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Edward Carberry

**The Symbolic Use of Stock Option Accounting:
Defending Organizational Legitimacy After Enron**

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DEFENDING ORGANIZATIONAL LEGITIMACY AFTER ENRON**

Edward J. Carberry
Department of Sociology
Cornell University
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ABSTRACT

This paper examines the forces driving the adoption of an accounting practice, stock option expensing (SOE), among the Fortune 500 in the wake of the recent corporate scandals. I argue that in the ensuing debates and challenges to the legitimacy of existing institutional frameworks governing corporate behavior, SOE became a symbol of normative legitimacy and a way for organizations to defend against threats to their own legitimacy. In analyzing the effects of different types of legitimacy threats, the results indicate that organizations in industries that were under intensive levels of investigation were more likely to adopt SOE, but that negative media scrutiny and shareholder activism did not influence SOE adoption. The results also suggest that as the Financial Accounting Standards Board threatened to require SOE, the significance of the practice as a symbol of normative legitimacy began to diminish. The findings broaden and deepen our understanding of how organizations engage in symbolic practice adoption to defend their legitimacy as well as the processes shaping the social construction of accounting practices. This paper also provides empirical support for recent theoretical claims regarding legitimacy defense and expands upon recent work that has made links between the impression management literature and neoinstitutional theory.

INTRODUCTION

The concept of organizational legitimacy has been central to both institutional and ecological approaches in organizational theory (Carroll and Hannan 2000, Scott 2001). An impressive body of research has examined how organizations seek to acquire and maintain not only material resources, but seek to become legitimate to various constituents by bringing their structures, procedures, policies, and goals in line with legal rules and regulations, field-level norms, and taken-for-granted cultural constructs. Organizational scholars have theorized the process of organizational legitimation as both a passive adherence to existing rules and norms (DiMaggio and Powell 1983, Meyer and Rowan 1977), as well as an active process that organizational actors engage and manage (Pfeffer and Salancik 1978, Ashforth and Gibbs 1990). Research on the active management of organizational legitimacy, however, has traditionally focused on how organizations acquire legitimacy in their early development stages, rather than how organizations maintain and defend their legitimacy once it has been established.

This paper examines how organizations attempted to defend their legitimacy in the wake of the recent corporate scandals. Instead of focusing on impression management techniques, however, this paper focuses on how organizations which were experiencing challenges to their legitimacy adopted an accounting practice that became infused with symbolic meaning in the post-Enron environment: stock option expensing (SOE). By adopting this practice, an organization calculates the cost of the stock options it has granted to employees and includes this item in its income statement, thus reducing earnings and earning per share. In the intense public debates following the collapse of Enron, stock options became a target of extensive criticism as a compensation mechanism that created powerful incentives for executives to manipulate financial statements in order to boost short-term earnings. In addition, since companies were not required to formally recognize a compensation expense for stock options on their financial statements, their accounting treatment was viewed as fraudulent. Consequently, voluntary stock option expensing became a way in which organizations could signal their legitimacy within the normative environment that emerged after Enron, an environment that placed renewed emphasis on financial transparency and restraining executive compensation.

Between July 2002 and July 2004, 753 publicly traded companies in the United States voluntarily decided to adopt SOE, even though the Financial Accounting Standards Board (FASB) had adopted formal rules defining SOE at the end of 1995. Prior to July 2002, only 13 publicly traded companies had adopted SOE. The financial economics literature (Aboody et al. 2003, Deshmukh et al. 2004, Seethamraju and Zach 2004) has emphasized firm-level financial considerations as well as the individual financial incentives of managers as primary drivers of SOE adoption. Although this literature acknowledges the connection between SOE adoption and the scandals, it focuses on the ways in which the scandals altered the economic costs and benefits of adoption, and eschews a deeper analysis of the complex connections between the political pressures for corporate reform that were set in motion by the corporate scandals and patterns of SOE adoption. In contrast to economic approaches, this paper expands upon the work of Mezas (1990, 1995), Carruthers (1995), and Hatherly et al. (2005), which has demonstrated that our understanding of the adoption and use of accounting practices can be greatly enhanced by sociological analysis and, more specifically, institutional organizational theory.

The adoption of SOE during this time period provides an interesting research site for examining how practice adoption is connected to organizational legitimacy challenges and for assessing the relative power of different institutional forces in challenging organizational legitimacy, such as regulatory agencies, the media, and shareholders. This paper expands upon recent theoretical work on the management of organizational legitimacy (Ashforth and Gibbs 1990, Suchman 1995) and recent attempts to combine institutional theory with perspectives on impression management (Elsbach 1994, Elsbach and Sutton 1992). In addition, this paper extends the core tenet of institutional organizational theory that organizations symbolically adopt practices to gain legitimacy (Meyer and Rowan 1977) by highlighting the possibility that organizations engage in symbolic practice adoption to defend legitimacy.

My primary argument is that the Enron scandal and the ensuing debates about corporate reform challenged the legitimacy of specific organizations, as well as the legitimacy of prevailing norms of corporate governance, corporate reporting, the power and compensation of executives, and the role of regulatory institutions. In this period of institutional destabilization, stock option expensing emerged as a symbol of normative legitimacy because it signaled that an organization was adhering to a new set of

norms that valued financial transparency and curbs on excessive executive compensation. Given this symbolic meaning, I argue that organizations that were experiencing a threat to their legitimacy were more likely to adopt the practice as a way to defend their legitimacy. I then develop and test hypotheses about which organizations were more likely to adopt: those under investigation or in an industry with a high level of investigation, those that were the subject of intensive media scrutiny relating to investigations, and those that were the target of shareholder activism.

DEFENDING ORGANIZATIONAL LEGITIMACY

The concept of organizational legitimacy has been central to organizational sociology. For population ecologists, the legitimacy of organizations and organizational forms has been fundamental to analyzing the growth and decline of organizational populations over time (Carroll and Hannan 2000, Hannan and Freeman 1992). Population ecology has for the most part neglected analyses of the mechanisms through which legitimacy is socially constructed, in favor of using legitimacy as a variable in analyzing broader historical processes at the macro level. Institutional theory, however, has devoted a great deal of energy to analyzing the social construction of the legitimacy of organizations, organizational practices, and organizational populations at multiple levels (Barron et al., 1986, Baum and Powell 1995, DiMaggio and Powell 1983, Meyer and Rowan 1977, Scott 2001). Although the meaning of organizational legitimacy is often itself taken for granted, theoretical definitions and typologies of organizational legitimacy have much in common.

Suchman (1995: 574) provides a concise but expansive definition of organizational legitimacy as “a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions.” Suchman (1995) further specifies this general definition by identifying three forms of organizational legitimacy: pragmatic, moral, and cognitive. Pragmatic legitimacy is “support for an organizational policy based on that policy’s expected value to a set of constituents” (1995: 574), while moral legitimacy is based on whether organizational actions are perceived as “the right thing to do ... by the audience’s socially constructed value system” (1995: 579). Finally, cognitive legitimacy is not based on “interest or

evaluation” but “acceptance of the organization as necessary based on some taken-for-granted cultural account.”(1995: 582). Both Aldrich (2001) and Ruef and Scott (1998) invoke Suchman’s broad definition of organizational legitimacy, but make slight modifications to his more detailed typology. Aldrich (2001: 230) modifies Suchman’s scheme to define two primary forms of organizational legitimacy: cognitive, which refers to a taken-for-granted status, and socio-political, which “refers to the acceptance by key stakeholders, the general public, key opinions, and government officials” that an organization, organizational feature, or organizational practice “is appropriate and right.” For Aldrich (2001: 230), sociopolitical legitimacy can be further broken down into moral acceptance, or “conformity with cultural norms and values,” and regulatory acceptance, or “conformity with government rules and regulations.” The cognitive, moral, and regulatory legitimacy of Aldrich’s typology corresponds directly with Scott’s (2001) well-known three part typology of cognitive, normative, and regulative legitimacy.

At the risk of glossing over deeper ontological differences, there appears to be broad agreement that organizational legitimacy is a socially constructed, taken-for-granted status of an organization and its activities as appropriate within broad, culturally-defined norms of appropriateness (taken for granted and not), more proximate field-level norms of appropriateness, as well as formal legal rules that exist at multiple levels. In addition, the existing literature has demonstrated that organizational legitimacy can emerge through an uncontested process of alignment of an organization and its activities within existing sets of laws and norms (DiMaggio and Powell 1983). However, organizational legitimacy also emerges out of a more complex set of social processes in which organizations seek to acquire and maintain legitimacy; constituents, stakeholders, and other groups of actors define and confer legitimacy; and different groups conflict over how legitimacy is defined and conferred (Hirsch 1995). Hence, the social construction of organizational legitimacy is both an active and passive process between organizational actors, field-level actors, and broader society.

Suchman (1995) has drawn another distinction between strategic approaches to the study of legitimacy, which have emphasized the active intervention of organizational actors in managing organizational legitimacy, and institutional approaches, which have taken a broader perspective on the gradual ways in which organizations attain and maintain legitimacy by becoming isomorphic with their

broader field and societal environments over long periods of time. Acknowledging Suchman's (1995) insight that both approaches are useful for identifying coexisting processes in real organizations, this paper focuses on strategic action that organizations take when their legitimacy is under some type of threat or challenge, but places these actions within a broader institutional perspective by paying close attention to the field and societal level dynamics in which this strategic action occurred. As I will show, the strategic action of SOE adoption by organizations took place within a broader context in which norms regarding accounting practices, corporate governance, and executive compensation were being challenged and redefined by a diverse group of actors.

