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What is This?
The Effects of Organizational and Political Embeddedness on Financial Malfeasance in the Largest U.S. Corporations: Dependence, Incentives, and Opportunities

Harland Prechel\textsuperscript{a} and Theresa Morris\textsuperscript{b}

Abstract
This article examines the causes of financial malfeasance in the largest U.S. corporations between 1995 and 2004. The findings support organizational-political embeddedness theory, which suggests that differential social structures create dependencies, incentives, and opportunities to engage in financial malfeasance. The historical analysis shows that neoliberal policies enacted between 1986 and 2000 resulted in organizational and political structures that permitted managers to engage in financial malfeasance. Our quantitative analysis provides three main findings. First, capital dependence on investors creates incentives to engage in financial malfeasance. Second, managerial strategies to increase shareholder value create incentives to engage in financial malfeasance. Third, the multilayer-subsidiary form and the political structure permitting corporate PAC contributions create opportunities to engage in financial malfeasance. These findings have important implications for public policy; the corporate and state structures enacted in the late-twentieth century were the outcome of a long-term, well-financed, and systematic political strategy that provided managers with unprecedented power, autonomy, and opportunity to engage in financial malfeasance.

Keywords
financial malfeasance, organizational and political embeddedness, managerial autonomy, public policy

In 2001, the financial crisis and collapse of Enron Corp. and others, including Adelphia, Tyco, and WorldCom, illuminated the public impact of decisions made by corporate management. Thousands of jobs and millions of dollars in employee retirement funds and shareholder value were lost. Although many corporate leaders and government officials attributed this crisis to individual characteristics such as greed, little explanation was given for why investors and regulators were largely unaware of corporations’ financial conditions. Moreover, despite the financial crisis’ effects on the working and middle
classes and the emphasis on public sociology in recent years (Burawoy 2004), there is little systematic sociological research on the underlying social structural causes of the financial crisis in corporate America.

Our research moves beyond formulations that attribute deception of corporate finances to individual characteristics by examining how organizational and political structures in which managers are embedded create dependencies, incentives, and opportunities to misrepresent corporate balance sheets. The social structural causes of financial malfeasance must be identified to implement remedies protecting the public from future occurrences.

To explain financial malfeasance, we elaborate organizational-political embeddedness theory, which maintains that corporate-state relations cannot be separated from one another in modern society because state policy gives form to corporate structures and creates opportunities for managers to engage in financial malfeasance. Financial malfeasance is an act that violates a law or a rule (or their intent) established by a government agency or a nongovernmental organization responsible for corporate financial oversight. We focus on the concept of malfeasance rather than crime because behaviors that are legal may still mislead investors, especially small investors, due to information asymmetry. The central proposition is that corporations’ embeddedness in these political structures created opportunities for managers to exploit information asymmetries and illegitimately advance their self-interests and firms’ capital accumulation agendas.1

ORGANIZATIONAL-POLITICAL EMBEDDEDNESS THEORY

The revitalization of historical and comparative sociology in the 1980s raised many questions about the explanatory power of theories that assume historical continuity and disregard historical ruptures and turning points (Abbott 1997; Isaac and Griffin 1989). Building on this theoretical tradition, organizational-political embeddedness theory (1) identifies historical conditions that structure corporate actors’ motives and actions, and (2) maintains that corporate-state relations cannot be separated from one another in modern society because state policies give form to corporate structures. This formulation extends the research on structural embeddedness (Granovetter 1985) by elaborating political embeddedness: the structure of ties between organizations and the state (Prechel 2000).

Examining the effects of historical conditions on corporate behavior is important because they structure the “motives and actions” of social actors as well as their “interests and opportunities for satisfying them” (Prechel 1990:665). Conditions encompass the structure of available alternatives, incentives, and constraints that affect aggregates of individual actions (e.g., collective decisions) (Hernes 1976). In this application, organizational-political embeddedness theory posits that neoliberal policies enacted between 1986 and 2000 allowed the development of organizational and political structures that created dependencies, incentives, and opportunities for managers to engage in financial malfeasance.

Dependencies and Incentives

Theories that focus on organizational structure maintain that when corporations are externally constrained and controlled, they become resource dependent. Resource dependence causes lack of autonomy and uncertainty, both of which threaten organizations’ capacity to survive (Pfeffer and Salancik 1978; Zald 1970; Zeitlin 1974).

Research examining corporate behavior focuses on capital dependence because it limits autonomy and may threaten corporations’ survival. Capital dependence affects corporate strategies and how corporations manage their finances (Mizruchi and Stearns 1994; Palmer, Jennings, and Zhou 1993). It also creates incentives for corporations to change their structure. For example, in response to capital
In the 1980s, corporations changed to the multilayer-subsidiary form (Prechel and Boies 1998) and spun off noncore product lines (Davis, Diekmann, and Tinsley 1994). In the following decade, when capital dependence declined, many corporations diversified their product lines by acquiring other corporations that held critical resources upon which they were dependent (Prechel et al. 2008).

