

**SETTLING UP, SCAPEGOATING AND STIGMA:
EARNINGS RESTATEMENTS AND THE SYMBOLIC CONTEST FOR CORPORATE CONTROL**

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What are the consequences of organizational misconduct for organizational leaders? When things go wrong in organizations, when organizational actors violate rules or laws in pursuit of individual or organizational goals (Vaughan 1999), the costs incurred may range from reduced stock prices to employee firings, criminal charges, and even organizational bankruptcy and failure. Given free and open markets, these social costs should imply consequences for those at the helm, who ultimately bear responsibility for firm behavior and outcomes (Carpenter, Geletkanycz and Sanders 2004; Hambrick and Mason 1984; Khanna and Poulsen 1995), and whose images are inextricably linked with those of their organizations (Pfeffer and Salancik 1978; Sutton and Callahan 1987). Yet the degree to which organizational leaders are held responsible for misconduct, and the determinants of the severity of the consequences they face, are not yet fully understood.

My dissertation investigates three questions surrounding the process of *ex post* settling up. First, who, if anybody, takes the blame for organizational misconduct, given the symbolic contest for control over the corporation among internal and external stakeholders? Second, does the apportionment of blame through scapegoating effectively insulate other organizational leaders from labor market consequences, or does the mere presence of misconduct effect consequences on organizational leaders through the process of stigmatization? Finally, is stigma a binary or continuous construct? I analyze these questions by positing that, following revelations of organizational misconduct, top executives and corporate directors attempt to avoid stigmatization by shifting blame. The result of this political process is determined by the actions and relative power of various stakeholders, and in turn determines the degree to which stigma will spread to top executives, corporate directors, and subgroups thereof. My findings will contribute to research on corporate governance, top management teams, corporate succession and contagion, as well as the body of work on organizational misconduct and stigma.

Effects of External Stakeholder Action on *Ex Post* Settling Up

It has been argued that, just as managers and corporate directors should be rewarded for achieving good performance, so should they be penalized for negative outcomes through a process referred to as *ex post* settling up (Fama and Jensen 1983; Fama 1980). The *ex post* settling up process implies that

managers and directors associated with organizational misconduct will face consequences on both internal and external labor markets, by losing their positions in the focal firm, as well as through a reduction in the total number of appointments they hold on other corporate boards. Tests of this hypothesis, however, have received mixed support (e.g., Agrawal, Jaffe and Karpoff 1999; Beneish 1999; Collins, Reitenga and Sanchez-Cuevas 2005; Arthaud-Day et al. forthcoming; Boeker 1992; Coles and Hoi 2003; Desai and Hogan 2006; Fich and Shivdasani 2005; Gove and Janney 2004; Srinivasan 2005; Yermack 2004).

The presence of settling up can therefore be seen as a political struggle for the control over the corporation among internal and external stakeholders. Given the potential for negative consequences, CEOs, CFOs and corporate directors will attempt to distance themselves from the misconduct by scapegoating (Burke 1969), or shifting blame to other potentially culpable parties. If organizational leaders are able to change external auditors following revelations of accounting irregularities, for example, they may avert the process of *ex post* settling up in two ways: first, they may deny responsibility for the misconduct, and second, they can maintain legitimacy by taking purposive action (Arthaud-Day et al. forthcoming; Pfeffer and Salancik 1978; Selznick 1957). In contrast, external stakeholders may see organizational leaders as responsible for the misconduct, and consequently take steps to ensure that consequences accrue by calling attention to top executive and corporate director complicity. External stakeholders will attempt to remove culpable organizational leaders, both to prevent future misconduct by current leaders, and to bring in untainted leadership and oversight by engaging in a symbolic struggle for control over the corporation. Thus, the greater the degree of external stakeholder action in response to revelations of misconduct – including the number of shareholder resolutions, shareholder lawsuits, negative stock price returns, institutional investor sell-offs, regulatory actions, criminal charges filed, and mentions of misconduct in the media, as well as the revelation of misconduct by external parties – the fewer opportunities available to organizational leaders to scapegoat others, therefore the greater the likelihood that they will lose their current positions. Hence:

H1a: The more action taken by external stakeholders in response to organizational misconduct, the greater the likelihood of turnover among top executives and corporate directors.

