# DEFENDING ORGANIZATIONAL LEGITIMACY AFTER ENRON: THE SYMBOLIC USE OF STOCK OPTION ACCOUNTING

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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.

## BIOGRAPHICAL SKETCH

Edward J. Carberry is a Ph.D. student in the Department of Sociology at Cornell University. He received a Bachelor of Arts in History from Bates College in 1991. Prior to graduate school, he was Director of Research at the National Center for Employee Ownership in Oakland, California. His academic areas of specialization include the sociology of organizations and work, economic sociology, and social stratification. His research interests focus on employee ownership, the decentralization of authority within contemporary capitalist organizations, and the intersection of organizations and inequalityh.

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# CHAPTER 1

# INTRODUCTION

The concept of organizational legitimacy has been central to institutional and ecological approaches in organizational theory. 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 scandals at Enron and other companies. 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 Mezias (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. Finally, this paper challenges economic interpretations of accounting practice adoption.

This paper will begin with a brief review of the literature on the defense of organizational legitimacy, highlighting the gaps in the research on practice adoption as a strategy for legitimacy defense. I will then provide a detailed examination of the broader social and political context in which SOE adoption occurred and how SOE acquired symbolic meaning in the post-Enron environment. 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. The paper then develops and tests 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 or malfeasance, and those that were the target of shareholder activism.

# CHAPTER 2

# 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

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

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 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.

# CHAPTER 3

# THE 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. This section provides a brief overview of the history of stock option accounting and the most recent period of controversy that began in the wake of the Enron scandal.

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. Employees gradually receive the right to exercise (or purchase) these shares through a process known as vesting, which is usually linked to continued employment. Once employees are vested in their options, they can exercise their options at any time. The advantage for the employee is that if the company's stock price rises, the employee can exercise the option, purchase the stock at the contractual price, and then sell it at the higher market price. Unlike publicly traded stock options, employee stock options can not be purchased or sold, only exercised by the employee or allowed to expire.

Since the 1920s, a diverse group of companies have used stock options as a form of compensation for employees. 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. Executive stock options have been the

subject of much criticism as one of the primary forces driving the astronomical increase in executive compensation since the 1980s (Lowenstein 2004). The granting of stock options, however, has not been restricted to executives. As far back as the 1950s, many high-tech companies, particularly in Silicon Valley, have granted stock options to a majority or all of their nonmanagement employees (Blasi et al. 2003). Stock options have been a way that these companies have attempted to attract, retain, and motivate knowledge workers, such as software programmers and engineers, who represent some of the core assets of these organizations. Stock options also allow startups to save cash for other capital investments rather than compensation. In the 1980s and 1990s, new industries around software development and the Internet emerged. Due to tight labor markets and a more intense dependency on knowledge capital, these companies granted stock options to employees beyond a select group of knowledge workers (Blasi et al. 2003). By the mid 1990s, broad-based stock option plans (BBSOPs) had become institutionalized as a standard practice within most high-tech industries, in Silicon Valley and elsewhere. At this time, the practice also spread in a more limited fashion to nontechnology companies.

Another reason why stock options became a popular form of compensation for executives and other employees is 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 the mid-1980s, the regulatory agency that establishes and maintains accounting standards, the Financial Accounting Standards Board (FASB), began to review the accounting treatment of stock options. In 1992, 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 that had been originally developed for publicly traded stock options. 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.

As part of its process of setting accounting standards, FASB allows for a public comment period on rules that it proposes. 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, who have relied heavily on stock options as a form of compensation not only for top management but for broad groups of employees, 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. Between the adoption of FAS 123 and July 2002, only 13 companies chose to formally expense their stock options under the rules of 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 and even persuaded some members of Congress to draft a bill in 2004 to protect stock options from expensing. In December 2004, however, FASB issued its final ruling on the matter, requiring expensing starting in 2005. Since then, the start date for required adoption has been pushed back. Some technology companies still hold out hope that the expensing rule will be rescinded, but this appears unlikely.

**Patterns of SOE Adoption**

Although FASB did not finalize an SOE requirement until December 2004, between July 2002 and July 2004, over 750 publicly traded companies voluntarily decided to adopt SOE, i.e., to formally recognize a compensation expense of stock options. Such an expense directly reduced their earnings, earnings per share, and potentially, their stock prices. Why would these companies 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? Before turning to possible explanations, it is useful to examine the descriptive data about the SOE adopters.

I acquired a list of SOE adopters from Bear Stearns, an investment banking and securities brokerage firm that has tracked SOE adoptions. The list provided basic demographic information about the adopters and the method of stock option expensing.[2] Bear Stearns tracked adopters through corporate press releases and media reports.[3] Of the 753 companies who adopted SOE between July 2002 and July 2004,

[2] Initially, if a company adopted SOE, it could chose between three different ways to calculate current and past expense. This choice was not preserved in the final ruling released in December 2004.
[3] Although most of these companies did actually adopt, some announced their intentions but did not adopt. One example is Amazon.com, which announced their intention to adopt in July 2002, but as of this writing, had not actually started expensing. For the purposes of this study, this distinction does not

68% were based in U.S., 24% were Canadian, and the remainder were incorporated in 14 other countries in Europe, Asia, and the Caribbean. About 17% (126) of these companies were in the S&P 500. The average market capitalization of these companies was $8.2 billion, with a median of $1.2 billion.

Table 3.1 provides more detailed information about the industries in which SOE adoption was most common. The top industries include real estate investment trusts, precious metals, and regional banks, followed by oil and gas production, major banks, and property/casualty insurance. 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. Between December 1995 and July 2002, only 13 publicly traded companies adopted SOE. Three distinct peak

**Table 3.1: Incidence of SOE Adoption by Industry, 1995-2004**

| Industry | # of Adopters | % of Total |
|---|---|---|
| Real Estate Investment Trusts | 74 | 9.83 |
| Precious Metals | 46 | 6.11 |
| Regional Banks | 37 | 4.91 |
| Oil and Gas Production | 28 | 3.72 |
| Major Banks | 27 | 3.59 |
| Property/Casualty Insurance | 23 | 3.05 |
| Electric Utilities | 19 | 2.52 |
| Life/Health Insurance | 17 | 2.26 |
| Finance/Rental/Leasing | 15 | 1.99 |
| Investment Banks/Brokers | 15 | 1.99 |
| Other Metals/Minerals | 14 | 1.86 |
| Telecommunications | 13 | 1.73 |
| Biotechnology | 11 | 1.46 |
| Financial Conglomerates | 10 | 1.33 |
| Multi-Line Insurance | 10 | 1.33 |
| Telecommunications Equipment | 10 | 1.33 |
| **Total** | **369** | **49.01** |

raise serious theoretical issues since I am interested analyzing the symbolic adoption of SOE, which is adequately captured in the methodology used by Bear Stearns.

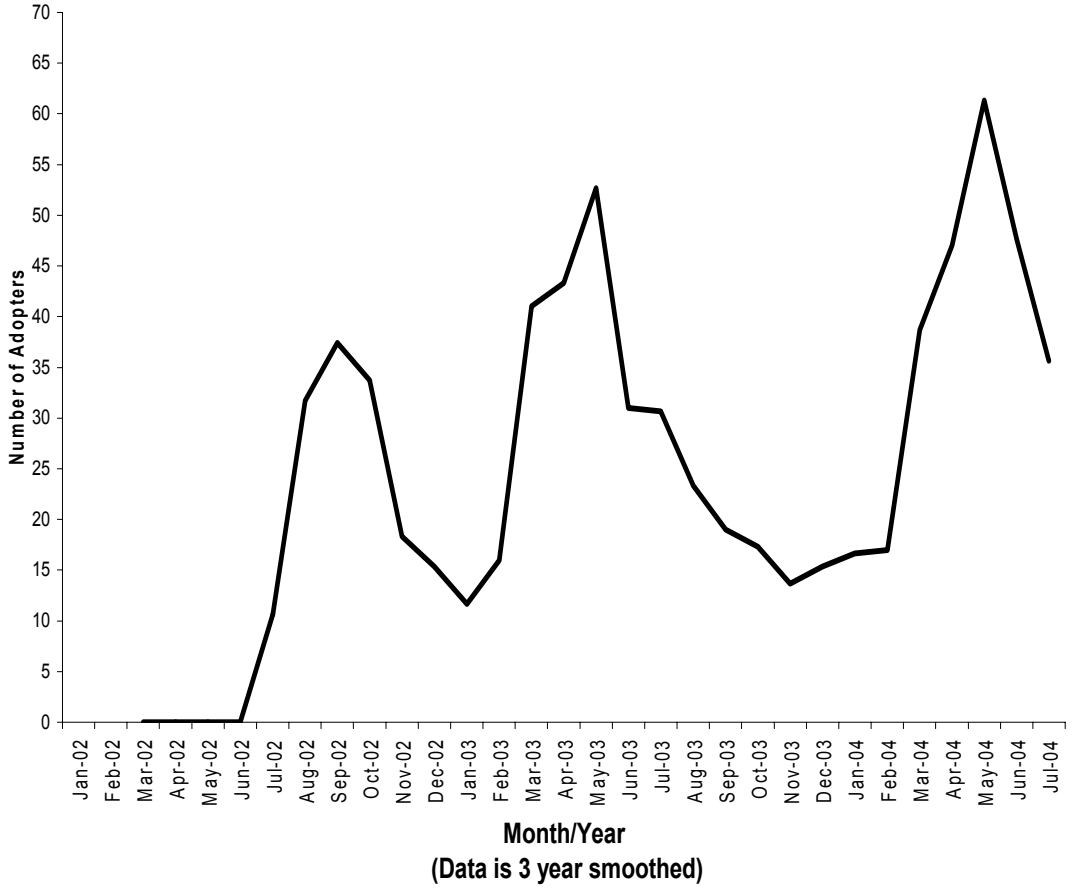


**Figure 3.1: Number of SOE Adopters, January 2002 – July 2004**

periods of adoption activity are apparent: July through September 2002 (112 companies in 14 sectors and 55 industries); January through May 2003 (198 companies in 20 sectors and 73 industries); and February through May 2004 (210 companies in 20 sectors and 74 industries). Taken together, these three waves account for 520 (69%) of the total number of expensers between July 2002 and July 2004.