My choice to focus on the strategic management of organizational legitimacy is not based on a view of legitimacy as primarily instrumental in nature. Organizations do engage in instrumental action to acquire, maintain, and defend their legitimacy by structuring their organizations in certain ways and adopting particular practices. However, such action is embedded within a network of other actors who confer legitimacy, such as the state, labor and employee groups, professions, investors, competitors, suppliers, and other stakeholders, all of whom have specific interests in defining which organizations and which actions are legitimate. In addition, instrumental action relating to the management of organizational legitimacy is shaped by a broader set of societal and cultural processes that define and legitimize formal rules, norms, and ideologies. In this paper, I examine a period in which these broader processes were particularly visible as the normative expectations and the legitimacy of systems of accounting, corporate governance, and executive compensation and power were being challenged and redefined. The same forces also generated a number of challenges to the legitimacy of particular organizations involved with or seen as connected to the scandals. More specifically, I will examine how, within this environment, certain organizations used symbols of the emerging normative order to manage their own legitimacy, or more specifically, to defend their legitimacy. My choice to focus on the relatively instrumental act of legitimacy defense does not represent a view of this as the most important facet of the myriad processes surrounding the social construction of organizational legitimacy. It is merely one part of a much larger picture, but one that was particularly visible and interesting after the collapse of Enron.

The empirical literature on the strategic management of organizational legitimacy has focused primarily on how organizations acquire and maintain legitimacy, rather than how organizations defend their legitimacy (Suchman 1995, Ashforth and Gibbs 1990). In reviewing the literature on legitimacy management, Suchman (1995) claims that when organizational legitimacy comes under attack, the focal organization will engage in specific actions to repair legitimacy.¹ A common action is the creation of a normalizing account that “separates the threatening revelation from larger assessments of the organization as a whole.” (Suchman 1995: 597). Another strategy is strategic restructuring in which an organization makes specific changes to practices, procedures, or structures that are associated with the legitimacy challenge. As Suchman (1995: 598) explains, an effective strategy for legitimacy repair is to make “narrowly tailored changes that mesh with equally focused normalizing accounts,” rather than “indiscriminate structural shifts that may make the organizational appear unstable.” In a similar theoretical approach, Ashforth and Gibbs (1988: 180) contend that organizations use both substantive changes to organizational goals and practices, as well as symbolic adoption “to appear consistent with social values and expectations.” The latter includes both rhetorical strategies and the ceremonial adoption of practices along the lines first sketched out by Meyer and Rowan (1977). When organizations have to defend legitimacy, they are more likely to use symbolic activities rather than “real, material change in organizational goals, structures, and processes” (Ashforth and Gibbs 1988: 183) because it is more difficult for an organization to respond with immediate and substantial structural changes that are viewed without skepticism by constituents.

The existing theoretical literature on the defense and repair of organizational legitimacy, therefore, has claimed that in the face of legitimacy challenges, organizations will rely to a large extent on symbolic activities, including both rhetorical strategies and restructuring. However, empirical research on legitimacy defense (e.g., Elsbach 1994, Elsbach and Sutton 1998, Marcus and Goodman 1991, Metzler 2001, Sutton and Callahan 1987) has focused primarily on impression management techniques, i.e., the different types of rhetorical devices that organizations use in response to a crisis, whether these are media

¹ I treat legitimacy defense and legitimacy repair as conceptually the same process.

or advertising campaigns, press releases, press conferences, or other public statements (for an exception, see Westphal and Zajac, 1994). Some of these studies have examined the connection between rhetorical strategies and existing legitimate organizational structures. For example, in examining the success of different rhetorical strategies in protecting organizational legitimacy in the face of controversial events, Elsbach (1994) found that the most successful accounts were those that both acknowledged (as opposed to denied) a problem and referred to an organization's institutionalized characteristics (as opposed to its technical characteristics). Also, Elsbach and Sutton (1998) found that social movement organizations engaging in controversial protest activities still acquired legitimacy by decoupling these activities from other institutionalized and legitimate practices, in conjunction with impression management strategies that highlighted these practices.

Hence, the empirical research on legitimacy defense has started to examine how rhetorical strategies relate to existing legitimate organizational practices, but we still know very little about how organizations use symbolic practice adoption in defending their legitimacy. More specifically, we know little about what types of threats will generate symbolic practice adoption as a response, what types of organizations in what types of situations will use symbolic practice adoption, what types of practices organizations will use, and how field-level dynamics shape legitimacy challenges and organizational responses to them. The analysis presented in this paper is an effort to begin filling this gap by examining a situation in which a group of organizations adopted an accounting practice as a way to defend their legitimacy.

In addition, the literature on the defense of organizational legitimacy, and legitimacy management in general, has not incorporated the more sophisticated typologies of organizational legitimacy that have been developed (Aldrich 2001, Ruef and Scott 1998, Suchman 1995). For example, do organizations react to challenges to their normative legitimacy differently from how they react to challenges to their regulative or cognitive legitimacy? If so, how and why? I do not develop a comprehensive theoretical incorporation of these typologies in this paper, but, recognizing the challenge posed by Ruef and Scott (1998) to move beyond "vague, general assertions about organizations being legitimated by societal values," I will specify the types of legitimacy that were challenged and the type of legitimacy that SOE

seemed to confer. This represents an attempt to take seriously how different forms of legitimacy can be challenged and how these challenges influence both active legitimacy management strategies and more gradual processes of isomorphism within organizational fields.

The scandals at Enron and other companies generated different types of legitimacy challenges. First, the scandals challenged the regulative, normative, and cognitive legitimacy of existing systems of accounting, auditing procedures, corporate governance, and executive compensation. Second, the scandals challenged the regulative and normative legitimacy of specific organizations involved in behavior that was perceived as either illegal or not in alignment with prevailing norms and beliefs, or organizations connected to such behavior. These legitimacy challenges emanated from direct investigations by a variety of regulatory agencies, media scrutiny of company activities and allegations of malfeasance, successful and unsuccessful attempts at the creation of new laws and regulations, extensive debates in the media about broader consequences and solutions, and a resurgence of shareholder activism. This paper will examine one way in which organizations addressed challenges to their legitimacy: by adopting the accounting practice of stock option expensing. SOE became a symbolic way that companies could demonstrate their legitimacy within a shifting normative landscape and hence was a particularly useful way for organizations to deal with challenges to their own normative and regulative legitimacy. This paper will, therefore, attempt to provide empirical support for Suchman's and Ashford and Gibbs' claims that organizations engage in symbolic restructuring when defending legitimacy.

To gain a better sense of how SOE acquired symbolic meaning in the wake of the scandals, I will now turn to a more detailed examination of first, the contentious history of stock options accounting, and second, the investigations and broader debates about corporate reform that emerged in 2002.

THE SHIFTING LANDSCAPE OF STOCK OPTION ACCOUNTING

The accounting treatment of employee stock options has been the focus of periodic conflict between corporate managers, the accounting profession, regulators, legislators, and the investment community. These controversies have centered on whether it is possible to accurately value a stock option at the time it is given to an employee and whether companies should account for stock options formally as a

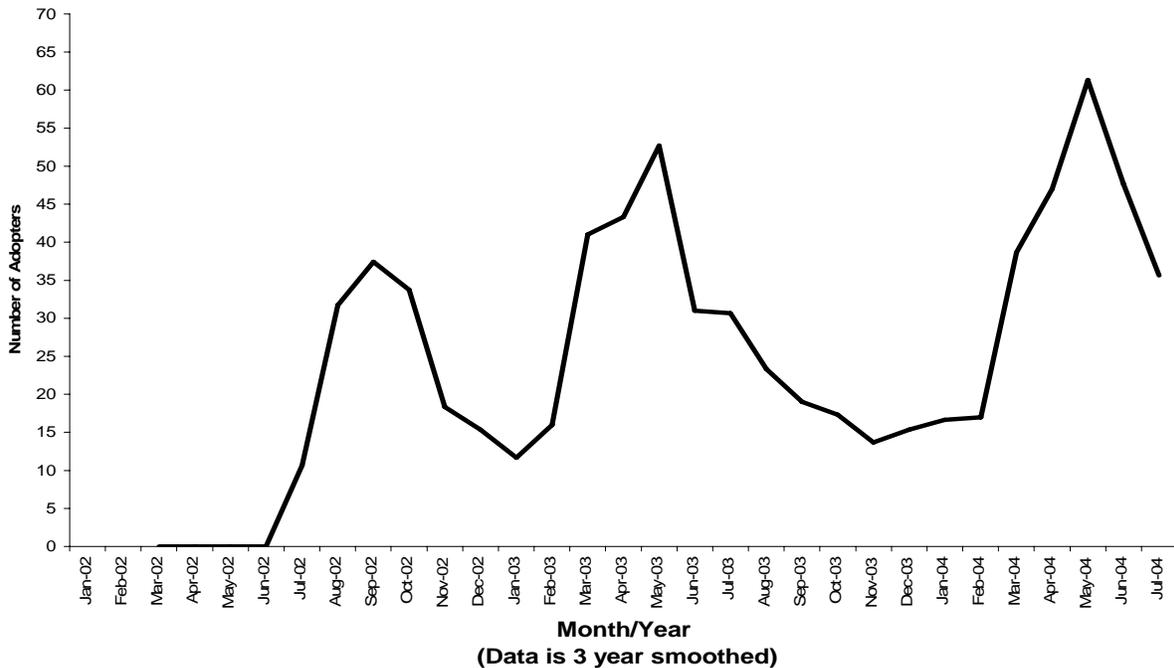
compensation expense in their financial statements. A stock option is a contract that gives an employee the right to purchase a fixed number of shares at a fixed price for a fixed period of time. Stock options have historically been used as an executive benefit and surged in popularity as a form of executive compensation in the 1980s. The primary corporate rationale for granting stock options to executives has been that options help to mitigate the principal-agent problem by linking the interests of management with those of shareholders. In the 1990s, the practice of granting stock options to broadly to employees at all organizational levels became a standard practice in high-tech industries as a way attract, retain, and motivate knowledge workers; allow startups to save cash for other capital investments rather than compensation (Blasi et al. 2003), and because of their favorable accounting treatment.

