn statement. In all "clean" companies, we first define the "*early*" submission as companies submit their statements no later than Aug. 2, 2002 if the fiscal year of the company ends in December and companies submit their statement no later than Aug. 14, 2002 if their fiscal years do not end in December. As we suggest in the univariate analysis, there is some problem with the critical date Aug. 2, 2002 for the calendar-year-end companies. For the robustness check, we run the regression by using only the non-calendar-year-end companies and defining variable *early* = "yes" if the statements are submitted no later than Aug. 14, 2002.

Table 4 reports the logistic regression results of above two methods. Consistent with the univariate analysis, the firm specific characteristics have strong effects on the companies. The coefficient estimates of leverage and firm size are positive and significant, which indicates that large companies and companies with high leverage are less likely to submit their statement early. The coefficient estimates for the percentage ownership held by all outside blockholders is negative and significant in model (2). This finding is consistent with the univariate analysis and with the notion that large outside blockholders have strong incentive to monitor managers. With high percentage ownership of outside blockholders, managers are less likely to expropriate wealth. The coefficient estimate of the equity-based CEO compensation is not significantly different from 0. Although the equity pay aligns the CEO's interest with shareholders' as a whole, it is not necessarily with outside shareholders'. And the certification only conveys new information for the outside investors. This is consistent with the finding that the outside blockholder ownership is important.

TABLE 4
LOGISTIC REGRESSION ANALYSIS

Dependent variable = log(P(early="no")/P(early="yes"))

	(1)	(2)
Intercept	-1.32**	-0.81
	-3.88	-1.28
CEO_option	0.11	-0.11
	-0.11	-0.08
Leverage	1.39***	2.07***
	-5.79	-9.63
MarketBook	-0.05	-0.11
	-0.18	-0.88
Block	-0.01	-0.02**
	-1.97	-6.12
Size	0.23***	0.23***
	-11.08	-9.61

***, ** significant at the 1% and 5% level, respectively. The Wald Chi-Square are given in parenthesis below each estimate.

This table represents results from regressing log odds ratio on CEO option share (*CEO_option*: the ratio of new option and total compensation), the leverage (*Leverage*: the ratio of long-term debt and total asset), market to book ratio

(*MarketBook*: the ratio of market value and book value), firm ownership composition (*Block*: percentage ownership held by all outside blockholders), and firm size (*Size*: Ln(total asset)). In all "clean" the companies, model (1) we first define variable early = "yes" for those companies who submit the statements no later than Aug. 2, 2002 if the fiscal year of the company ends at December, and who submit the statements no later than Aug. 14, 2002 if the fiscal year of the company does not end in December. We define variable early = "no" for other companies; model (2)We define variable early = "yes" for those companies who submit the statements no later than Aug. 14, 2002 if the fiscal year of the company does not end in December (those companies submit their statements far away from the deadline), and early = "no" for other companies.

SUMMARY AND FUTURE RESEARCH

By examining the companies' response to the SEC Order 4-460, we confirm that the better legal protection of shareholders is associated with higher firm valuation. When the financial statements are certified by CEO/CFO, the investors react positively. The timely certification signals that the company has better internal corporate governance and its financial reports are reliable, therefore, it has a higher valuation, especially for those companies with high market to book ratios. Consistent with the notion that large outside blockholders have strong incentive to monitor managers, we find that outside blockholders play an important role in ensuring the accuracy and timeliness of financial reports. With regard to the managerial incentive, we found that although the equity pay may align the CEO's interest with shareholders', but not necessarily with outside shareholders'.

Future research will further investigate the following issues:

(1) For those firms which have efficient corporate governance, the certification conveys less new information. So, the abnormal return on the day of certification is expected to be smaller or not significant from 0. Therefore, the certification (regulation) requirement for these firms is redundant.

(2) As La Porta et al. (2002) suggests, the better protection of shareholders is associated with higher valuation of firm assets. Thus, it is expected that those firms who certified early may have higher value before the certification.

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