When examined longitudinally at the level of industry, during the first wave, companies in 55 industries expensed, with the highest percentages among real estate

investment trusts (11%), major banks (7.1%), and financial conglomerates (6.3%). In the second wave, the number of industries represented increased to 73, with the highest concentrations among real estate investment trusts (21%), regional banks (5.5%) and electric utilities (5%), which represented the first significant non-finance industry clustering. During the third wave, companies in 74 industries expensed, and the concentration in finance industries diminished. The precious metals industry represented the highest percentage (17%), followed by oil and gas production (5%), and regional banks (4%). In all three of the waves, the industry composition beyond these leaders is fairly evenly distributed.

The descriptive evidence, therefore, reveals that by the end of July 2004, 753 companies traded on the US stock markets had adopted SOE and that adoption occurred in three distinct waves of heightened activity. While companies in a diverse group of industries adopted SOE, a few industrial sectors represented a large proportion of the expensers, with the finance sector clearly the dominant one in all three periods, particularly the first two periods. Also, 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. In terms of industry, the data indicate that the highest industry concentrations were among real estate investment trusts during the first two periods, banks in all three periods, and precious metals and oil and gas production in the final period.

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. Prior to July 2002, only 13 publicly traded companies had adopted SOE, something that was first made possible by FASB in 1995. The last adoption prior to the scandals occurred in April 2001. The fact that a dramatic spike in SOE adoption occurred in the immediate wake of the WorldCom scandal 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?

**Existing Explanations of SOE Adoption**

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. These studies emphasize the role of rational economic decision-making at the firm-level and the individual incentives of managers in shaping adoption patterns. Although these studies acknowledge that adoption was most likely linked to the scandals, they treat the scandals as altering the cost-benefit calculus of rational economic decision making, eschewing a more in-depth analysis of the specific institutional and political dynamics that the scandals set in motion, and the direct influence that these dynamics may have had on adoption patterns.

In the most extensive study to date, Aboody et al. (2003: 127) argue that firms will voluntarily adopt SOE "only when they believe that it is cost beneficial to do so"

and that in the wake of the scandals in 2002, the parameters for calculating the costs and benefits changed. They authors test hypotheses regarding the types of firms that would have expected positive valuation benefits from stock option expensing in the post-scandal environment: those more active in capital markets, those with more information asymmetry between management and shareholders, and those who were more vulnerable to political pressures (as measured by size and profitability). They also examine how managerial incentives influenced adoption, hypothesizing that managers whose compensation was sensitive to net income would be less likely to adopt (because SOE adoption would reduce net income), while those with large equity holdings would be more likely to adopt because managers would benefit from the positive stock market valuation that SOE adoption would generate.

Seethamraju and Zach (2004) provide an analysis based on a similar core assumption that firms will choose to adopt SOE primarily based on a cost-benefit analysis, but they define costs and benefits more broadly to include nonfinancial metrics, such as improving a company's image or preventing future scrutiny, particularly in the face of the scandals. The authors predict that firms with high levels of media exposure will be more likely to benefit from the positive signal of SOE in the post-Enron environment and that firms who had recently experienced a drop in their stock price would use SOE adoption to improve their public image. In addition, the authors predicted that firms that had "something to hide" (as measured by managed earnings) would be more likely to adopt SOE to prevent future scrutiny. Finally, they predict that firms with a strong governance structure (as measured by the percentage of outsiders serving on the board) will be more likely to expense because the board has more oversight over management. In the third study, Deshmukh et al. (2004) examined the impact of both the alignment of management and shareholders' interests

(as measured by the level of share ownership by management), and information asymmetry on the likelihood of SOE adoption.

Overall, these studies present a somewhat disjointed and incomplete picture of the determinants of SOE adoption. The findings indicate that SOE adoption was positively associated with capital market activity, the size of managers' equity holdings, company size, and media exposure. Although Aboody et al. (2003) found that firms with less information asymmetry (as measured by the level of institutional ownership) were less likely to adopt, Deshmukh et al (2004) found that firms with less information asymmetry (as measured by transparency) were more likely to adopt. The former argues when better information is available to stakeholders, a firm will not perceive that SOE adoption will lead to positive valuation benefits. The latter argues that less information asymmetry is a sign of good governance, which will lead to expensing. In terms of other corporate governance variables, the second study finds that stronger governance (as measured by % of outsiders on the board) had no impact on SOE adoption, while the third study finds that management-shareholder interest alignment (as measured by the % of ownership of management) made firms more likely to expense. The latter argues that such alignment is also a sign of good corporate governance. One of the major weaknesses of the literature, therefore, is that it is difficult to compare the findings because these studies do not use similar measures. In addition, the operationalization of some variables is questionable, such as using management stock ownership as a proxy for management-shareholder interest alignment (Deshmukh et al. 2004), and size and profitability to measure vulnerability to political pressures stemming from the scandals (Aboody et al, 2003). Finally, all three of these studies are cross-sectional and only examined the first wave of SOE adopters in 2002.

More substantially, however, 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. The existing research on SOE adoption ignores the vast sociological literature that provides ample evidence that organizations adopt practices for reasons other than cost-benefit considerations, for example, as a reaction to coercive pressures, to signal legitimacy within prevailing institutional norms, or to cope with uncertainty by imitating successful organizations (DiMaggio and Powell). Although the adoption of a practice for these reasons may result in financial benefits for the organization and executives, 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.

In other words, although the existing literature recognizes that the corporate scandals of 2001 and 2002 created pressures for reform that may have influenced the voluntary adoption of SOE, it relegates these pressures to an indirect role. 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. In the next section, I will take a closer look at the scandals that began with Enron in late 2001, the dynamics they set in motion, and the emergence of the symbolic significance of SOE in order to develop specific hypotheses about SOE adoption patterns.

# CHAPTER 4

# SCANDALS, REACTIONS, AND THE EMERGENCE OF STOCK OPTION ACCOUNTING AS SYMBOL

This section will provide a detailed overview of how the issue of stock options and stock option accounting became connected to the scandals and the broader movement for corporate reform that emerged in 2002, and how SOE became a symbol of normative organizational legitimacy in this environment. My primary purpose is to situate stock option expensing within the detailed context of the corporate scandals and reactions to them. More specifically, I will show how, in the immediate aftermath of the scandals, stock option expensing became a symbol of normative legitimacy because it was a way for organizations to signal their recognition of and adherence to emerging norms for more transparent accounting and constraints on executive equity compensation. In addition, this section reviews how the scandals set in motion a regulatory threat in the attempt, ultimately successful, of the FASB to make stock option expensing mandatory, and suggests how this may have effected SOE's symbolic significance and adoption patterns.

## The Collapse of Enron and Its Consequences

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. 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. Enron was certainly not unique in its behavior, but the scale, complexity, and arrogance of Enron's machinations seemed unparalleled at the time and involved the complicity of not only major accounting firms, but also prominent Wall Street investment banks. Viewed from a broader historical perspective, the collapse of Enron was the first significant challenge to the dominant ideology of shareholder value that had emerged in the 1980s, an ideology in which corporations exist primarily to enrich shareholders by boosting short-term share prices and in which any individual could become wealthy by investing in the stock market (Lowenstein 2004). This ideology reached its most sophisticated and unabashed realization in Enron's activities.

At first, public scrutiny and investigative energy focused on Enron's executives and its auditor, Arthur Andersen. In January 2002, the SEC also began an investigation into the connections between Wall Street financial firms and Enron, which was soon followed by similar Congressional investigations, a class action lawsuit filed by Enron shareholders which listed a number of Wall Street firms as defendants, and finally, an investigation by Eliot Spitzer, Attorney General of New York State, into the practices of the nation's major financial institutions.[4] These companies, such as Citigroup, JP Morgan, and Merrill Lynch, were accused of helping Enron to create and fund special purpose entities that removed debt off Enron's books and bolster its stock price. They were also accused of misrepresenting Enron's

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[4] "SEC Examines Ties Between Banks and Enron," *Wall Street Journal,* January 15 2002; K. Kranhold and J. Weil, "Enron Holders Suit Adds New Defendants," *Wall Street Journal,* April 8, 2002.

financial condition to investors. In addition to auditors and financial conglomerates, the Enron crisis sparked scrutiny of the energy industry. In early March, the attorney general of California sued four energy providers for manipulating California's energy supply between 1998 and 2000. In May 2002, the Federal Energy Regulatory Commission launched its own investigation into the manipulation of energy markets. These investigations illuminated various accounting schemes and market manipulations used by not just Enron, but other energy companies.

In addition to these investigations, the collapse of Enron sparked broad public debate and conflict 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. These debates and conflicts manifested themselves through the actions and rhetoric of a number of different actors: politicians, regulators, the accounting profession, corporate executives, business elites and intellectuals, journalists, shareholder groups, and social and economic justice organizations. 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, including: regulation of the accounting and auditing industry; conflicts of interest within auditing firms who perform consulting services for their auditing clients; executive

compensation; fraud and speculation on Wall Street; better protection of retirement assets; and the adequacy of the penalties for corporate crime. Amidst these calls for specific reforms, deeper questions were raised about not only the behavior of executives at Enron, but the behavior of corporations, their leaders, and the efficacy of regulatory and enforcement agencies.

Although the reform movement gathered steam as the number of companies implicated and the exposure of accounting fraud at other companies grew, legislation fundamentally altering the regulation of corporate reporting, auditing practices, the independence of boards of directors, and the reform of executive compensation faced serious opposition from a large segment of the corporate community, the accounting industry, the Bush administration, and some lawmakers, all of whom portrayed Enron as an aberration and calls for deeper reform as ill-founded. The actors pushing for wide-reaching corporate reforms, including Democratic legislators, some institutional investors, and some regulators, were not in a strong position politically until the end of June 2002, when WorldCom announced that it had overstated its earnings by $6 billion, a figure that dwarfed the amount of the accounting fraud uncovered at Enron.