Historically, companies have not been required to account for employee stock options granted as a compensation expense. This makes stock options unique among all forms of cash or equity-based compensation. In 1992, the regulatory agency that establishes and maintains accounting standards, the Financial Accounting Standards Board (FASB) announced that it wished to require companies to formally recognize the value of stock options as an expense in their financial statements, as calculated by an option pricing model. FASB's rationale was that options do have value when they are granted as compensation, both to the employee and to the company, and that accounting for them as an expense adds to the transparency of financial statements. FASB faced stiff opposition to its proposed regulations, primarily from technology companies, but also from some shareholder groups and legislators inside the Beltway. Due to the powerful lobbying capacity of large technology companies, FASB backed down from its initial proposal (Levitt 2002). In 1995, FASB released Financial Accounting Statement 123 (FAS 123), which represented a compromise between FASB and the opponents of expensing. FAS 123 recommended that firms formally show an expense on their financial statements for employee stock options, but did not require them to do so. However, FAS 123 stipulated that if a firm did not expense their options, it was required to reveal in a footnote to its financial statements what the impact of such an expense would have been on earnings and earning per share. Stock option accounting reform was considered to be complete with the compromise embodied in FAS 123.

With the high profile collapse of companies like Enron and WorldCom in late 2001 and early 2002, stock option accounting reform was put back on the table amidst calls for a broader set of reforms of accounting and auditing practices, corporate governance, and executive compensation. FASB remained out of the fray until October 2002, when it began to reassess stock option accounting. In the post Enron era, FASB enjoyed broader support for SOE than it had in the mid-1990s, particularly from institutional investors, the SEC, the stock exchanges, some government officials, and some corporate leaders. Despite this broader base of support, technology companies continued to oppose stock option expensing. In December 2004, FASB issued its final ruling on the matter, requiring expensing starting in 2005.

Although FASB did not finalize an SOE requirement until December 2004, between July 2002 and July 2004, 753 publicly traded companies voluntarily decided to adopt SOE, i.e., to formally recognize a compensation expense of stock options. Figure 3.1 tracks the incidence of stock option expensing adoption from January 2002 to July 2004, the latest month for which data was available at the time this research was conducted. Adoption occurred in three distinct waves of activity (July – September

Figure 3.1: Number of SOE Adopters, January 2002 – July 2004



2002, March – May 2003, and March – May 2004). Companies in a diverse group of industries adopted SOE, but a few industrial sectors represented a large proportion of the expensers, with the finance sector the dominant one in all three periods, particularly the first two periods. The composition of companies begins to shift towards a more diverse sectoral composition beginning in June 2003. Finance, electronic technology, and utilities companies increase their activity in the second period, while non-energy minerals, energy minerals, health technology, electronic technology, and technology services have notable increases in the final period, with non-energy minerals and health technology showing the largest increases. There were also significant decreases in the number of finance and utilities companies expensing by the third wave.

Taking an expense for stock options directly reduced the earnings, earnings per share, and potentially, the stock prices of the adopting companies. Why would these firms voluntarily decide to incur such costs if the practice was not required by any regulatory agency, especially considering the history of corporate resistance to the practice? The descriptive evidence does not suggest obvious explanations regarding why some companies voluntarily adopted SOE while others did not, with one exception: the timing of the first wave. At the end of June 2002, WorldCom disclosed that it had overstated earnings by \$6 billion. The disclosure at WorldCom accelerated public and regulatory pressures for corporate reform that had started with the Enron scandal in late 2001. This suggests that adoption may have been related to the concomitant intensification of public scrutiny and the acceleration of regulatory pressures. But exactly how was SOE adoption linked to the scandals?

The existing literature on voluntary SOE adoption (Aboody et al, 2003; Deshmukh et al., 2004; Seethamraju and Zach, 2004) has recognized that the scandals most likely influenced adoption patterns, but has generally placed the influence of the scandals in an indirect role. The existing literature has accorded a primary role to rational, economic decision-making (either at the firm level or individual executive level), i.e., firms will only adopt when it is cost beneficial to them or to their executives to do so, and that the scandals altered this calculus. The assumption that the primary motivator of adoption is a cost-benefit analysis that accurately anticipates that SOE will lead to an increase in share price ignores the broader social, institutional, regulatory, and political environments in which organizations are embedded,

and the complex ways in which forces in these environments shape organizational action. The work of Mezias (1990, 1995), Carruthers (1995), and Hatherly et al (2005) has demonstrated that sociological, and in particular institutional, approaches have significant analytic potential to help us understand the adoption of accounting practices. My intention is to take seriously the political and regulatory pressures for corporate reform that were set in motion by the corporate scandals, and the role these pressures may have played in SOE adoption patterns. Institutional theory and its recent expansion to include the more active structuration of organizational fields (Fligstein 2001, Lounsbury et al. 2003) provides a useful lens for identifying some of the primary forces that may have influenced adoption: regulatory pressures embodied in direct investigations, public scrutiny of corporations through the media, political pressure as expressed through shareholder activism, and regulatory pressures embodied in FASB's attempt to require SOE.

THE SCANDALS AND EMERGENCE OF STOCK OPTION ACCOUNTING AS SYMBOL

The Enron Corporation began to publicly collapse in October of 2001 and filed for bankruptcy in early December 2001. Initially, the extent of the fraud and the ultimate consequences were uncertain. Immediate investigations into Enron were launched by the Justice Department, Department of Labor, and the Securities and Exchange Commission, soon to be followed by the US Congress. The energy and finance industries also came under intensive investigative scrutiny in early 2002. Although the financial mechanisms used by Enron were complex, the primary issues raised by the bankruptcy included fraudulent accounting schemes developed with the assistance of some of Wall Street's largest firms; the lack of independence of Enron's chief auditor, Arthur Andersen; the manipulation of energy markets, one of Enron's primary areas of business; the rapid decimation of employee retirement accounts; and the self-serving actions of executives enriching themselves as they engaged in fraud to drive up short-term share prices.

The collapse of Enron also sparked extensive public debate about the broader institutional framework in which corporations operate, such as formal legal rules and informal norms regarding accounting and auditing practices, corporate governance, and executive compensation. An immediate

tension emerged between groups calling for new regulations and legislation, and other groups who claimed that Enron and other companies were just bad apples within an otherwise law-abiding universe of corporations. The initial calls for reform were sounded by the SEC, Democratic legislators, and the accounting industry itself, and focused on the problem of insuring transparency for investors. Corporate leaders and the Bush Administration quickly tried to emphasize the limited reach of the behaviors connected to the scandals. As the magnitude of the problems of Enron came into sharper focus and as more regulators, legislators, business intellectuals, and shareholder activists entered the fray, a diverse set of issues emerged in the public debate as targets of potential reform. The exposure of accounting fraud at WorldCom's in June 2002 lent serious legitimacy to the critics who claimed that the situation of Enron was not an aberration, but the result of more systemic problems relating to corporate reporting, governance, and regulation. WorldCom forced President Bush to publicly engage these issues more directly and hastened the passage of the Sarbanes Oxley Act, which established new laws relating to auditing processes, the auditing industry, corporate reporting, insider trading, and protecting investors.

The reform movement that Enron and subsequent scandals set in motion had potentially powerful consequences (Levitt 2002). The swift collapse of prominent firms such as Enron and Arthur Andersen revealed that the legitimacy and survival of organizations engaged in criminal activity were indeed at risk. Also at stake was the legitimacy of corporate reporting processes, accounting standards, the accounting profession, capital markets, and corporate governance. In addition, the privileged positions of corporate executives, boards of directors, the investment banking community, and the corporate consulting industry as a whole, as well as the capabilities of regulatory organizations such as the SEC, FASB, and others, were all brought into question. The corporate scandals at Enron and other organizations, therefore, exposed a number of systemic problems within corporate America and generated a serious threat to the accepted ways in which corporations were run, executives compensated, capital invested, and markets operated.

The Emergence of Stock Option Expensing as Symbol

In the initial media coverage of the events at Enron, stock options and their accounting treatment received a little attention, but the focus of most of the media coverage in December 2001 and January 2002 was on the fraudulent accounting schemes used by Enron and the complicity of Arthur Andersen in the creation and approval of these schemes.² The role of stock options and their accounting treatment emerged more prominently in early February 2002. At this time, Senators Levin and McCain introduced a bill that would have required companies to expense their stock options if they wanted to take the tax deduction they are entitled to when employees exercise their stock options. The Senators were heading up the Senate's investigation of Enron and indicated that the bill was motivated by the accounting problems of Enron. The bill was effectively killed by the same group of high-tech lobbyists who had successfully derailed FASB's efforts at imposing mandatory SOE in 1994. The introduction of the bill, however, opened up a broader debate in the business press about stock options, their accounting treatment, and the connection to Enron.