H1b: The more action taken by external stakeholders in response to organizational misconduct, the greater the likelihood of a loss of net external board seats among top executives and corporate directors.

Effects of Internal Stakeholder Power on *Ex Post* Settling Up

Although Fama (1980) and Fama and Jensen (1983) suggest that settling up will apply equally to managers and directors, the degree to which either group, or subgroups thereof, is affected has not yet been sufficiently delineated, which may also partially account for inconsistent findings. For example, Srinivasan (2005) finds evidence of settling up in terms of outside directorships among outside directors and audit committee members, but does not account for insiders and top executives. Beneish (1999) discovers no settling up among top executives, although Desai (2004) does find increased turnover in this group, and neither study accounts for directors. Arthaud-Day and colleagues' (forthcoming) results indicate turnover among top executives, outside directors and audit committee members, but the authors do not make predictions regarding when those different groups will be affected relative to each other, whereas Collins (2005) finds mixed results within the same population.

I assert that comprehensive understanding of the process of settling up requires simultaneous consideration of both top executives and directors, as well as differentiation of the CEO, CFO, outside directors, and audit committee members. Viewing the settling up process as the result of a symbolic contest for control over the corporation, situated in the context of a power struggle among top executives and corporate directors (Boeker 1992; Pfeffer 1981; Westphal and Zajac 1995; Zald 1965), we can make specific predictions regarding who will be scapegoated, hence lose their positions, following organizational misconduct. That is, if the CEO is more powerful, directors are likely to be scapegoated, resulting in director turnover, whereas if the board is more powerful, the CEO is more likely to take the blame. Similarly, power dynamics within the board and among the CEO and CFO will determine who will depart the organization following misconduct. Following Westphal and Zajac (1995), I measure power among the board and top managers as a function of the insider ratio of the board, CEO/Chairman duality, relative tenure among top managers and the board, and director stock ownership.

H2a: The greater top executive power relative to the board, the greater the likelihood of turnover among corporate directors.

H2b: The greater board power relative to top executives, the greater the likelihood of turnover among top executives.

H2c: The greater CEO power relative to the CFO, the greater the likelihood of CFO turnover.

H2d: The greater general board power relative to members of the audit committee, the greater the likelihood of audit committee member turnover.

Moderators of Ex Post Settling Up

Finally, once we establish if top executives and directors will be held accountable, and which groups will be scapegoated, we must consider potential moderators. Extant research often takes the magnitude of organizational misconduct into account (Arthaud-Day et al. forthcoming; Srinivasan 2005), but few other moderators. In addition to the magnitude of the misconduct, I will analyze the effects of repeated misconduct, which would indicate worse governance and oversight practices, and make the likelihood of turnover more likely. Similarly, organizational reputation is likely to affect the likelihood of the settling up process, such that leaders of organizations with better reputations will suffer more severe consequences than those of firms with worse reputations, because misconduct runs counter to expectations of organizations with higher reputations (Jensen 2004). Finally, regulatory changes stemming from the 2002 Sarbanes-Oxley Act increase the accountability of top executives and audit committee members, in particular, making turnover more likely. Hence:

H3a: The greater the magnitude of organizational misconduct, the greater the likelihood of turnover among top executives and corporate directors.

H3b: The more incidents of misconduct, the greater the likelihood of turnover among top executives and corporate directors.

H3c: The better the organizational reputation, the greater the likelihood of turnover among top executives and corporate directors.

H3d: Turnover among top executives and corporate directors will be greater for misconduct occurring after the passage of the Sarbanes-Oxley Act than for earlier instances of misconduct.