The announcement by WorldCom 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. Even President Bush, who up to this point had not taken any serious steps towards addressing the problems at Enron, made a speech on Wall Street in early July 2002 decrying corporate fraud. Bush also created the Corporate Fraud Task Force within the Department of Justice to coordinate the investigative efforts of the Department and all other agencies involved in investigating corporate crime. The disclosure by WorldCom revived and accelerated legislative conflict and action, leading to the hurried passage of the Sarbanes-Oxley Act in August 2002. This act established new

laws relating to auditing processes, the auditing industry, corporate reporting, insider trading, and protecting investors. It also established a new accounting oversight board within the SEC but did not address stock option accounting. Although the passage of Sarbanes-Oxley was seen as a victory for corporate reformers and quelled some of the pressures for reform, its ultimate reach and long-term effectiveness have been questioned since its inception. The movement for broader reforms remained active after the passage of the Act, but more far-reaching legislation has yet to be implemented.

In hindsight, it is questionable that the movement for corporate reform that emerged after the Enron collapse was going to lead to broad and significant changes, but this was not a foregone conclusion at the time. 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 were the normative and cognitive 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 scandals ignited broader public discussions and debates about criminal behavior in America's boardrooms and on Wall Street, as well as the necessity of more comprehensive changes to the ways in which corporations are

regulated. It is within these broader discussions and debates that the issue of stock option expensing emerged, after being out of the spotlight for almost seven years.

**The Emergence of Stock Option Expensing as Symbol**

To gain a better sense of the renewed debate about stock option accounting, I examined mainstream business media coverage from November 1, 2001 to July 31, 2004.[5] 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. 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. As the *Wall Street Journal* explained:

> Mr. Levin suggested Enron's issuance of stock options-and claim of the tax deduction-was part of a broader interest within the company of moving obligations off the books and out of public view, as happened with Enron's dubious networks of affiliate partner ships. "The situation is partly about misleading annual statements, and that's what our issue is about," Mr. Levin said.[6]

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

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[5] The sources included the *Wall Street Journal, Business Week, Fortune, the New York Times,* and *Forbes*.

[6] Greg Hitt, "Senators Probing Enron Will Try to Repeal Stock-Option Tax Rule," *Wall Street Journal.* February 7, 2002.

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.[7] Through their use of such sources as government officials, executives, consultants, industry and trade association representatives, institutional investors, and academics, these articles articulate the primary explanations in the management discourse regarding the connection between executive stock options, their accounting treatment, and the scandals. One explanation argued that stock options helped generate the stock market bubble that began in the late 1990s by providing executives with strong incentives to boost short-term earnings in any way, whether legitimate or fraudulent. As the *Wall Street Journal,* in describing the critics of stock options, noted: "options have bred a culture of irresponsible greed."[8] The system of accounting machinations at Enron was an example of this culture taken to its logical extreme, with executives making large profits on their stock options as they ran the company into the ground and hid behind arcane and fraudulent accounting schemes. A second connection made between stock options, their accounting treatment, and the scandals was that the lack of a formal requirement to expense stock options created incentives for boards of directors to increase the size of executive stock option grants, which in turn intensified the incentives for executives to boost short-term stock prices. Finally, stock options and their accounting treatment provided, according to Jeffrey Skilling, former CEO of Enron, "an egregious way to inflate a

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[7] 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.
[8] G. Hitt and J. Schlesinger, "Perk Police: Stock Options Come Under Fire in Wake of Enron's Collapse," *Wall Street Journal,* March 26, 2002

company's reported earnings."[9] Hence, as the analysis of Enron's collapse proceeded in the mainstream business press, a clear indictment of stock options emerged: 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."[10]

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, academics, and institutional investors. Senators Levin and McCain were the most vocal legislators supporting expensing, but their actions, described above, were part of a broader set of efforts on the part of Congress to deal with the many manifestations of corporate fraud exposed by the collapse of Enron.[11] Another proponent was Alan Greenspan, Chairman of the Federal Reserve Bank, who on March 27, 2002, came out in support of stock option expensing as he simultaneously voiced his personal opposition to "too much regulation" in response to the scandals.[12] Greenspan argued that "one step toward better earnings quality would be forcing companies to treat the value of stock options granted to employees as an expense."[13] Similarly, in a commentary piece in the *Wall Street Journal,* Joseph Stiglitz, Professor of Economics at Columbia and

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[9] Ibid.
[10] Ibid.
[11] G. Ip, "Mood Swings in Favor of Regulation: Congress Begins to Deliver on Plethora of Bills," *Wall Street Journal,* March 29, 2002.
[12] G. Ip, "Greenspan Warns Against Too Much Regulation," *Wall Street Journal,* March 27, 2002.
[13] Ibid.

former member of President Clinton's Council of Economic Advisors, also supported the expensing of stock options on the grounds that it provided more accurate information and that "such information is like a public good: better standards-more transparency-lead to better resource allocation and better functioning markets."[14]

A number of shareholder groups, including institutional investors, mutual fund managers, and individual gadfly activists, also supported stock option expensing. Although most shareholder groups remained out of the fray during the battles over SOE in the mid-1990s, the scandals changed the position of many on the issue. For example, on March 15, 2002, the Council of Institutional Investors, which represents the largest institutional investors, came out in favor of SOE, arguing that "the size of option programs has exploded, the true costs of fixed-price options are obscured, and shareholders have lost their right to vote on many option plans, so many feel that disclosure-based solutions are no longer adequate."[15] Echoing this sentiment, TIAA-CREF, one of the largest institutional investors, sent a letter that endorsed stock option expensing to the chairmen of over 1,700 public companies. The letter stated that SOE "contributes to clear, straightforward and high-quality financial reporting, enhancing credibility that surely will be highly valued in the post-Enron market."[16] Finally, Warren Buffett, the high profile investor and shareholder activist was a very vocal proponent of SOE as a way to improve the transparency of financial statements. In an oft-cited statement, Buffet mused: "If options aren't a form of compensation, then what are they? If compensation isn't an expense, what is it? If expenses do not belong on the income statement, where in the world should they go?"[17] Supporters of stock

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[14] J. Stiglitz, "Accounting for Options," *Wall Street Journal,* May 3, 2002.
[15] "Council of Institutional investors Backs Expensing of Stock Options." *Tax Management Financial Planning Journal,* April 16, 2002.
[16] J. Lublin, "Leading the News: TIAA-CREF Wants Options Seen as Expenses," *Wall Street Journal,* July 24, 2002.
[17] "Warren Buffett Rips into Stock Option Accounting," *Directorship,* June 1999.

option expensing, therefore, included members of Congress, government officials, shareholder activists and institutional investors, and some business elites and intellectuals. 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 The Bush Administration and its allies in Congress opposed most proposed regulation, including SOE. The administration's opposition to regulation makes a great deal of sense considering its consistent ideological commitment to small government and its close network and financial ties to corporate donors. Another opponent within government included Harvey Pitt, then Chairman of the SEC, who, in a well-reasoned defense, argued that stock option expensing was a red herring: requiring expensing would not prevent future Enrons, but that more controls over how executives were compensated would.[18] Certain legislators, such as Joseph Lieberman, who had been very active in opposing SOE in the mid-1990s (Levitt 2002), were also active in opposing Congressional attempts to impose new requirements, as were legislators representing districts with heavy concentrations of technology companies, such as Silicon Valley.

In addition to opponents within the federal government, a number of corporate executives and industry associations were against mandatory stock option expensing. The high-tech industry presented the most active opposition to SOE, both historically and during the post-Enron debates. Their primary argument opposing mandatory SOE has been that since there is no reliable and consistent way to measure the value of stock options, SOE actually distorts financial statements rather than improves

[18] G. Ip et al., "Pitt Calls for Stricter Control of Options," *Wall Street Journal,* April 5, 2002.

transparency. High-tech executives and trade groups have also argued that any requirement to expense stock options would constrain their ability to grant options to employees, which would in turn limit their ability to recruit the best talent, and in turn, stifle American innovation. Although the high-tech industry has been very persuasive in using this logic, such claims rest on a foundation of self-interest. First, as an industry that has relied on high levels of stock option grants, these organizations stood the most to lose, financially, if forced to expense the value of their stock options. Furthermore, an SOE requirement would make the large option grants of technology company executives (Blasi et al. 2003) more transparent and open to criticism. Such potential transparency most likely also fueled resistance to mandatory SOE expressed by some executives in non-technology industries, who have continued to receive very large and very valuable stock option grants. (Blasi et al. 2003). Despite the apparent contradictions of executives' defense of stock options, in the wake of the scandals, the technology industry was quick to organize against an SOE requirement and scored significant victories by defeating the Levin-McCain bill and by preventing the inclusion of an SOE requirement in the Sarbanes-Oxley Act.

It is clear that stock option accounting emerged as a topic of heated debate and high visibility after the collapse of Enron.[19] Within these initial debates, 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 this 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

[19] The number of articles in ABI Inform discussing stock option expensing increased from 71 in 2000 to 107 in 2001 to 614 in 2002 (175 in the first six months), and 440 in 2003.

inflation of the stock market bubble. This success was evident in the much broader support that SOE had in the post-Enron era. In the mid-1990s, the battle over expensing was essentially a battle between the accounting profession and the technology industry, with Congress intervening in the 11th hour to help the technology industry force a compromise from FASB. Most other actors remained out of the picture. The success of SOE proponents in the post-Enron world was also evident in the first ever significant wave of voluntary SOE adoption activity that followed the massive accounting at WorldCom and the concomitant acceleration in reform pressures.

The supporters of SOE were successful at framing 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. For neoinstitutional theory, accounting practices are one of the most common ways that organizations signal rationality and legitimacy (Meyer and Rowan 1977, Carruthers 1995). In the post-Enron environment, stock option expensing 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."[20]

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. Of the 51 organizations within this group that adopted during the first wave of initial activity in

[20] "Fighting Coke's Lead Could Bring Big Changes," *Wall Street Journal,* July 16, 2002.