In March and April 2002, a number of articles appeared in the mainstream business press describing and analyzing a growing movement in support of stock option expensing.³ These articles articulate the primary explanations in the management discourse regarding the connection between executive stock options, their accounting treatment, and the scandals: their excessive use as a component of executive compensation motivated a variety of practices through which executives attempted to bolster short-term earnings, which, in turn, fueled the escalation of the stock market in the late 1990s. Furthermore, the favorable accounting treatment of stock options exacerbated these problems and more generally stigmatized their use as fraudulent, or as the Council of Institutional Investors described it, stock options “[turned] companies into Ponzi schemes.”⁴

² The sources I analyzed for this section included the *Wall Street Journal*, *Business Week*, *Fortune*, the *New York Times*, and *Forbes*.

³ D. Henry et al., “Too Much of A Good Incentive,” *Business Week*, March 4, 2002; G. Hitt and J. Schlesinger, “Perk Police: Stock Options Come Under Fire in Wake of Enron's Collapse,” *Wall Street Journal*, March 26, 2002; H. Gleckman, “Options: Its Time for Companies to Come Clean,” *Business Week*, April 1, 2002; H. Jenkins, “Business World: Much Ado about Stock Options,” April 3, 2002; J. Whitman, “Stock Options Face Scrutiny in the Wake of Enron,” *Wall Street Journal*, April 3, 2002.

⁴ *Ibid.*

As stock options and their accounting treatment became identified as closely connected to the scandals, a number of actors came out in favor of stock option expensing as one solution to the myriad problems that the scandals exposed. The most prominent proponents of SOE included certain lawmakers and regulators (such as Alan Greenspan), academics, and institutional investors. Their support rested primarily on the grounds that SOE would add much needed transparency to financial statements and help to curb some of the excesses that created the problems at Enron and fed the stock market bubble. There were also, however, strong opponents of the views of stock options as villain and SOE as solution, including the Bush Administration, other legislators, government officials, the high-tech industry, and executives in other industries. FASB remained remarkably silent on the issue. Overall, the various opponents of SOE appeared to be on less stable ground than they were during the first battle over SOE in the mid-1990s, but they were far from powerless. Despite the opposition and the lack of any SOE regulation from FASB or Congress, proponents of stock option expensing were successful at framing SOE as a reform that could alleviate some of the problems driving the scandals: accounting fraud, excessive executive compensation, and the inflation of the stock market bubble. The supporters of SOE framed SOE as a practice that was symbolic of a new normative environment, which focused attention on the virtues of accounting transparency, limits on excessive executive compensation, a mitigation of widespread conflicts of interest within financial institutions and the stock market, and increased punishment for those engaged in corporate fraud.

In the post-Enron environment, the adoption of SOE became a way for organizations to signal their normative legitimacy by demonstrating their willingness to make changes in line with emerging norms, or as Roman Weil, a professor of accounting at the University of Chicago, told the *Wall Street Journal* in analyzing the first SOE adopters: “corporations are trying to signal to investors that they are squeaky clean and not the bad guys.”⁵ To gain a better sense of the symbolic meaning of SOE, I examined all press releases or media reports relating to SOE adoption among the Fortune 500 during the first wave of initial activity in July and August of 2002. Of the 51 organizations within this group that

⁵ “Fighting Coke’s Lead Could Bring Big Changes,” *Wall Street Journal*, July 16, 2002.

adopted, 31 (61%) issued statements to the press about the adoption. I performed a content analysis of these press statements, and two primary types of explanations emerged. The most common (42% of all press releases during this period) had a tone of moral righteousness that the organization was a leader in the new normative environment by stating that SOE adoption was a sign of integrity, honesty, responsibility, accountability, or similar qualities. The second type of explanation, employed by 10 companies (32% of all press statements during July and August 2002) highlighted the company's awareness of the new demands of investors and shareholders for increased financial transparency. The press releases reveal that in the initial stage of SOPE adoption, organizations presented SOE as a symbol of their legitimacy, if not their leadership, within an emerging normative environment. Moreover, SOE adoption was unusual, if not unique, in having this symbolic character to address the multiple issues raised by the scandals. Few other actions that a company could take had the same symbolic power at this point.

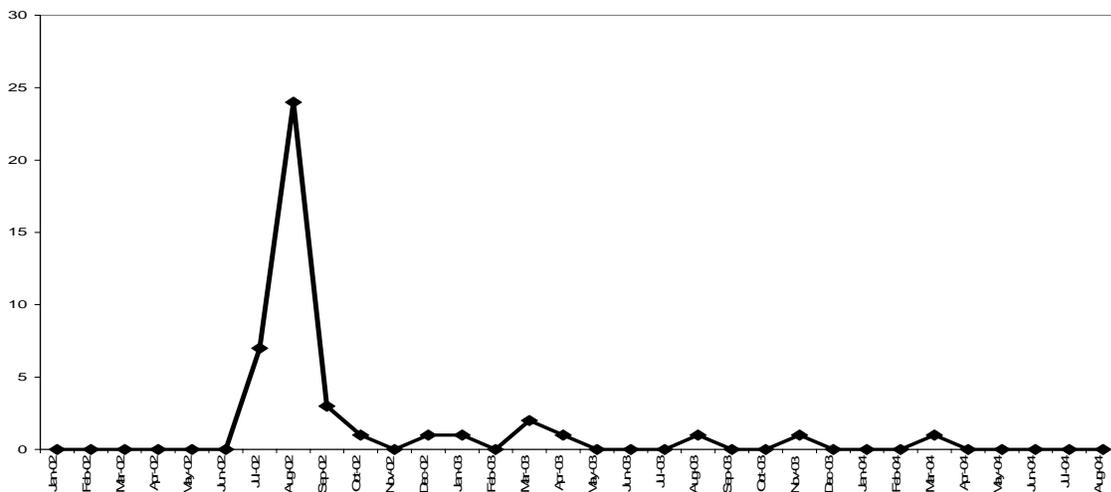
This symbolism would soon begin to change, however, as a new actor stepped into the ring. In late 2002, important changes began to occur that eventually led to FASB adopting new rules in 2004 that required stock option expensing. However, the perception that SOE would become mandatory appeared to occur much earlier than the official implementation of FASB's requirement. FASB's attempt to make SOE mandatory began on October 9, 2002 when Robert Herz, then chairman of FASB, told a group of investor relations professionals that he believed that attitudes had changed to the point that there was support for mandatory stock option expensing. On November 8, 2002, the International Accounting Standards Board (IASB) issued a draft proposal to make stock option expensing mandatory for non-US companies. Although the IASB's standards do not apply to U.S. companies, the proposal was widely perceived as something that would exert significant pressure on FASB to adopt similar standards. An article in the *San Jose Mercury News* the following day cited both a top Silicon Valley attorney and the president of a software industry trade association describing their perception that the IASB's action would most likely lead FASB to make SOE mandatory.⁶ However, the perception that SOE would become

⁶ M. Schwanhauser, "International Board's Plan for Expensing Options Irks High-Tech Executives," *San Jose Mercury News*, November 8, 2002.

mandatory may have emerged even earlier than this. A survey conducted by Mercer Human Resource Consulting in August 2002 found that 87% of the 200 U.S. companies surveyed believed that mandatory stock option expensing was inevitable.⁷ This broad perception of an inevitable requirement most likely signaled the beginning of a shift in the significance of SOE away from being a symbol of normative legitimacy. Once it became evident that the practice was going to be required, its ability to function as symbol of an organization’s special status as recognizing a new normative environment was most likely diluted. Adoption of SOE may still have signaled legitimacy once it became widely perceived as mandatory, but this legitimacy may have become more regulative in nature.

A more detailed look at the press release activity around SOE adoption provides evidence that such a shift away began to occur around August 2002. Figure 4.1 provides shows the number of press releases or press statements made by Fortune 500 companies. The graph shows a dramatic spike and then drop in the number of press releases issued by adopters after August 2002. From September 2002 to July 2004, both the volume and tone of press releases changed dramatically. Only 12 of the 72 (16%) of the Fortune 500 companies that adopted SOE issued press releases during this time, and only two of these statements presented the action as a sign of the organizations leadership in corporate governance,

Figure 4.1: Number of Press Releases Regarding SOE Adoption Issued by the Fortune 500, January 2002 – July 2004



⁷ M. Katz, “The Implications of Stock Option Expensing: It’s Closer Than You Think,” *Employee Benefit Plan Review*, November 2002.

accountability, or ethical standards. The tone of most of these statements focused on SOE as a way to meet the new demands of shareholders for financial transparency. The dramatic reduction in the volume of the press releases and the shift in their tone away from moral righteousness suggests that after August 2002, the significance of SOE as symbol of normative legitimacy diminished, and this shift was most likely influenced by the perception among many organizations, by August 2002, that SOE would become mandatory. These expectations regarding an imminent requirement proved to be accurate as FASB followed quickly behind the November 2002 action of the IASB. On March 13, 2003, FASB formally voted to add stock option accounting to its agenda in 2003. In October 2003, FASB announced that it intended to require SOE beginning in 2005, and on December 16, 2004, FASB finally issued its final statement, which required stock option expensing by the 3rd quarter of 2005 for most companies.