Scapegoating and Stigma

In addition to studying if and to whom the process of *ex post* settling up will apply, I will also address the degree to which organizational misconduct stigmatizes organizational leaders. The concept of stigmatization – the process through which actors’ status or reputation is diminished through association with either discrediting characteristics or discredited others (Goffman 1986) – has been used to explain

the negative outcomes experienced by organizational leaders following organizational misconduct. Arthaud-Day and colleagues (forthcoming) argue that organizations attempt to remove stigmatized directors and executives, who might be blamed for the misconduct occurring under their watch, to avoid organizational stigmatization. Similarly, Srinivasan (2005) finds evidence of outside director stigmatization through the loss of seats on other boards.

Goffman (1986) argues that stigma is transferred through social structure, although with diminishing intensity as the connections to the stigmatized actor become less direct. Stigma tends to reduce social interaction with the stigmatized individual, stemming from the fundamental tendency to separate the pure or the sacred from the dirty, dangerous, or profane (Douglas 2004; Durkheim 1995; Goffman 1986). Thus association with those held accountable for organizational misconduct is likely to transfer damaging effects to other actors through a process social psychologists call “stigma by association” (Neuberg et al. 1994). Because these effects are potentially damaging, it is likely that actors will take steps to contain its spread. The simplest way to contain stigma transfer through is to cut the stigmatized party out of the social relationships entirely. I propose that the stigma associated with organizational misconduct is so strong, that even severed relationships with tainted others will incur social costs, such that the top executives and directors remaining in the focal organizations will still be affected by the process of settling up in terms of a net loss of other board seats, once others have departed.

H4a: Organizational leaders who depart following organizational misconduct will suffer a net loss of corporate board seats.

H4b: Organizational leaders who remain following organizational misconduct will suffer a net loss of corporate board seats, though to a lesser degree than those who have departed.

Data and Methods

To test my hypotheses regarding the effects of organizational misconduct on organizational leaders, I have collected data on firms restating earnings between 1997 and 2003, as reported by the GAO (D'Agostino 2002), a population that includes approximately 1,239 restatements. My sample includes 429 restatements of from firms listed in the S&P 500 Index, as well as non-restating firms included in the S&P 500 Index, and includes data from 1996 through 2006.

Dependent measures. My dependent variables are turnover, or loss of position in the restating firm, and net loss of seats on other corporate boards for three years following the focal restatement, to account for staggered board elections. These data were collected using Thomson Research's *Compact D* and IRRC's *Directors* databases. To test H1 and H3, the dependent measure is a categorical variable indicating departure of at least one top executive or board member. The dependent measure to test H2 is a categorical variable indicating departure of a CEO, CFO, outside director, inside director, and audit committee member. To test H4, I create a measure of net loss of external board seats for each director, and conduct supplemental analyses on measures indicating lost board seats as well as renewed new board appointments for each director.

Independent measures. Predictor variables include a dummy variable for restatement, based on the GAO database. Additional data on restatements collected from proxy reports filed in the *Edgar* database and press reports collected from the *Lexis-Nexis* database includes magnitude of restatements, number of restatements, number of quarters restated, whether they are income-reducing or income-increasing, restatement issue, and restatement prompter. I also collected data from these sources indicating SEC investigations, exchange delistings, delayed filings, criminal charges filed, and number of media mentions, as well as director and executive demographics. Using the *Compustat* and *CRSP* databases, I collected data on stock price reaction, analyst coverage, exchange listing, SEC code, institutional investor holdings, and measures of performance, including sales and ROA. Data on shareholder resolutions were collected from IRRC/ISI's database of shareholder resolutions, and data on shareholder resolutions were collected from the *Stanford Securities Class Action Clearinghouse*. Data on organizational reputation is gathered from *Fortune's* Reputation Index.

To test H1 and H3, I employ logistic regression models with maximum-likelihood estimation provided in the Stata 8 statistical package. I use multinomial logistic regression models to test H2; multinomial logistic regression simultaneously estimates logistic regression models, with pairwise comparisons (Aldrich and Nelson 1984; Greene 1993). I will test H4 using an event count model.

Bibliographic references available