July and August of 2002, 31 (61%) issued statements to the press about the adoption. I performed a content analysis of these press statements, and three 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. For example, in August 2002, Citibank announced that stock option expensing was yet another sign that the company was at the "forefront of progressive industry change." Similarly, MetLife stated that stock option expensing was "the right thing to do and, alongside other leading companies, is part of an ongoing effort to help restore confidence in Corporate America."[21] Also, in explaining the adoption of SOE, the Calpine Corporation, noted that it was "committed to the highest level of integrity,"[22] while Bank of America stated that SOE was an indicator that it was "dedicated to the highest level of corporate accountability."[23]

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 PPL Corporation, for example, claimed that stock option expensing indicated the company's "commitment to clearly communicate financial results to investors."[24] Similarly, Cinergy stated that SOE represented its "ongoing commitment to ensuring that compensation costs are clearly recorded in our financial statements."[25] In a press statement, General Electric's CEO noted that "investors clearly want these expenses

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[21] Metlife Corporation, "Metlife Employee Stock Options to be Expensed Beginning in January 2002," August 12, 2002.
[22] Calpine Corporation, "Calpine to Expense Future Stock Options," August 27, 2002.
[23] Bank of America, "Bank of America Will Expense Employee Stock Options," August 12, 2002.
[24] PPL Corporation, "PPL Corporation to Expense Future Stock Options," October 4, 2002.
[25] Cinergy Corporation, "Cinergy Corp. to Expense Future Stock Options," July 24, 2002.

incorporated into results and we will do so."[26] Other companies, such as AIG, simply stated that stock option expensing is "in the best interest of our shareholders."[27] The third type of explanation, only used by 3 of those 31 organizations with press releases during this time, focused on the importance of stock options a tool of human resource management, stating that stock options have been an important way in which the company recruits, maintains, and/or motivates talent. This was not used as a direct justification for expensing, but was mentioned alongside a statement explaining that the organization was adopting SOE.

These examples reveal that in the initial stage of SOE adoption, organizations presented stock option expensing as a symbol of their legitimacy within an emerging normative environment. A vast majority (75%) of organizations that issued press statements either made grand claims about their normative legitimacy within this new environment or more modestly acknowledged the new norms of financial transparency articulated by shareholders and investors, and their adherence to these norms. Both types of explanations reveal that SOE was a way that organizations attempted to enhance or bolster their normative legitimacy in the post-scandal world. In addition, because neither FASB nor Congress had taken any action to make adoption mandatory, the act remained voluntary, and this most likely made the action a more powerful symbol, particularly among early adopters. If a corporation adopted SOE, it was doing so on its own, taking active steps to make amends. 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.

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[26] R.E. Silverman, "Leading the News: GE to Expense Stock Options Held by Workers." *Wall Street Journal.* August 1, 2002.
[27] AIG Corporation, "AIG to Expense Employee Stock Options," August 11, 2002.

**Changes in the Institutional Environment: FASB and Regulatory Pressures**

In the immediate aftermath of the Enron and WorldCom scandals, FASB remained silent about the issue of stock option expensing. 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, who was then the 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. Although this comment received little media attention, it foreshadowed what would soon follow. In addition, 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.[28]

However, the perception that SOE would become mandatory seems to 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.[29] This broad

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[28] M. Schwanhausser, "International Board's Plan for Expensing Options Irks High-Tech Executives," *San Jose Mercury News,* November 8, 2002.
[29] M. Katz, "The Implications of Stock Option Expesning: It's Closer Than You Think," *Employee Benefit Plan Review,* November 2002.

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 a shift away from SOE as symbol of normative legitimacy 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. During July and August 2002, 61% of all Fortune 500 adopters issued a press release about SOE adoption. As described in the previous section, the justifications for SOE adoption during these two months focused primarily on appeals to SOE as a symbol of normative legitimacy within the post-Enron environment. 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, 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 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.

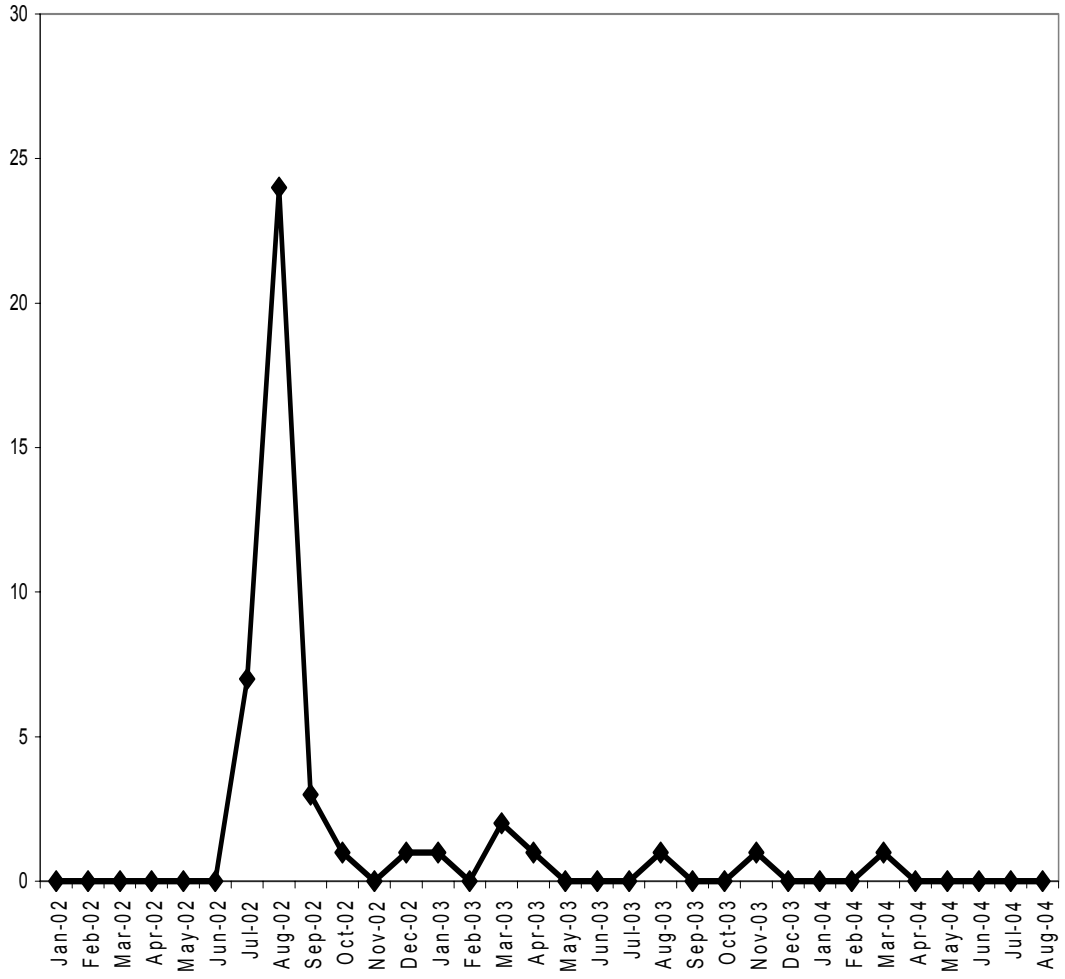


**Figure 4.1: Number of Press Releases Regarding SOE Adoption Issued by the Fortune 500, January 2002 – July 2004**

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, and on May 12, 2003, voted to require companies to adopt SOE and announced that a formal proposal would be released later in the year. In October 2003, FASB announced that it intended to require SOE beginning in 2005, but also that it would not release any further details until early 2004. This statement set in motion the final

regulatory battle over SOE, a battle that resembled those that occurred in 1994 between FASB and the high-tech industry. However, in 2004, the technology industry had much less support for its opposition to FASB that it did in 1994. On March 31, 2004, FASB formally announced that it would require stock option expensing in 2005. Following this announcement, a 90 day comment period on the decision commenced, during which a group of technology companies heavily lobbied Congressional leaders. In reaction to this, the leaders of the Big Four accounting firms and the SEC urged Congress not to get involved. On December 16, 2004, FASB finally issued its final statement, which required stock option expensing by the 3rd quarter of 2005 for most companies.

The preceding discussion of the connections between stock option accounting and the corporate scandals of 2001 and 2002 has revealed that stock option accounting became a target of much discussion and debate in the wake of the Enron scandal. A number of prominent actors in government, academia, the press, and the investor community believed that the excessive use of stock options had driven not only the behavior of Enron executives but also the inflation of the stock market bubble and its subsequent bursting. The fact that companies were not required to reveal the cost of stock options in their financial statements only exacerbated the problem and made the mechanism itself appear fraudulent. Stock option accounting, therefore, 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, perhaps towards regulative legitimacy.

# CHAPTER 5

# 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. The literature on the defense of organizational legitimacy has focused almost exclusively on impression management techniques that organizations use when their legitimacy is challenged. The analysis that follows will reveal that organizations also engage in symbolic practice adoption in the face of challenges to their legitimacy.

Although there has been little theoretical development regarding what constitutes a threat to organizational legitimacy, previous literature has examined a variety of threats, such as accidents, scandals, and product safety incidents (Marcus and Goodman 1991, Perrow 1981); bankruptcy (Hambrick and D'Aveni 1998, Sutton and Callahan 1987); negative media publicity of destructive business practices (Elsbach 1994, Metzler 2001) offshore reincorporation (Johnson and Holub 2003); and social activism (Elsbach 1994). In the wake of the scandals at Enron and other companies, the primary legitimacy challenges that emerged took the form of direct investigations by a variety of regulatory agencies, negative media scrutiny, and shareholder activism.

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. These forces challenged both the regulative and normative legitimacy of specific organizations. This section provides a more detailed picture of different types of legitimacy challenges that organizations faced in the post-Enron environment and develop specific hypotheses regarding how the companies that were vulnerable to these challenges were more likely to adopt SOE.

**Hypotheses: Scandals, Investigations, and Media Scrutiny**

One of the most significant challenges to organizational legitimacy after the fall of Enron were direct investigations into various types of corporate crime. Investigations that are conducted by enforcement agencies represent a challenge to the regulative legitimacy of organizations since they examine whether organizations are in violation of specific laws. To provide a more complete picture of the investigations in the periods immediate preceding and following the Enron scandal, I collected data from publicly available information of various regulatory agencies and media sources. 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 the reports to the President that the Corporate Fraud Task Force (CFTF), an interagency group established by President Bush in July 2002, published in July 2003 and July 2004. The latter provide details about the contributions of the task force members: the Department of Justice, FBI, IRS, Department of Labor, Department of the Treasury, SEC, Commodities Futures Trading Commission, Federal Energy Regulatory Committee, Federal Communications Commission, and United States Postal Inspection Service. I supplemented this information with media reports from the period, and developed a master list of 179 companies that became the subjects of investigation between January 2001 and July 2004. This list, therefore, represents the investigations that regulators saw as the most significant, and therefore, the ones that were likely to receive the broadest media attention and a share of the limited pool of resources allocated to regulatory and enforcement agencies, and in turn, the ones that posed the greatest threats to organizational legitimacy.