This section has revealed that in the wake of the corporate scandals of 2001 and 2002, stock option accounting became a target of much discussion and debate in the wake of the Enron scandal. Stock option accounting became a symbol of a broader system of behaviors at the root of the scandals at Enron and other companies. As an immediate consequence, the expensing of stock options became a way for organizations to symbolically signal their normative legitimacy in the post-scandal environment. Accounting regulators capitalized on this new normative environment to push for mandatory expensing, and as this regulatory threat became obvious it appeared that the symbolic meaning of SOE began to shift away from normative legitimacy.

HYPOTHESES, DATA ANALYSIS, AND RESULTS

While many companies could have potentially benefited from adopting SOE and invoking this symbol, one of the primary claims of this paper is that the companies that were more likely to adopt SOE in this environment were those that faced some type of challenge to their legitimacy. When their legitimacy is under attack, organizations are likely to engage in symbolic actions through rhetorical devices and restructuring (Ashforth & Gibbs 1990, Suchman 1995). One of the most important types of restructuring is what Suchman (1995: 598-599) has called disassociation, in which the organization “employs structural change to symbolically distance” itself from executives, “delegitimized procedures, structures, and even

geographic locales.” However, efforts at restructuring “require a light touch and sensitivity to environmental reactions” since “indiscriminate structural shifts may make the organizational appear unstable and unreliable.” (Suchman 1995: 598-599) Therefore, acts of restructuring intended to defend or repair organizational legitimacy will likely be closely connected to the legitimacy challenge. In the post-scandal environment, SOE adoption was a logical way for organizations to deal with legitimacy challenges embodied in investigations, media scrutiny, and shareholder activism because these threats focused primarily on accounting fraud, corporate reporting practices, executive compensation, corporate governance practices, or the malfeasance of those in the highest ranks of corporate America.

The Enron scandal both occurred within a broader context of ongoing investigations and fundamentally reshaped this context by motivating new investigations and expanding their scope. Between January 2002 and August 2002, 75 companies came under formal investigation by either the SEC, FBI, etc., with another 104 companies coming under investigation from between September 2002 and July 2004. Of all these 179 total investigations, 40% were related to accounting fraud, 20% were related to investment advice fraud, 12% were related to securities fraud, and 10% were related to the manipulation of energy markets. The remaining investigations regarded insider trading, tax fraud, and similar activities.

The adoption of SOE was a way that an organization could defend against these legitimacy challenges. For example, on July 30, 2002, Computer Associates, a software firm based in New York, announced that it would adopt stock option expensing. In a statement to the press, Sanjay Kumar, the president, explained that the decision was part of an “ongoing commitment to adhere to the best practices in everything we do.”⁸ At the time, the company was under investigation for accounting fraud by the Department of Justice. Similarly, in the beginning of August 2002, Citigroup, which was at the center of investigations by the SEC and Congress into a number of fraudulent activities relating to Enron, adopted SOE. Sanford Weill, CEO of Citigroup, explained that “Citigroup has always strived to be at the forefront of industry change.”⁹ Hence:

⁸ “Computer Associates to Record Worker Stock Options as Expenses,” *Wall Street Journal*, July 30, 2002.

⁹ “Citi Claims Major Reforms in Corporate Governance,” *American Banker*, August 8, 2002.

Hypothesis 1: Organizations that were under direct investigation were more likely to adopt SOE.

Furthermore, organizations linked to those under direct investigations may have perceived these investigations as a current or future threat to their own legitimacy. Suchman (1995: 597) notes that “legitimation crises tend to become self-reinforcing feedback loops, as social networks recoil to avoid guilt by association.” In addition, a vast literature in institutional theory has examined how organizations in similar industries tend to become more like one another (DiMaggio and Powell 1983, Haunschild & Miner 1997, Haveman 1993). In the same way, organizations may also perceive that challenges to the organizational legitimacy of their industry peers as challenges to their own legitimacy. Therefore:

Hypothesis 2: The more industry peers of an organization that were under investigation, the more likely it was to adopt SOE.

In addition, the evidence from the data about investigations reveals that the industries with the highest incidences of investigations included telecommunications, electric services, broker-dealers, commercial banks, investment advisors and software firms. Hence:

Hypothesis 3: Telecommunications companies were more likely to adopt SOE.

Hypothesis 4 Electric services companies were more likely to adopt SOE.

Hypothesis 5: Securities broker-dealers were more likely to adopt SOE.

Hypothesis 6: Commercial banks were more likely to adopt SOE.

Hypothesis 7: Software companies were more likely to adopt SOE.¹⁰

The scandals also generated a great deal of media publicity, and the work of Abrahamson (1997), Guillen (1994), Hirsch (1986), and Ruef (1999) has demonstrated that the media is an important field-level actor shaping perceptions of organizations, organizational phenomenon, and broader institutional logics. Therefore:

Hypothesis 8: The more negative media scrutiny faced by a company regarding fraud, scandals, investigations or related deviant behavior, the more likely it was to adopt SOE.

In addition to the challenges to organizational legitimacy expressed through investigations and media scrutiny, shareholder activists also posed challenges to the normative legitimacy of specific organizations. These challenge were expressed through actions and resolutions that demanded that organizations make specific changes to bring their activities in line with what shareholders perceived to

¹⁰ I did not include a hypothesis about investment advisors, another industry with heavy investigative activity, because my sample did not contain any companies in this industry.

be norms regarding corporate governance, executive compensation, and social responsibility. In reviewing the literature on the effectiveness of shareholder activism, Karpoff (1998) points out that shareholder activism through proxy fights has been the most effective when effectiveness is measured as a company making the targeted structural change, such as adopting SOE, as imposed to increasing financial performance. In the context of the post-scandal environment and the resurgence of shareholder activism, it is likely that organizations were more receptive to the demands of shareholders. Therefore,

Hypothesis 9: Organizations that received shareholder resolutions to adopt SOE were more likely to adopt SOE.

The effects of shareholder activism, however, do not only stem from the specific reforms that they target. Shareholder resolutions and proxy battles can focus negative attention on organizational policies, structures, and procedures (Davis and Thompson 1994) that are not in line with the expectations of shareholders. On a broader level, therefore, shareholder activism represents a challenge to the normative legitimacy of organizations. Similar to other challenges to legitimacy, SOE adoption was a way that organizations could defend against challenges expressed through shareholder activism. Therefore:

Hypothesis 10: The more shareholder resolutions a company received, the more likely it was to adopt SOE.

Finally, shareholder activism in the post-Enron era was directed at some of the issues connected to the scandals, in particular executive compensation and stock option practices. Resolutions that called on companies to restructure these practices challenged normative organizational legitimacy and, therefore, may have led these organizations to engage in legitimacy defense through SOE adoption.

Hence:

Hypothesis 11: Organizations that received shareholder resolutions to reform executive compensation or stock option practices (not including SOE), were more likely to adopt SOE.

The preceding hypotheses have specified the primary challenges to organizational legitimacy that emerged in the post-Enron era. The fundamental claim underlying all of these hypotheses is that organizations that were experiencing threats to their legitimacy were more likely to adopt SOE. Before moving on to the analysis that tested these hypotheses, it is important to note three other possible

influences on SOE adoption: prior adoption activity, organizational prestige, and the magnitude of the potential stock option expense.

One of the central insights of the literature on the diffusion of organizational innovations is that as more organizations adopt a practice, the practice becomes more legitimate, and the adoption rate increases, up to a certain level (e.g., Burns and Wholey 1993, Fligstein 1985, Haveman 1993). However, such contagion effects, which have been primarily examined as they flow through social structure, are not straightforward, but mediated through processes of interpretation and theorization that influence the “cultural status of the diffusing item” (Strang and Soule 1998: 276). Hence, diffusion rates may not automatically increase as more organizations adopt. As the earlier discussion revealed, such processes of interpretation were clearly influencing the status of SOE and most likely influenced adoption patterns. More specifically, the evidence discussed above regarding the volume and tone of press statements around SOE adoption suggests that as more companies adopted, the significance of SOE as a symbol of normative legitimacy became diluted because organizations could not present themselves as unique upholders of the new normative order. Hence:

Hypothesis 12: As the total number of companies adopting SOE increased, the adoption rate decreased.

Organizational prestige has been used as a variable in analyses of diffusion processes (Haveman 1993, Still and Strang 2005) as well as studies of market dynamics and competition (Benjamin and Podolny 1999, Podolny 1994). In their analysis of SOE adoption, Seethamraju and Zach (2004) found that organizations with a higher level of publicity, which can function as a measure of status (Still and Strang 2005), would be more likely to adopt SOE. The authors suggest that this indicates that organizations with more visibility believed that they would benefit more from symbolic adoption because the adoption would receive more positive attention. While this is certainly possible, higher status organizations might also be more likely to adopt SOE in order to defend their legitimacy. These organizations may have felt a threat to their own legitimacy in the face of the broader challenges to the legitimacy of the core institutions governing corporate behavior that emerged at this time. Hence:

Hypothesis 13: Higher prestige organizations were more likely to adopt SOE.

In addition to organizational status, the magnitude of the potential stock option expense may have influenced SOE adoption. A straightforward economic argument would predict that companies with large potential stock option expenses would be less inclined to adopt SOE because the financial hit would be substantial. Similarly, those with a smaller potential expense from employee stock options, would be in a better financial position to adopt SOE. Therefore:

Hypothesis 14: The larger the potential expense from adopting SOE, the less likely a company was to adopt SOE.

