Market Reaction to Events Surrounding the Sarbanes-Oxley Act of 2002 and Earnings Management

Haidan Li, Morton Pincus, and Sonja Olhoft Rego

Santa Clara UniversityUniversity of California, IrvineUniversity of Iowa

Abstract

The Sarbanes-Oxley Act (SOX) of 2002 is the most important legislation affecting corporate financial reporting enacted in the United States since the 1930s. Its purpose is to improve the accuracy and reliability of accounting information that is reported to investors. We examine stock price reactions to legislative events surrounding SOX and focus on whether such stock price effects are related cross-sectionally to the extent firms had managed their earnings. Our univariate results suggest that significantly positive abnormal stock returns are associated with SOX events, and our primary analyses reveal considerable evidence of a positive relationship between SOX event stock returns and the extent of earnings management. These results are consistent with investors anticipating that the more extensively firms had managed their earnings, the more SOX would constrain earnings management and enhance the quality of financial statement information.