Figure 5.1 shows the timing of investigations started between January 2002 and July 2004. At the time of the Enron bankruptcy (December 2001), 39 companies were already under an existing investigation. Between January and May 2002, 59 more companies had come under investigation. The number of investigations drops sharply after May 2002, but between June 2002 and July 2004, 81 more investigations began. In the post-Enron period of this study between January 2002 and July 2004), the industries with the highest concentrations of companies under investigation included securities broker-dealers (7.6% of total), software companies (6.4%), and electric services (5.9%), with other clustering among national commercial banks (4.7%), investment advisors (4.7%), and telecommunications companies (4.7%). The

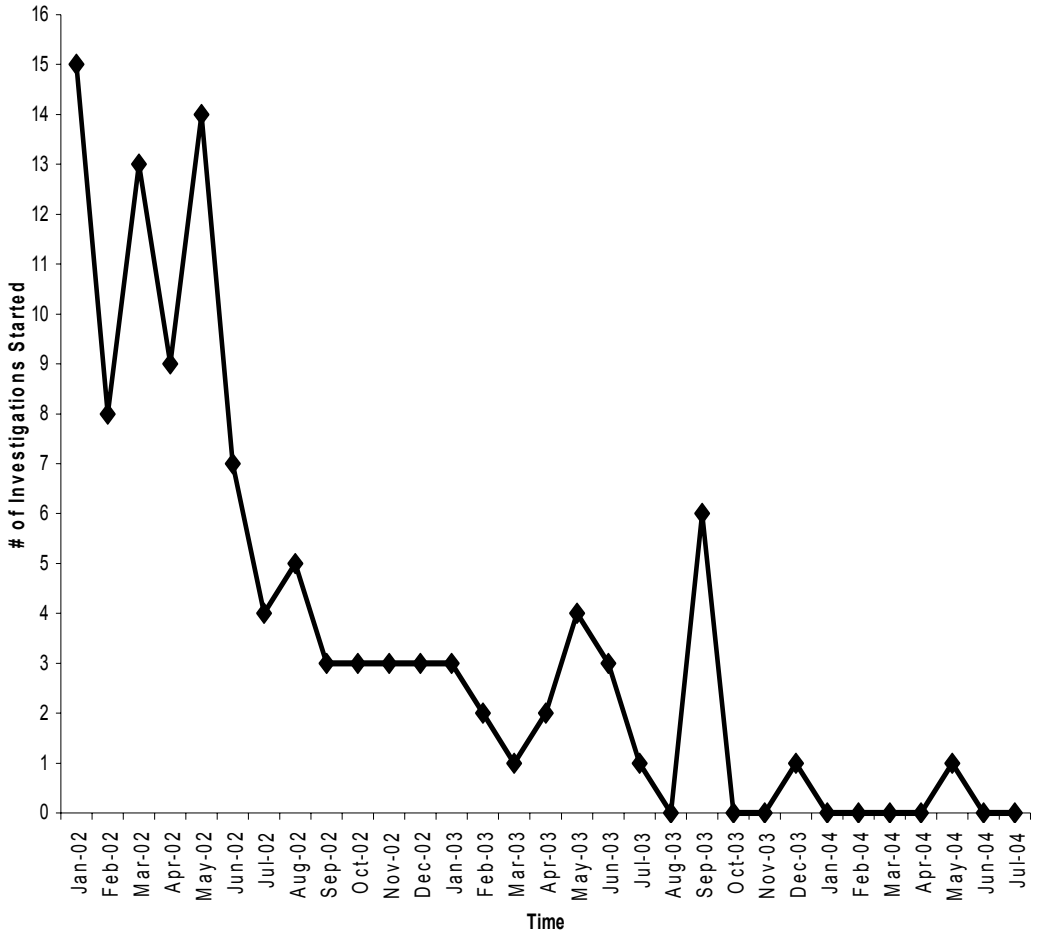


**Figure 5.1: Number of Investigations by Starting Date, January 2002- July 2004**

other investigations were distributed relatively evenly throughout the remaining 80 industries.

Table 5.1 lists the types of activities on which these investigations focused. The most common focus of investigations was accounting fraud. Accounting frauds come in various guises, but all have in common a misrepresentation of the company's actual financial position on the financial statements. Examples include straightforward ones, such as improperly booking expenses and reporting income before it has been collected, as well as the more complicated activities of Enron, such as round-tripping,

the latter of which was also used by telecommunications companies trading high-capacity bandwidth.[30] Overall, a diverse group of companies in 49 industries and 26 sectors were investigated for accounting fraud during this time. The highest concentration was among companies selling prepackaged software, which accounted for 14% of the 72 companies investigated for accounting fraud.

**Table 5.1: Types of Major Investigations, January 2002-July 2004**

| **Alleged Activity** | **Number of Companies** | **% of All Investigations** |
|---|---|---|
| Accounting Fraud | 72 | 40 |
| Investment Advice Fraud | 36 | 20 |
| Securities fraud/mail fraud | 21 | 12 |
| Energy markets manipulation | 17 | 10 |
| Insider trading | 7 | 4 |
| Tax fraud/evasion | 7 | 4 |
| Auditor Conflict | 5 | 3 |
| Other | 14 | 8 |
| **Total** | **179** | **100** |

The next most common focus of investigations included those related to investment banks, securities broker-dealers, and investment advisors. The types of activities investigated included providing misleading or fraudulent investment advice; broker-dealers and underwriters profiteering off of IPOs by charging excessive brokerage fees or receiving illegal payments for allowing access to IPOs; and involvement in the creation of Enron's sophisticated accounting schemes. Another set of investigations focused on conflicts of interest within financial conglomerates like Citigroup, Merrill Lynch, and JP Morgan. An example of such a conflict is a commercial lending division placing pressure on the investment divisions to push the stock of a banking client. These conflicts were new targets of investigations because these financial conglomerates themselves were new organizational forms that only

[30] For an overview of these schemes, see Drutman and Cray (2002).

emerged in the wake of Congress repealing the Glass-Steagal Act in 1999. The third most frequent type of activity investigated in the post Enron period (10% of investigations) related to the manipulation of energy markets. The remaining significant investigations involved a number of familiar offenses, such as insider trading, tax evasion, tax fraud, embezzlement, money laundering, misleading investor information, and bribes of foreign officials. Finally, although only a small number of companies were involved, an issue that became the subject of high profile investigations were those involving conflicts of interest between auditors and their clients, with Arthur Andersen as the high-profile example.

This brief review of the evidence on formal investigations reveals that 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. These investigations represented a threat to the regulative legitimacy of the companies that were targets. As discussed in the preceding section, the adoption of SOE was a way that an organization could signal its legitimacy within an emerging set of post-Enron norms and, therefore, defend against 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."[31] 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

[31] "Computer Associates to Record Worker Stock Options as Expenses," *Wall Street Journal,* July 30, 2002.

has always strived to be at the forefront of industry change."[32] Bank of America, another large commercial bank that came under investigation by the SEC in February 2002, adopted SOE in 2002. In discussing their adoption, the CEO explained that "Bank of America is dedicated to the highest level of corporate accountability."[33] These three examples reveal that companies that were under investigation and adopted SOE used the adoption as an opportunity to present themselves as virtuous and to defend their legitimacy. This leads to the following hypothesis:

*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." Although Suchman is referring to the negative impacts of this association for the organization facing the legitimacy challenge, he articulates the possibility that organizations related to an organization facing a threat to legitimacy might also feel threatened. 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.*

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[32] "Citi Claims Major Reforms in Corporate Governance," *American Banker,* August 8, 2002.
[33] "Charlotte, N.C.-Based Bank of America Says it Will Report Impact of Options," *Charlotte Observer,* August 13, 2002.

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.*[34]

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. In the case of investigations, if a company comes under investigation and its stakeholders know nothing about it, this may not constitute a threat to legitimacy. However, if a company receives a large amount of media attention over investigations or deviant behavior, the challenge to legitimacy may be stronger. For example, the *American Banker* noted that Citibank's decision to adopt SOE occurred right after the company "faced a barrage of bad press" about its activities relating to Enron.[35] However, organizations not under investigation may still face media scrutiny regarding certain types of activities, and this scrutiny represents a challenge to legitimacy. Media scrutiny of deviant behavior, whether the focus of investigations or not, represented challenges to both regulative and normative legitimacy since it focused attention on organizations not obeying specific laws or not acting within accepted norms. Therefore:

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[34] 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.

[35] L. Moyer, "Citi Claims Major Reforms in Corporate Governance," *American Banke,*. August 8, 2002.

*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.*

**Hypotheses: Shareholder Activism**

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 be norms regarding corporate governance, executive compensation, and social responsibility. The surge of shareholder activism in the post-Enron world extended out of the shareholder activism movement that had begun in the late 1980s, when institutional investors and individual shareholders began to acquire a more active role in corporate governance (Davis and Thompson 1994, Monks and Minow 2003). In this new role, shareholders attempted to shape corporate decision-making through the submission of shareholder resolutions and publicity campaigns, and by engaging in private negotiation with corporate management. Shareholder activists have included a diverse group of individual shareholders (a.k.a. "gadflies") and institutional shareholders such as public employee pension funds, labor union pension funds, mutual funds, religious organizations, and economic and social justice groups.

In the decade before the scandals, activists had made significant progress in getting corporations to make changes on specific issues. Shareholders also pushed for an expansion of the legal framework that defined the range of issues and the ways in which shareholders could be involved in governance. For example, shareholder activists were instrumental in pushing the SEC to change rules in 1992 that reduced

barriers to communication between shareholders and opened up the space for shareholder groups to submit resolutions relating to a number of issues that were previously closed off to shareholders, such as executive compensation. Despite these gains, the legal framework continued to constrain the ability of shareholders to influence organizational behavior (Carberry 1996).