ANALYSIS AND RESULTS

To test these hypotheses, I analyzed the determinants of SOE adoption among the Fortune 500, as published by Fortune magazine in April 2002. A total of 27 organizations were dropped from the sample because they were not at risk of adopting SOE during the observation period. This included companies that had already adopted SOE, privately held companies that do not file audited financial statements with the SEC, and other companies whose stock plans were designed in ways as to make SOE adoption irrelevant. The final sample included 473 companies, of which nine became right-censored at various points during the observation period because of bankruptcy, merger, or acquisition.

The dependent variable is the probability that a company adopted stock option expensing, or more specifically, the hazard rate of the event of adoption. Adoption was measured as the announcement by an organization of its intention to recognize an expense in their financial statements for employee stock options, according to the procedures detailed in Financial Accounting Statement 123. Data on SOE adoptions were collected from a publicly available list compiled by Bear Stearns, which dated adoption by examining corporate press releases and media reports. (Bear Stearns 2004)

Independent Variables

Investigations: I created a binary variable coded as 1 if an organization was under investigation by a federal agency. This variable was measured as a time-varying covariate that changed from 0 to 1 during the month that the organization first came under investigation. Data on investigations was gathered from

publicly available information of regulatory agencies. Since the number of companies under any type of investigation is extremely large due to a high number of minor infractions, I used two sources to focus the data collection on the most significant cases: the SEC's *Annual Reports* from 2001 to 2003, which list "significant enforcement actions," and reports to the President made by the Corporate Fraud Task Force (CFTF), which were published in July 2003 and July 2004. To date the timing of these investigations, I supplemented the information in these sources with media reports.

Industry Level Investigations: I measured investigations at the industry level in two ways. First, I created an ordinal variable equal to the number of an organization's industry peers that were under investigation, based on four digit SIC code. This variable was measured as a time-varying covariate that changed from 0 to the number of industry peers under investigation at the time that the first industry peer came under investigation. I created a second set of variables to identify the industries that had the highest number of companies to come under investigation between January 2002 and July 2004: telecommunications, electric services, commercial banks, securities broker-dealers, and prepackaged software. I created a dummy variable for each of these five industries, with each equal to 1 if the company was in the particular industry and 0 if not. The sixth variable was coded as 1 if a company was in any other industry and 0 otherwise.

Negative Media Scrutiny: Using the ABI Inform database, I measured negative media scrutiny by counting the number of articles that contained, in the title or abstract, the company name and any of the following words: investigation, scandal, fraud, litigation, corruption, insider trading, or white collar crime. I measured the level of media scrutiny during five periods of time: 2001, January – June 2002; July – December 2002; January – June 2003; July – December 2003. For each spell, negative media scrutiny was measured by using the period that ended closest to the spell's starting time.

Organizational Prestige: I measured organizational prestige using *Fortune* magazine's annual ranking of corporate reputations in its "Index of Most Admired Companies" (Still and Strang 2005). *Fortune* uses an interval scale to rate each company in its list, and I used the logged ratings for 2001.

Shareholder Activism: I measured shareholder activism using three variables. The first counted all shareholder resolutions submitted to the company during the previous proxy season. Since proxy

seasons are annual, the effect of this variable was constant for spells that began during the 12 month period after the company's proxy statement was submitted to the SEC. The second and third variables that tracked shareholder activism were measured in the same way. The former measured all resolutions submitted relating to the reform of executive compensation, including resolutions relating to stock options. This excluded resolutions calling for the specific adoption of SOE. The final shareholder activism variable was a binary variable that measured whether or not shareholders had submitted a resolution calling on a company to adopt SOE. Such resolutions were only possible after November 2002.

Prior Adoption Activity (Contagion): I measured prior adoption activity within the sample by counting the cumulative number of organizations that had adopted SOE from the beginning of the observation period up to and including the month prior to the beginning of each spell.

Control Variables: I included four control variables: revenues (log), net income, number of employees, and option expense as a percentage of net income. I used option expense as a percentage of net income in order to standardize the impact of the option expense across all companies. The controls were all measured as constants and collected from 2001 corporate annual reports.

Analysis

I used event history analysis to model the effects of the independent variables on the instantaneous hazard rate of a company adopting SOE. I measured the time of SOE adoption by month, with the observation period beginning in January 2002 and ending in July 2004. To incorporate the effects of the time-varying covariates into the models, I employed the method of episode splitting (Blossfeld and Rohwer 2002), with all relevant changes in the covariates measured by month. After all splits were complete, the final dataset consisted of 9,368 total spells, with 123 events occurring during the observation period and 350 right-censored cases.

Although the Cox model is appropriate for estimating the effects of independent variables on the hazard rate (Allison 1984, Blossfeld and Rowher 2002), it is not able to capture any form of time-dependence since it effectively "controls for" time-dependence. Therefore, the Cox model was not appropriate for measuring the effect of previous adoption activity through time or for providing unbiased

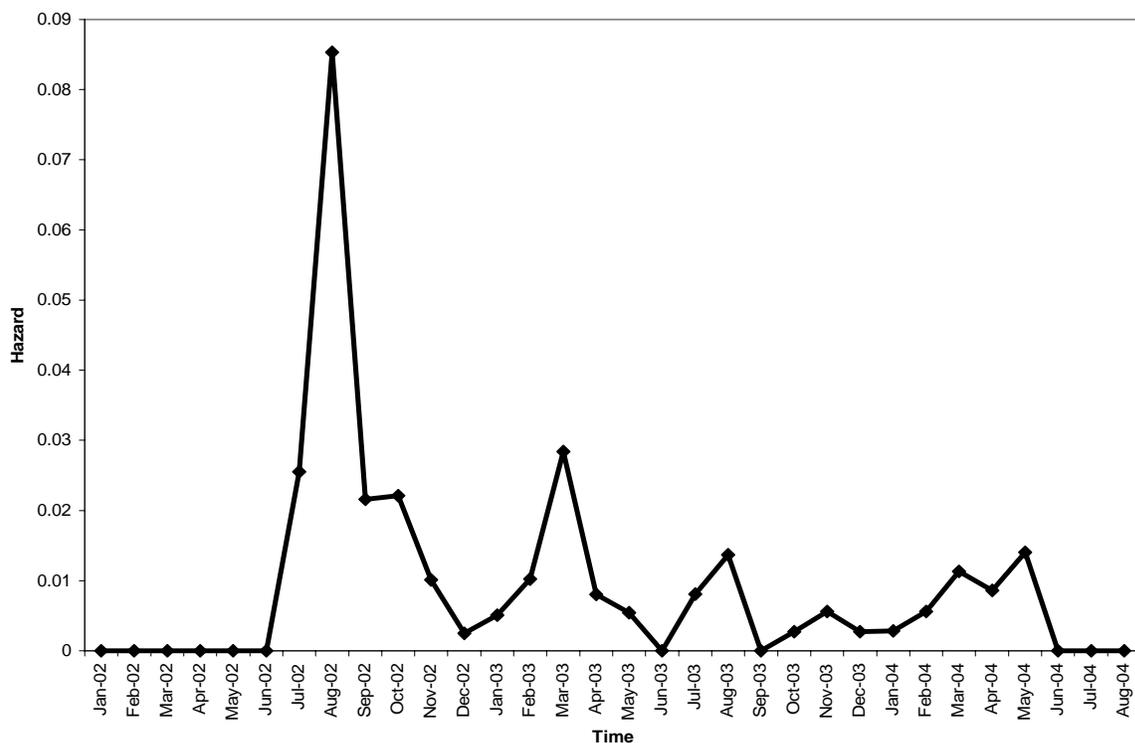
estimates of shareholder activism as expressed in resolutions calling for companies to adopt SOE, something that was only possible after November 2002. Hence, a model was needed to capture at least some of these time effects, if not formally model time dependence. As Figure 5.2 indicates, however, the empirical hazard rate does not conform to any of the common parametric models such as the Gompertz, Weibull, log-normal, or log-logistic.

I therefore used a piecewise exponential model, which allows the observation period to be divided into different time periods, assumes a constant baseline hazard rate during each time period, and allows the effects of the covariates to vary between time periods. (Blossfeld and Rohwer 2002). This model takes the form:

$$\log r_{jkp} = x(t) \beta_{jkp}$$

where r represents the transition rate from state j to state k during time period p , $x(t)$ is a vector of covariates, β is a vector of coefficients associated with the covariates during time period p .

Figure 5.2: Empirical Hazard Rate of SOE Adoption, January 2002 – July 2004



The empirical hazard rate (Figure 5.2) reveals two distinct periods of SOE adoption activity: an initial increase through August 2002, followed by a sharp decline and then modest fluctuation. These two periods reflect changes, discussed earlier, in both the expectations about regulatory forces imposing mandatory stock option expensing, and the volume and tone of corporate press releases about SOE adoption. These changes suggest that a shift occurred around this time in the way in which SOE was perceived and used as a symbol of normative legitimacy. As a consequence, there may have also been a shift in the strength of the forces driving SOE adoption at this time. I therefore divided the time axis into two periods, January 2002 – August 2002 and September 2002 – July 2004, and allowed the effects of the covariates to differ between these two time periods.

Results and Discussion

Table X provides descriptive statistics and Table X the correlation matrix. Table X shows results from two different piecewise event history models that differ only in how they measure the legitimacy challenge posed by investigations at the industry level. Model 1 measures the total number of companies in each organization's industry that were under investigation, while model 2 measures the effect of industry-level investigations by using dummy variables for each of the five industries that were under the most intensive investigative activity: telecommunications, electric services, commercial banks, broker dealers, and software. I included model 2 to provide a more detailed picture of the effect of investigations at the industry level.

The results from the event history models indicate that investigation activity at the industry level had a significant effect on SOE adoption, particularly between September 2002 and July 2004, thus providing strong support for hypotheses two, three, four, five, and six. Organizations in four of the five industries that were under the most intensive levels of investigation were more likely to adopt SOE: commercial banks, telecommunications, electric services, and securities broker-dealers. Commercial banks, broker-dealers, and electric services were all implicated, in different ways, with the highest profile scandal, Enron. The telecommunications industry was the focus of another high-profile scandal,

Table 5.2: Descriptive Statistics

Variable	MEAN	SD	MIN	MAX
# of Investigations in Industry	1.34	2.73	0	13
Fortune's Most Admired Rating	3.67	3.16	0	8.6
Negative Media Scrutiny	11.63	84.97	0	3113
# of All Shareholder Resolutions	.387	.851	0	8
# of Shareholder Resolutions:				
Executive Compensation Reform	.077	.281	0	2
Revenues (\$ millions)	13539.88	18442.31	3042.5	219812
Net Income (\$ millions)	496.33	5457.97	-56121.9	87760
Stock Option Expense/ Net Income (%)	.333	2.79	0	84.46
Employees (thousands)	46248.08	66828.84	199	13830000
Other Variables				N
Companies Under Investigation				58
Companies with at Least One Industry Peer Under Investigation				198
Companies on Fortune's Most Admired List				280
# of Shareholder Resolutions-Stock Option Expensing, 2003				45
# of Shareholder Resolutions-Stock Option Expensing, 2004				17
# of Passed Shareholder Resolutions-Stock Option Expensing, 2003				23
# of Passed Shareholder Resolutions-Stock Option Expensing, 2004				13

Table 5.3: Correlation Matrix

	1	2	3	4	5	6	7
1 Investigation	1						
2 Industry Investigations	0.23	1					
3 Negative Media Scrutiny	0.22	0.08	1				
4 # of All Shareholder Resolutions	0.18	0.02	0.02	1			
5 # of Shareholder Resolutions: Executive Compensation	0.13	0.08	-0.00	0.20	1		
6 Shareholder Resolution: Adopt SOE	0.01	0.03	-0.01	0.12	0.27	1	
7 Fortunes Most Admired	0.11	-0.04	0.09	0.20	0.12	0.10	1
8 Revenues (log)	0.31	0.17	0.21	0.36	0.16	0.07	0.41
9 Net Income	0.03	0.01	0.01	0.03	-0.01	0.01	0.03
10 Option Expense/Net Income	-0.02	-0.03	-0.00	0.04	0.02	0.02	0.04
11 # of Employees	0.06	-0.06	0.36	0.29	0.08	0.07	0.29
	8	9	10	11			
8 Revenues (log)	1						
9 Net Income	0.08	1					
10 Option Expense/Net Income	0.01	-0.01	1				
11 # of Employees	0.54	0.06	0.02	1			

Table 5.4: Event History Models: Voluntary Adoption of Stock Option Expensing¹¹*Period 1: January 02 – August 02*

	Model 1	Model 2
Constant	-7.3030**** (1.89)	-8.189**** (1.97)
Investigation	.5172 (.419)	- -
# of Investigations Industry	.0668 (.042)	- -
Telecommunications	-	-12.983 (49.19)
Electric Services	-	-.8616 (1.02)
Commercial Banks	-	1.335**** (.828)
Broker Dealers	-	.4797 (1.05)
Software	-	1.174 (1.10)
Negative Media Scrutiny (log)	.1547 (.134)	.1766 (.141)
# of All Shareholder Resolutions	.0457 (.130)	.0587 (.131)
# of Shareholder Resolutions: Executive Compensation	.5367 (.760)	.7910 (.757)
Fortune's Most Admired	-.2687 (.185)	-.340* (.189)
Revenues (log)	.2938 (.218)	.4035* (.230)
Net Income	.0001 (.000)	.0000 (.000)
Option Expense (as % of net income)	.0315** (.013)	.0317** (.013)
Employees	.0000 (.000)	.0000 (.000)

¹¹ Standard errors in parentheses. * p ≤ .10, ** p ≤ .05, *** p ≤ .01, **** p ≤ .001

Table 5.4 (Continued)*Period 2: September 2002 – July 2004*

	Model 1	Model 2
Constant	-5.295**** (1.74)	-5.502**** (1.76)
Investigation	-.0368 (.390)	- -
# of Investigations Industry	.1093**** (.033)	- -
Industry: Telecommunications	-	1.315*** (.520)
Industry: Electric Services	-	.9425** (.420)
Industry: Commercial Banks	-	.8282 (.601)
Industry: Broker Dealers	-	1.714*** (.693)
Industry: Software	-	.9956 (1.05)
Negative Media Scrutiny (log)	.1394 (.105)	.1171 (.107)
# of All Shareholder Resolutions	.1223 (.126)	.1260 (.129)
# of Shareholder Resolutions: Executive Compensation	-.5813 (.526)	-.5868 (.535)
Shareholder Resolution to Adopt SOE	-.2060 (.622)	-.1688 (.628)
# of Previous Adopters	-.0148**** (.004)	-.0145**** (.004)
Fortune's Most Admired	.0089 (.147)	-.0125 (.151)
Revenues (log)	.2938 (.218)	.1807 (.207)
Net Income	.0000 (.000)	.0000 (.000)
Option Expense (as % of net income)	-.4473 (.370)	-.5428 (.415)
Employees	.0000 (.000)	.0000 (.000)
Log Likelihood	-347.898	-340.820
Degrees of Freedom	23	29
Number of observations	9368	9368

WorldCom. In contrast, the software industry experienced a high number of investigations, but the results indicate that software companies were not more likely to adopt SOE. Investigations in this industry were not driven by a high profile scandal such as Enron or WorldCom.

The results do not provide support for hypothesis one, that organizations under direct investigation were more likely to adopt SOE. It appears that a direct investigation in and of itself was either not a strong enough threat to legitimacy or was not a threat against which organizations believed SOE adoption would be an effective defense. This suggests that investigations did not translate into a threat to organizational legitimacy until they reached a certain intensity at the industry level. Although the results do not provide support for hypothesis 8 that companies that were under more intensive negative media scrutiny were more likely to adopt SOE, I did not measure this effect at the industry level.

The results also indicate that the effect of industry level investigations was strongest in the second time period, i.e., after August 2002, but there was an effect in both time periods. Although Model 1 does not show an effect in July and August 2002, Model 2 shows that during this period, commercial banks, an industry under intensive investigative scrutiny, were more likely to adopt SOE. Model 1 shows that between September 2002 and July 2004, companies in industries with high levels of investigative activity were more likely to adopt SOE. Model shows that telecommunications companies, electric service companies, and securities broker-dealers accounted for this effect. The finding that the effect of industry-level investigations was more pronounced after August 2002 may seem contradictory in light of the claim that the significance of SOE as a symbol of normative legitimacy began to decline after August 2002. However, the finding may in fact be consonant with the changing significance of SOE as symbol of normative legitimacy over time and may also reveal variation in how different companies viewed the practice's significance. It is reasonable to suggest that this initial spike in SOE activity among all companies was linked to the early strength of SOE as a symbol of normative legitimacy for all companies.¹² While companies facing a legitimacy threat may have had much to gain from adopting SOE and signaling their normative legitimacy in both the first and second periods, companies that were *not*

¹² When I ran the piecewise event history models without covariates, the constants were -4.300 in the first period and -4.813 in the second period, both significant at $p \leq .0001$.

under a legitimacy threat may have been more likely to adopt in the initial period than in the second period. Hence, the lack of strong industry investigation effects in the first period and the presence of strong industry investigation effects in the second period suggests that the practice's significance as a symbol of normative legitimacy was only useful, during the second period, for those organizations in industries under heavy investigation. For other organizations, the significance of the practice as a symbol of normative legitimacy may have diminished sharply after August 2002. This suggests that SOE retained its significance as a symbol of normative legitimacy for companies in industries under investigation even as FASB was making an attempt to make the practice mandatory, a threat that was widely perceived as very credible.

The results provide strong support for hypothesis 12, that as the number of previous adopters increased, the adoption rate dropped. The effect is highly significant in both models, but only in the period after August 2002.¹³ This provides further evidence that the ability of the practice to confer a distinctive normative legitimacy may have become diluted over time as more companies adopted. It is important to point out, however, that the negative findings regarding a contagion effect may also suggest another time-dependent process at work. This finding remains important, however, because it shows that the emergence of a credible regulatory threat did not increase the chances of SOE adoption, something that would be expected considering the coercive effects of regulatory pressures on practice adoption (DiMaggio and Powell 1983).

It may be difficult, however, to detect dramatic shifts in symbolic meanings within the short observation period of this study. It does seem clear that in the aftermath of the WorldCom scandal and the intensification of political pressures that followed, SOE acquired status as a symbol of normative legitimacy. The volume and content of the press releases, as well as broad perceptions of the inevitability of an SOE requirement, suggests the beginning of a shift away from normative legitimacy after August 2002, but does not suggest a definitive shift in SOE's symbolic significance to one of regulative legitimacy. It is likely that this shift became more definitive after the final requirement was implemented

¹³ The variable was dropped for the first time period because of multicollinearity.

in December 2004. The period between the initial emergence of SOE as a symbol of normative legitimacy and FASB's implementation of this requirement, i.e., most of the observation period used in this study, was most likely a period of transition in the practice's symbolic meaning with regards to organizational legitimacy. In this interim period, while a requirement seemed imminent, it was not a complete certainty, and most companies were probably waiting to see if SOE would become a requirement before they adopted.