The severity, scale, and arrogance of the corporate scandals of 2001 and 2002 mobilized a collective wave of shareholder activism that pressed for changes relating to both the issues at the core of the scandals and to some of the historically contentious shareholder issues noted above. The scandals motivated institutional shareholders, from large pension funds like Calpers and TIAA-CREF, union pension funds, mutual funds, religious groups, and individual investors, to push for a variety of changes.[36] This activism did not manifest itself fully until the proxy season of 2003 because the rules governing the submission of shareholder resolutions requires that they be submitted many months ahead of corporate annual meetings. These deadlines for the 2002 proxy season had mostly passed before the full scope of the scandals was exposed in the first half of 2002.

The 2003 and 2004 proxy seasons saw a 56% and 52% increase, respectively, in the number of shareholder proposals that came up for a vote, as compared to 2002.[37] Labor union pension funds were the most active in terms of shareholder resolutions: these funds submitted 48% of all resolutions in 2003 and 44% in 2004, both up significantly from 27% in 2002. The United Brotherhood of Carpenters and Joiners of America (UBCJA) submitted the most resolutions in both 2003 and 2004. The percentage of all resolutions submitted by public pension funds, such as Calpers, was

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[36] Q.S. Kim, "Corporate Gadflies Are the Buzz; Shareholder Activists Sting Company Boards in Proxy Wars," *Wall Street Journal,* June 10, 2004.

[37] Statistics on shareholder resolutions in this section are from Georgeson Shareholder's *Annual Corporate Governance Review* 2002, 2003, and 2004, and C. Deutsch, "Revolt of the Shareholders," *New York Times,* February 1, 2003.

low in 2002 (6%) and dropped slightly to 2% in 2003 and 3% in 2004. This relatively low percentage of resolutions submitted by these powerful shareholder groups may not be a true indicator of the activism and influence of these funds, which have made significant use of other tactics, such as private negotiations. (Carleton et al. 1996) Individual shareholders accounted for 60% of all resolutions in 2002, 43% in 2003, and 46% in 2004. Overall, the percentage of all resolutions that received majority votes remained roughly constant between 2002 and 2003.

In terms of resolutions aimed at reforming executive compensation or stock options,[38] the number increased dramatically from 26 (10% of all resolutions) in 2002 to 104 (24%) in 2003, and 120 (29%) in 2004. While unions submitted 21% of these resolutions in 2002 ( the same amount as pension funds), they submitted 70% in 2003 (vs. 2% of pension funds) and 60% in 2004 (vs. 2% for pension funds). Individual shareholders submitted 52%, 21%, and 35% of all resolutions aimed at reforming executive compensation in 2002, 2003, and 2004, respectively. Resolutions that called on a company to adopt SOE became allowable under SEC rules in the 2003 proxy season. Prior to this ruling, some of the largest and most influential institutional investors, such as the Council of Institutional Investors and TIAA-CREF, had already come out in favor of expensing. Calpers never endorsed expensing, despite its staff urging the group to formally do so.[39] In the 2003 proxy season, shareholder groups submitted resolutions demanding the adoption of SOE in 67 companies. Labor union pension funds submitted 95% of these resolutions (the remainder were submitted by individuals). The UBCJA submitted 40% of all SOE resolutions. In 2004, the number

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[38] The shareholder resolutions that I group here as related to executive compensation or stock options included in 2002: disclose executive compensation, freeze executive pay during downsizing, no repricing of underwater options, establish a performance-based compensation system, restrict executive compensation, and vote on all stock-based compensation. In 2003, this list included all of these plus: no repricing of stock options, abolish stock options, ask CEO to voluntarily reduce pay, and disclose executive compensation.

[39] A. Borrus, "The Campaign to Keep Options off the Ledger," *Business Week,* July 15, 2002.

of SOE resolutions dropped to 31, with union funds submitting 90% of these. In 2003, 7 resolutions (40%) for SOE adoption received majority votes in favor, while in 2004, 20 (65%) received majority votes in favor.

Clearly, shareholder activism, as expressed in the number of shareholder resolutions that were submitted and went to a vote, significantly increased in 2003 and 2004. Labor union pension funds and individuals were responsible for the majority of all resolutions in 2003 and 2004, while labor unions alone were responsible for a sizable majority of the resolutions aimed at reforming executive compensation and stock options, including SOE. How might this resurgent shareholder activism in general and that which was specifically related to SOE have an impact on SOE adoption? The second two waves of SOE adoption (January - May 2003, February - May 2004) occurred during two proxy seasons, thus suggesting a possible connection. However, in general, shareholder resolutions, even when they receive a majority in favor, are not legally binding (although a small percentage are), and in only between 10% and 30% of cases in which resolutions receive majority support does management implement the changes demanded. (Bebchuk and Fried 2004)

Although Davis and Thompson (1994: 141) found that shareholder activists "increased their influence in corporate governance in the early 1990s," sociologists of organizations and social movements have conducted few empirical investigations of the phenomenon of shareholder activism. The post-Enron wave of shareholder activism presents a logical research site for examining its influence. In reviewing the literature on the effectiveness of shareholder activism, Karpoff (1998) notes that the evidence on the impacts of shareholder activism remains ambiguous because studies use different sampling frames, shareholder actions, shareholder groups, and use different outcomes. However, Karpoff (1998) points to two conclusions that can be drawn from the literature. The first is that shareholder activism had been most

effective when it is channeled through private negotiation, as opposed to shareholder resolutions and proxy fights. The second is that shareholder activism 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, and that this effectiveness has increased with time. Moreover, 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 form 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.*

**Other Hypotheses**

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.*

This section has provided a detailed description of the broader institutional context in which SOE adoption occurred and developed specific hypotheses relating to how this context may have shaped SOE adoption. This paper now turns to the testing of these hypotheses.

**Sample**

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.

**Dependent Variable**

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. For example, for a spell that began in September 2002, negative media scrutiny was measured from January – June 2002. For a spell that began in June 2003, negative media scrutiny was measured from July – December 2002. I used this strategy rather than a time constant, one year lag because media coverage of the scandals began at the end of 2001 and continued through the entire observation period. Measuring negative media scrutiny by only using 2001 would not have captured the majority of media coverage relating to the scandals and investigations.

*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 was an ordinal variable that 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. For example, if shareholders of Company A submitted 5 shareholder resolutions to the SEC in March 2002, this

variable was measured as 5 for all spells that began between April 2002 and March 2003. If shareholders of Company A submitted 10 shareholder resolutions in March 2003, this variable equaled 10 for all spells that started between April 2003 and March 2004. If shareholders of Company A submitted 0 resolutions in March 2003, the effect was 0 for all spells that began between April 2002 and March 2004.

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. These 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, $\beta$ is a vector of coefficients associated with the covariates during time period $p$.

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.

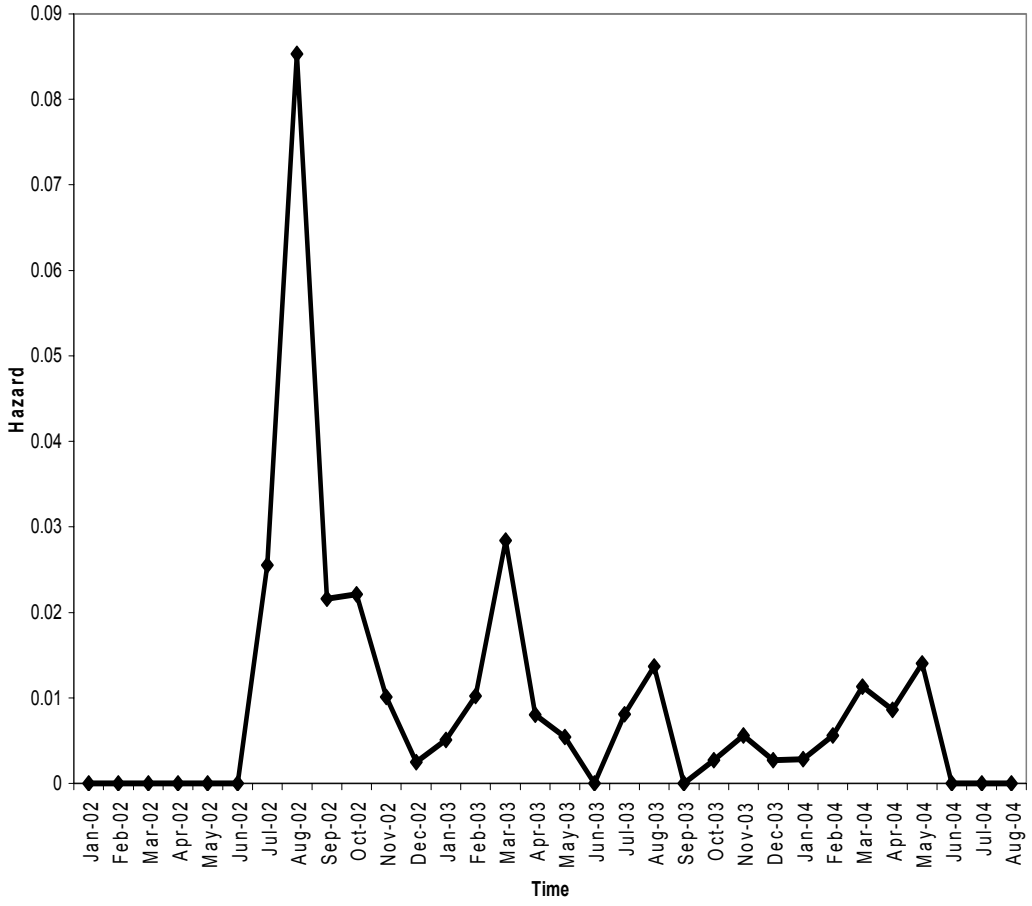


**Figure 5.2: Empirical Hazard Rate of SOE Adoption, January 2002 – July 2004**

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 5.2 provides descriptive statistics, and Table 5.3 provides the correlation matrix. (Additional descriptive information is presented in Appendices 1 – 4, including a list of the Fortune 500 adopters, non-Fortune 500 adopters, all companies in the sample,