With respect to shareholder activism, the results provide no support for hypotheses 9-11. Although the corporate scandals mobilized intense shareholder activism on a range of issues, the results reveal that none of the three shareholder activism variables had a significant effect on SOE adoption. This may indicate that the power and ability of shareholders to influence organizational behavior remains limited. Even in the wake of the scandals, organizations may not have seen shareholder activism as a significant threat to organizational legitimacy. It is also important to note that shareholder resolutions measure only one form of activism. Shareholder groups, and in particular institutional investors, also place pressure on boards of directors and management through informal meetings and communication, and publicity campaigns.

Although hypothesis 13, that companies with higher prestige will be more likely to adopt SOE, is not supported, Model 2 shows that higher prestige companies were actually *less* likely to adopt SOE in the first period. This suggests that, in the post-Enron debates and criticism of a variety of corporate practices and institutions, higher prestige companies did not believe it was necessary to recognize the new normative environment and signal their willingness to conform to it, even symbolically. This finding may also suggest that high status companies did not experience the general threats to the legitimacy of broader institutional frameworks governing corporate behavior more intensely than other companies simply because of their high status within this system. Finally, the results indicate that as the magnitude of the option expense increased, so did the likelihood of SOE adoption during July and August of 2002. This reveals that SOE adoption was not a simple choice based on a cost-benefit analysis of the potential expense. This finding also suggests that the symbolic value of SOE adoption may have increased as the magnitude of the potential option expense increased.

Overall, the findings present a complex picture of symbolic SOE adoption and the relative strength of different institutional forces in challenging organizational legitimacy. Although investigations were clearly an influence on SOE adoption rates, the effect operated primarily at the industry level. Hence, investigations appear to be a legitimacy challenge that organizations perceived could be managed by adopting SOE, but the effect is not direct. Such challenges were primarily challenges to regulative legitimacy because they involved an examination of whether an organization was in compliance with formal rules and regulations. In contrast, the legitimacy threats embodied in negative media scrutiny and shareholder activism were either not powerful enough or were of a type that companies did not perceive that SOE adoption would be effective in addressing. Media scrutiny and shareholder activism represented challenges to normative legitimacy, but did not illicit a similar response as industry-level investigations. Hence, organizations may perceive threats to regulative legitimacy as more immediate and real than threats to normative legitimacy, and respond to them more proactively through symbolic practice adoption.

CONCLUSION

The concept of organizational legitimacy has been a central one to organizational sociology. Although we know a great deal about the ways in which new organizations and new organizational forms acquire legitimacy, the importance of this legitimacy, and the social dynamics of conflict surrounding the creation of the norms and rules that confer such legitimacy, our understanding of the strategic action that organizations take to maintain their legitimacy over time and to defend their legitimacy when it is challenged has been limited. This paper has revealed that when organizational legitimacy is challenged, one way in which organizations react is to engage in symbolic adoption of practices that are closely connected, ideologically, to the sources of the legitimacy challenge. However, symbolic practice adoption does not appear to be a standard response to any legitimacy threat.

This paper broadens and deepens our understanding of how organizations attempt to manage their legitimacy in the face of challenges and threats. The evidence presented here provides empirical support for recent theoretical claims that organizations engage in symbolic practice adoption in addition to

rhetorical strategies in the face of legitimacy challenges (Ashforth and Gibbs 1990, Suchman 1995). The findings also expand upon the recent work of Elsbach (1994) and Elsbach and Sutton (1992) which has examined the ways in which impression management activities are closely connected to institutionalized organizational structures in the process of legitimacy defense. In addition, this paper has illuminated ways in which the symbolic meaning of organizational practices is socially constructed through field-level interaction between a diverse group of actors, a process that becomes particularly visible during times of institutional destabilization (Fligstein 2001). The results provide some support for the contention that the meaning of SOE shifted away from being a symbol of normative legitimacy to one of regulative legitimacy, but additional research is needed to examine more closely the field-level dynamics that construct legitimacy and the symbolic meaning of particular practices, and how organizational actors perceive these practices and their relation to organizational legitimacy in different settings

In terms of some of the central issues of interest to the ongoing project of the new institutionalism in organizational analysis, the research presented here confirms both the central role of accounting practices in organizational symbolism first postulated by Meyer and Rowan (1977) and the utility of examining the adoption of accounting practices through an institutional lens (Mezias 1990, 1995). In addition, this paper broadens some of the early neoinstitutional approaches to organizational analysis (Meyer and Rowan 1977, DiMaggio and Powell 1983) by examining a case in which practice adoption was not used a way for organizations to gain legitimacy by imitating successful organizations or responding to coercive pressures, but instead, was used as a way for organizations to defend their legitimacy by differentiating themselves from other organizations, but isomorphic with emerging norms. Furthermore, this paper expands upon a well-established stream of institutional research regarding early and late practice adopters. The work of Baron et al. (1986), Tolbert and Zucker (1983), and Westphal et al. Shortell (1997) has revealed that early adopters of a practice do so for economic or technical reasons, while later adopters do so to acquire legitimacy once a practice becomes institutionalized This analysis of SOE adoption reveals that in certain situations, early adopters may also adopt in order to manage their legitimacy.

The analysis presented in this paper also has distinct limits. First, the observation period is short, and it would be worthwhile in future research to extend this as far as possible past December 2004, when SOE became mandatory. Doing so would likely reveal more obvious shifts in the symbolic meaning of SOE and in the forces shaping adoption. Second, the sample only included the Fortune 500, the largest firms in terms of revenues. The sample excluded a number of organizations that adopted SOE and a number of industries in which SOE adoption was prevalent, e.g., real estate. Hence, SOE adoption may have been importantly shaped by additional factors. On a more general level, the dynamics of legitimacy defense may be very different in smaller organizations, and in nonprofit and governmental organizations. Third, as noted above, the analysis does not take a detailed view of how field-level forces shaped legitimacy challenges and responses in the post-Enron world. Finally, although the results presented here suggest that the ability of shareholder activism to affect change is limited, shareholder activism is measured only through shareholder resolutions. Shareholder groups have also applied political pressure to organizations to make changes through less formal methods such as meetings with executives and media campaigns, and future research that analytically incorporates these mechanisms is needed to examine the conditions under which shareholder activists have power to effect change. Organizational sociologists have largely ignored the phenomenon of shareholder activism, and it is clearly a phenomenon that requires much more intensive research and theoretical expansion. The results presented here take a small step in this direction.

The findings and analysis presented here illuminate a variety of additional research opportunities. Future projects could examine the ways in which symbolic practice adoption was connected to impression management techniques in order to examine Suchman's (1995) claim that both are necessary for effective legitimacy defense. In addition, it would be useful to understand how SOE adoption was connected to broader attempts of organizations to derail efforts to implement legislation that would have substantially altered existing rules of corporate governance, auditing, accounting, and executive compensation. Another line of research could examine the ways in which legitimacy challenges and defense strategies are contingent upon more proximate field-level dynamics. This paper merely illuminates industry-level variation in how organizations responded to legitimacy challenges. Additional research could provide

more detailed analysis of how legitimacy threats emerged and were perceived by companies in particular industries, as well as how and why different types of organizations reacted to these challenges in different ways. In addition, the results suggest that organizational actors may perceive challenges to different types of organizational legitimacy as stronger than others and more effectively defended against through symbolic practice adoption. Future research on the defense of organizational legitimacy that incorporates more sophisticated conceptions of organizational legitimacy (Ruef and Scott 1997, Suchman 1995) would greatly enhance our understanding of variation in the types of responses to these challenges. Finally, it would be useful to conduct a more detailed content analysis of the ideological battles that emerged in the media during this period regarding institutional change and corporate justifications for stock option expensing. This paper only touches upon such an analysis, which could help to make more substantial empirical and theoretical connections between discourse, framing processes, and social action.

On a broader level, this paper has examined the ways in which for-profit organizations defended their interests and resisted regulation by the state, professions, and civil society after the recent scandals at Enron and other companies. The scandals precipitated a general legitimacy crisis of the core institutional framework that defines the formal rules and informal expectations about how corporations operate in the United States. They also challenged the legitimacy of the ideology of shareholder value that emerged in the 1980s and matured in the 1990s, an ideology that has had significant consequences for the ways in which companies are managed and for whom, and how they distribute returns on investment to various stakeholders (Fligstein 2001, Lowenstein 2004). Furthermore, the scandals brought into question the cognitive legitimacy of a regulatory system that provides corporations with a great deal of freedom from regulation. The institutional destabilization provoked by the scandals opened up broad debate, albeit for a short period, about how corporations are regulated and governed, and who is entitled to claims on their productive assets and profits. To a great extent, the corporate managers and their advisors who were the targets of the investigations, public scrutiny, and political pressures were able to effectively prevent the enactment of regulation that was more burdensome than the Sarbanes-Oxley Act. Thus, this group of actors was able to preserve the institutional framework that provides them with a great deal of power. The success with which the largest corporations in the U.S. were able to defend their interests was in large part

a result of serious political lobbying and the support of people in the highest ranks of the federal government, but was also a function of corporations defending the legitimacy of the overall system and their own legitimacy as more or less virtuous actors. The symbolic adoption of SOE, therefore, can be seen as part of a much broader effort to derail debate about the potential implementation of significant changes to the institutional conditions that structure and define the dynamics of contemporary American capitalism.

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