**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 |

and industry breakdowns of Fortune 500 adopters.) Table 5.4 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,

**Table 5.4: Event History Models**
**Voluntary Adoption of Stock Option Expensing**[40]
*Period 1: January 02 – August 02*

| | **Model 1** | **Model 2** |
|---|---|---|
| Constant | -7.3030**** | -8.189**** |
| | (1.89) | (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 | .1766 |
| | (.134) | (.141) |
| # of All Shareholder Resolutions | .0457 | .0587 |
| | (.130) | (.131) |
| # of Shareholder Resolutions: Executive Compensation | .5367 | .7910 |
| | (.760) | (.757) |
| Fortune's Most Admired | -.2687 | - .340* |
| | (.185) | (.189) |
| Revenues (log) | .2938 | .4035* |
| | (.218) | (.230) |
| Net Income | .0001 | .0000 |
| | (.000) | (.000) |
| Option Expense (as % of net income) | .0315** | .0317** |
| | (.013) | (.013) |
| Employees | .0000 | .0000 |
| | (.000) | (.000) |

[40] 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**** | -5.502**** |
| | (1.74) | (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 | .1171 |
| | (.105) | (.107) |
| # of All Shareholder Resolutions | .1223 | .1260 |
| | (.126) | (.129) |
| # of Shareholder Resolutions: Executive Compensation | -.5813 | -.5868 |
| | (.526) | (.535) |
| Shareholder Resolution to Adopt SOE | -.2060 | -.1688 |
| | (.622) | (.628) |
| # of Previous Adopters | -.0148**** | -.0145**** |
| | (.004) | (.004) |
| Fortune's Most Admired | .0089 | -.0125 |
| | (.147) | (.151) |
| Revenues (log) | .2938 | .1807 |
| | (.218) | (.207) |
| Net Income | .0000 | .0000 |
| | (.000) | (.000) |
| Option Expense (as % of net income) | -.4473 | -.5428 |
| | (.370) | (.415) |
| Employees | .0000 | .0000 |
| | (.000) | (.000) |
| | | |
| Log Likelihood | -347.898 | -340.820 |
| Degrees of Freedom | 23 | 29 |
| Number of observations | 9368 | 9368 |

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, 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. The results suggest, therefore, that it was not investigations per se that influenced SOE adoption, but rather, the strength of the investigative activity at the industry level that increased the likelihood of SOE adoption. 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 from the event history models 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 2 provides more detail about which industries accounted for this effect: telecommunications companies, electric service companies, and securities broker-dealers. 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. This is worth investigating in a little more detail.

Among all Fortune 500 companies, adoption rates were at their highest above the average during July and August 2002. The average number of adoptions per month was 3.84 over the entire observation period, and there were 12 and 51 adoptions, respectively, in July and August 2002. 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.[41] 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* 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

[41] 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 $p \leq .0001$.

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. Hence, the shifting significance of SOE as a symbol of normative legitimacy may have been perceived differently by companies under investigative threats and those not experiencing them.

Furthermore, 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.[42] 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. Many of the initial adopters of SOE used the language of distinctiveness in explaining their recognition and adherence to the new normative environment. As more companies adopted, claims about distinctiveness would naturally be less effective. 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

[42] The variable was dropped for the first time period because of mutlicollinearity.

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 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. Hence the practice, while losing some meaning as a symbol of normative legitimacy, may not have acquired significance as a symbol of regulative legitimacy so quickly. Only additional research will provide a more definitive insight into this.

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. Another interpretation is that since the majority of these resolutions were submitted by labor unions, corporate management may have felt more ambivalent or less serious about a legitimacy threat from a group with whom it had been in long-term conflict and whose power had been eroding. It is 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. These vehicles often lead to negotiation and some capitulation from boards and managers, sometimes precluding more formal shareholder activism through proxy fights. This study did not measure the impact of informal means of shareholder pressure.

The results regarding organizational prestige are interesting. 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, nor do they appear to perceive that their prestige would make the potential benefits of symbolic SOE adoption more powerful. Alternatively, the findings regarding status suggest that high status firms may be more insulated from legitimacy threats, similar to the finding by Phillips and Zuckerman (2001) that high status companies do not have to worry about gaining legitimacy.

Finally, the results provide interesting evidence regarding the influence of the magnitude of the potential option expense. The common wisdom is that companies with a smaller potential option expense will be more likely to adopt SOE because the economic cost of adoption will not be large. Previous literature has revealed that the magnitude of the expense had no effect on SOE adoption. (Aboody et al. 2003). The

findings from both models above, however, 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.

# CHAPTER 6

# 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.

APPENDIX 1: FORTUNE 500 SOE ADOPTERS

AES
AIG
AT&T
Allegheny Energy
Allstate
Amazon.Com
Ameren
American Express
Ashland
Bank One Corp.
Bank of America Corp.
Bank of New York Co.
Bear Stearns
BellSouth
CMS Energy
CSX
Calpine
Capital One Financial
Cendant
Centex
Charter Communications
Chubb
Cinergy
Circuit City Stores
Citigroup
Coca-Cola
Comerica
Computer Assoc. Intl.
ConocoPhillips
Cooper Industries
Costco Wholesale
Cummins
Delphi
Dole Food
Dow Chemical
DuPont
Dynegy
Entergy
Equity Office Properties
Exxon Mobil
FMC
FPL Group
Fannie Mae
Fidelity National Financial
Fifth Third Bancorp
FleetBoston Financial
Fleming
Ford Motor
General Electric
General Motors
Genuine Parts
Georgia-Pacific
Goldman Sachs Group
Goodrich
Hartford Financial Services
Home Depot
Hormel Foods
Host Marriott
Household International
InterActiveCorp
Johnson Controls
Jones Apparel Group
KeyCorp
KeySpan
Kmart Holding
Lear
Leggett & Platt
Lehman Brothers Holdings
Lincoln National
Lowe's
Lyondell Chemical
Marathon Oil
May Dept. Stores
Mellon Financial Corp.
Merrill Lynch
MetLife
Microsoft
Morgan Stanley
National City Corp.
Northwest Airlines
Omnicom Group
PNC Financial Services
PPG Industries
PPL
Paccar
PacifiCare Health
PepsiCo
Pinnacle West Capital
Tremor
Principal Financial
Procter & Gamble
Progressive
Prudential Financial
Puget Energy
Pulte Homes
Rite Aid
Rohm & Haas
SBC Communications
Safeco
Saks
ServiceMaster
Smithfield Foods
Smurfit-Stone
Container
Sprint
St. Paul Cos.
State St. Corp.
Steel case
SunTrust Banks
Sunoco
Target
Temple-Inland
Tenet Healthcare
Tensor Petroleum
US Airways Group
United Parcel Service
Unocal
Unum Provident
Venison
Communications
Visitor
Wachovia Corp.
Wal-Mart Stores
Washington Mutual
Wasco International

APPENDIX 2: FORTUNE 500 SOE ADOPTERS BY INDUSTRY

| SIC Code | Industry | # of Adopters | % of All Adopters |
|---|---|---|---|
| 6021 | National Commercial Banks | 12 | 9.76 |
| 4911 | Electric Services | 9 | 7.32 |
| 2911 | Adhesives and Sealants | 7 | 5.69 |
| 6331 | Fire, Marine, and Casualty Insurance | 5 | 4.07 |
| 4813 | Telephone Communications | 5 | 4.07 |
| 6311 | Life Insurance | 4 | 3.25 |
| 6211 | Securities Broker-Dealers | 4 | 3.25 |
| 5331 | Variety Stores | 4 | 3.25 |
| 3711 | Automobiles | 3 | 2.44 |
| 2821 | Plastic Materials | 3 | 2.44 |
| 6798 | Real Estate Investment Trusts | 3 | 2.44 |
| 6022 | State Commercial Banks | 3 | 2.44 |
| 4512 | Air Transport | 2 | 1.63 |
| 3714 | Automobile Parts | 2 | 1.63 |
| 5211 | Building Materials Stores | 2 | 1.63 |
| 1531 | Construction: Operative Builders | 2 | 1.63 |
| 5311 | Department Stores | 2 | 1.63 |
| 4931 | Electric and Other Services | 2 | 1.63 |
| 6411 | Insurance Agents | 2 | 1.63 |
| 2011 | Meat Packing Plants | 2 | 1.63 |
| 5013 | Natural Gas | 2 | 1.63 |
| 6141 | Personal Credit Institutions | 2 | 1.63 |
| 7372 | Prepackaged Software | 2 | 1.63 |
| 2086 | Soft Drinks | 2 | 1.63 |
| 6321 | Accident and Health Insurance | 1 | 0.81 |
| 7311 | Advertising Agencies | 1 | 0.81 |
| 0174 | Agriculture: Citrus Fruits | 1 | 0.81 |
| 3728 | Aircraft Parts | 1 | 0.81 |
| 6159 | Business Credit Institutions | 1 | 0.81 |
| 4841 | Cable TV | 1 | 0.81 |
| 5961 | Catalog and Mail Order | 1 | 0.81 |
| 2653 | Corrugated Boxes | 1 | 0.81 |
| 4215 | Courier Services | 1 | 0.81 |
| 1311 | Crude Petroleum Producers | 1 | 0.81 |
| 5912 | Drug Stores | 1 | 0.81 |
| 3641 | Electric Bulbs | 1 | 0.81 |
| 5063 | Electrical Apparatus | 1 | 0.81 |
| 5731 | Electronic Stores | 1 | 0.81 |
| 3519 | Engines | 1 | 0.81 |
| 6111 | Federal Credit Agencies | 1 | 0.81 |

| SIC Code | Industry | # of Adopters | % of All Adopters |
|---|---|---|---|
| 5141 | Grocery Stores | 1 | 0.81 |
| 6324 | Hospital and Medical Services Plans | 1 | 0.81 |
| 3646 | Lighting Fixtures | 1 | 0.81 |
| 8741 | Management Services | 1 | 0.81 |
| 2515 | Mattresses and Beds | 1 | 0.81 |
| 8062 | Medical and Surgical Hospitals | 1 | 0.81 |
| 4924 | Natural Gas | 1 | 0.81 |
| 2522 | Office Furniture | 1 | 0.81 |
| 1382 | Oil and Gas Exploration | 1 | 0.81 |
| 3533 | Oil Field Machinery | 1 | 0.81 |
| 2851 | Paint | 1 | 0.81 |
| 2631 | Paperboard Mils | 1 | 0.81 |
| 2531 | Public Building Furniture | 1 | 0.81 |
| 2611 | Pulp Mills | 1 | 0.81 |
| 4011 | Railroad | 1 | 0.81 |
| 6531 | Real Estate Agents | 1 | 0.81 |
| 6036 | Savings Institutions | 1 | 0.81 |
| 2841 | Soap and Detergents | 1 | 0.81 |
| 6361 | Title Insurance | 1 | 0.81 |
| 4700 | Transportation | 1 | 0.81 |
| 2331 | Women's Blouses and Shirts | 1 | 0.81 |
| **Total** | | **123** | **100** |

APPENDIX 3: ALL FORTUNE 500 COMPANIES IN SAMPLE

3M
AES
AFLAC
AIG
AK Steel Holding
AMR
AOL Time Warner
AT&T
Abbott Laboratories
Adelphia Communications
Administaff
AdvancePCS
Advanced Micro Devices
Aetna
Agilient Technologies
Air Products & Chem.
Airborne
Albertson's
Alcoa
Allegheny Energy
Allied Waste Industries
Allmerica Financial
Allstate
Alltel
Altria Group
AmSouth Bancorp.
Amazon.Com
Amerada Hess
Ameren
American Axle & Mfg.
American Electric Power
American Express
American Financial Group
American Standard
AmerisourceBergen
Ames Dept Stores
Amgen
Anadarko Petroleum
Anheuser-Busch
Anixter International
Aon
Apple Computer
Applied Materials
Aramark
Archer Daniels Midland
Armstrong Holdings
Arrow Electronics
Ashland
AutoNation
AutoZone
ADP
Avaya
Avery Dennison
Avista
Avnet
Avon Products
BB&T Corp.
BJ's Wholesale Club
Baker Hughes
Ball
Bank One Corp.
Bank of America
Bank of New York
Barnes & Noble
Baxter International
Bear Stearns
Becton Dickinson
BellSouth
Best Buy
Big Lots
Black & Decker
Borders Group
Brink's
Bristol-Myers Squibb
Brunswick
Burlington No. Santa Fe
Burlington Resources
Chase Manhattan
C.H. Robinson
CDW
CMS Energy
CNF
CSX
CVS
Cablevision Systems
Caesars Entertainment
Campbell Soup
Capital One Financial
Cardinal Health
Caremark Rx
Caterpillar
Cendant
CenterPoint Energy
Centex
Charles Schwab
Charter Communications
ChevronTexaco
Chubb
Cigna
Cinergy
Circuit City Stores
Cisco Systems
Citigroup
Clear Channel
Communications
Clorox
Coca-Cola
Coca-Cola Enterprises
Colgate-Palmolive
Columbia/HCA Healthcare
Comcast
Comdisco Holding
Comerica
Compaq Computer
Computer Associates
Computer Sciences
ConAgra Foods
Conectiv
Conoco
ConocoPhillips
Conseco
Consolidated Edison
Constellation Energy
Continental Airlines
Cooper Industries
Cooper Tire & Rubber
Core-Mark International
Corning
Costco Wholesale

Aquila
Coventry Health Care
Cox Communications
Crown Holdings
Cummins
D.R. Horton
DTE Energy
Dana
Danaher
Darden Restaurants
Dean Foods
Deere
Dell
Delphi
Delta Air Lines
Devon Energy
Dillard's
Dole Food
Dollar General
Dominion Resources
Dover
Dow Chemical
DuPont
Duke Energy
Dynegy
EMC
Eastman Chemical
Eastman Kodak
Eaton
Echostar Communications
Edison International
El Paso
Equity Office Properties
Estée Lauder
Exelon
Express Scripts
Exxon Mobil
FMC
FPL Group
Family Dollar Stores
Fannie Mae
FedEx
Federal-Mogul
Federated Dept. Stores
Liz Claiborne
Calpine
Fidelity National
Fifth Third Bancorp
First American Corp.
First Data
FirstEnergy
FleetBoston Financial
Fleming
Fluor
Foot Locker
Ford Motor
Fortune Brands
Foster Wheeler
Gannett
Gap
Gateway
General Dynamics
General Electric
General Mills
General Motors
Genuine Parts
Georgia-Pacific
Gillette
Golden State Bancorp
Golden West Financial
Goldman Sachs Group
Goodrich
Goodyear Tire & Rubber
Group 1 Automotive
H.J. Heinz
Halliburton
Harley-Davidson
Harrah's Entertainment
Hartford Financial
Services
Health Net
HealthSouth
Hershey Foods
Hewlett-Packard
Hilton Hotels
Home Depot
Honeywell Intl.
Hormel Foods
Host Marriott
New York Times
Countrywide Financial
Household International
Humana
IBM
ITT Industries
Idacorp
Ikon Office Solutions
Illinois Tool Works
Ingram Micro
Intel
InterActiveCorp
International Paper
Interpublic Group
Interstate Bakeries
J.C. Penney
JDS Uniphase
Jabil Circuit
Jacobs Engineering Group
Jefferson-Pilot
John Hancock Financial
Services
Johnson & Johnson
Johnson Controls
Jones Apparel Group
KB Home
Kellogg
Kelly Services
Kerr-McGee
KeyCorp
KeySpan
Kimberly-Clark
Kindred Healthcare
Kmart Holding
Kohl's
Kroger
LTV
Lear
Leggett & Platt
Lehman Brothers Holdings
Lennar
Lennox International
Lexmark International
Limited Brands
Lincoln National
Principal Financial

Lockheed Martin
Loews
Longs Drug Stores
Lowe's
Lucent Technologies
Lyondell Chemical
MBNA
MCI WorldCom
MGM Mirage
Manpower
Marathon Oil
Marriott International
Marsh & McLennan
Masco
Mattel
Maxtor
May Dept. Stores
Maytag
McDonald's
McGraw-Hill
McKesson
Medtronic
Mellon Financial Corp.
Merck
Meritor Automotive
Merrill Lynch
MetLife
Micron Technology
Microsoft
Mirant
Mohawk Industries
Monsanto
Morgan Stanley
Motorola
Murphy Oil
NCR
NSTAR
NTL Europe
Nash Finch
National City Corp.
Nationwide
Navistar International
Sonic Automotive
SouthTrust Corp.
Southern
Newell Rubbermaid
Nextel Communications
NiSource
Nike
Nordstrom
Norfolk Southern
NorthWestern
Northeast Utilities
Northern Trust Corp.
Northrop Grumman
Northwest Airlines
Nucor
OGE Energy
ONEOK
Occidental Petroleum
Office Depot
OfficeMax
OfficeMax
Omnicom Group
Oracle
Owens & Minor
Owens Corning
Owens-Illinois
Oxford Health Plans
PG&E Corp.
PNC Financial Services Group
PPG Industries
PPL
Paccar
PacifiCare Health Sys.
Parker Hannifin
Pathmark Stores
Pepsi Bottling
PepsiCo
Performance Food Group
Pfizer
Phelps Dodge
Pinnacle West Capital
Pitney Bowes
Praxair
Premcor
Texas Instruments
Textron
Toys `R‘ Us
Procter & Gamble
Progress Energy
Progressive
Providian Financial
Prudential Financial
Public Service Enterprise
Puget Energy
Pulte Homes
Quantum
Quest Diagnostics
Qwest Communications
R.R. Donnelley & Sons
RadioShack
Raytheon
Regions Financial
Reynolds American
Rite Aid
Rockwell Automation
Rohm & Haas
Roundy's
Ryder System
SBC Communications
SCANA
SCI Systems
SPX
Safeco
Safeway
Saks
Sanmina-SCI
Sara Lee
Schering-Plough
Science Applications Intl.
Sears Roebuck
Sempra Energy
ServiceMaster
Sherwin-Williams
ShopKo Stores
Sierra Pacific Resources
Smith International
Smithfield Foods
Smurfit-Stone Container
Solectron
W.W. Grainger
Wachovia Corp.
Wal-Mart Stores

Southwest Airlines
Spartan Stores
Sprint
St. Paul Cos.
Staff Leasing
Staples
Starwood Hotels & Resorts
State St. Corp.
Steelcase
Sun Microsystems
SunTrust Banks
Sunoco
Supervalu
Sysco
TJX
TRW
TXU
Target
Tech Data
Temple-Inland
Tenet Healthcare
Tenneco Automotive
Tesoro Petroleum
TransMontaigne
Tribune
Tyson Foods
U.S. Bancorp
UAL
US Airways Group
USA Education
USG
Union Pacific
Union Planters Corp.
Unisys
United Auto Group
United Parcel Service
United Stationers
United Technologies
UnitedHealth Group
Unocal
UnumProvident
VF
Valero Energy
Verizon Communications
Viacom
Visteon
Walgreen
Walt Disney
Washington Mutual
Waste Management
WellPoint Health Networks
Wellpoint
Wells Fargo
Wesco International
Western Gas Resources
Westvaco
Weyerhaeuser
Whirlpool
Whitman
Willamette Industries
Williams
Wisconsin Energy
Wyeth
Xcel Energy
Xerox
Yellow Roadway
York International
Yum! Brands

## APPENDIX 4: SOE ADOPTERS AND DATES PRIOR TO JANUARY 2002[43]

| | |
|---|---|
| Alabama National Bancorporation | December 1998 |
| BASF AG | March 2001 |
| Boeing Co* | December 1998 |
| Entropin Inc | December 1999 |
| Level 3 Communications, Inc | December 1998 |
| MacDermid Inc | April 2001 |
| Mercantile Bankshares | December 1995 |
| Pearson PLC | August 2000 |
| Protective Life | December 1995 |
| RCN Corp | December 2000 |
| Star Scientific Inc | December 1999 |
| TCF Financial Corp | December 2000 |
| Winn-Dixie Stores Inc* | December 1996 |

**Fortune 500*

[43] Bear Stearns, 2004.

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