Organizational-political embeddedness theory posits that under certain conditions, capital dependence creates incentives for corporations and their managers to engage in financial malfeasance. These incentives exist at the organizational and individual levels. At the organizational level, capital dependence on external stakeholders who control critical resources creates incentives for managers to misrepresent corporations’ financial statements. Among the most powerful stakeholders that emerged during the 1980s and 1990s were mutual funds, pension funds, endowments, hedge funds, and other large institutional investors that acquired corporate securities. By the mid-1980s, institutional investors and wealthy individuals began to pressure management to increase returns on equity and price-earnings ratios because corporate securities’ value responds to these financial measurements (Krier 2005; Useem 1996). This capital dependent relationship created incentives for corporate managers to increase shareholder value. Failure to increase shareholder value may cause institutional investors to disinvest from a company, withhold future investments, or attempt to replace top management. When management is unable to achieve desired levels of financial performance through legitimate means, this condition provides motives for managers to misrepresent their balance sheets.

At the micro-individual level, the form of executive compensation that emerged during this period created incentives for managers to misrepresent corporations’ financial statements. By the 1990s, a large share of executive compensation was derived from stock options. Although many top managers in the largest corporations owned corporate securities by the mid-1970s (Lewellen 1971), this trend toward management ownership accelerated when stock options became viewed as an incentive for management to behave more like owners and, thus, increase shareholder value. Between 1992 and 2000, stock options as a percent of CEO pay increased from 27 to 51 percent among the Standard and Poor’s industrial firms. Between January 1999 and May 2002 alone, approximately $66 billion was granted in stock options by 1,035 corporations (Fortune 2002). This change in executive compensation created incentives for executives to inflate corporate balance sheets to increase the value of their stock options. It also increased the power, authority, and size of the managerial class (i.e., managers who own large amounts of corporate stock).

Neoliberal advocates of this form of compensation maintained that stock ownership would align managers’ and shareholders’ interests, encouraging managers to behave more like owners and increase returns on investment. These visionaries failed to understand, however, that this form of compensation created incentives for managers to pursue their self-interests in ways not beneficial to stockholders: managers increased the value of their stock options by inflating corporate balance sheets.

**Opportunities**

Organizational-political embeddedness theory also posits that variation in corporate and political structures provides differential opportunities to engage in financial malfeasance. This theoretical tenet is consistent with Sutherland’s (1949) conception of differential social organization, which suggests that some social structures provide greater opportunities to commit crime than others. Research in this tradition shows that variation in regulatory policy, enforcement structures, economic conditions, and organizational characteristics affect white-collar deviance and crime (Clinard and Yeager...
Among the most important changes in U.S. political structure in the twentieth century were the laws governing corporate political contributions. In an attempt to control the influence of money on federal elections in the post-Watergate era, Congress overturned the 1907 Tillman Act, which had banned corporate contributions to political campaigns. In 1971, Congress passed the Federal Election Campaign Act, legalizing political contributions by stockholders. Then, in 1974, Congress created the Federal Election Commission (FEC), an oversight agency monitoring campaign contributions. The most important change, however, occurred in the following year when, in response to corporate political pressure, the FEC passed the SUNPAC ruling, which legalized political contributions by employees. This transition in public policy was followed by a rapid increase in corporate PACs and corporate influence over the policy formation process (Clawson, Neustadt, and Scott 1992).

The emergent political structure created opportunities for management to influence the political process in two interrelated ways: (1) making political contributions to elected officials and (2) hiring lobbyists to present their agendas to appointed and elected officials. In subsequent years, to maximize corporations’ financial flexibility and access to capital, the managerial class pressured Congress, the executive branch, and the courts to change the political-legal arrangements governing corporate behavior. This effort included pressuring government officials to change corporate tax laws (e.g., depreciation allowances and investment tax credits) to increase cash flow (Prechel 1990). Because the presentation of accounting and financial information (Weber 1978) affects corporations’ capacity to raise capital (i.e., debt and equity issuances), management also pressured oversight agencies for accounting rules that would present corporate finances in the most favorable light. Among the most important of these changes was the 1984 Emerging Issues Task Force, which permitted corporate accountants and financial managers to influence the accounting rule-making process. Previously, the Financial Accounting Standards Board (FASB) made most accounting rules, and this process was largely closed to corporate managers (Krier 2005).

**Bridging Structural Holes: Illegitimate Exploitation of Information**

After management gained the right to openly influence the political process, corporations pressured Congress to transform political-legal arrangements in ways that increased corporations’ financial and organizational flexibility. The emergent organizational and political structures created asymmetric information between managers on the one hand and regulatory agencies and investors on the other. Information asymmetries provide managers with autonomy, which creates opportunities to engage in beneficial relationships that may entail financial malfeasance. In some cases, managers benefit from information asymmetries by bridging structural holes (i.e., separations between nonredundant contacts). The concept of structural holes was developed to show how entrepreneurial managers obtain resource benefits to advance their careers by legitimately exploiting information (e.g., a producer in a market negotiating with a supplier or a customer) (Burt 1992). When structural holes exist, the social actor has autonomy (i.e., lack of constraint), which translates into social capital and the opportunity to benefit from the relationship. The capacity to identify and act on information entails human capital (e.g., knowledge and skills), but social capital (e.g., relationships with other social actors) is of primary importance because managers establish networks to bridge structural holes and gain benefits (Burt 1992; see also Coleman 1988; Corra and Willer 2002; Granovetter 1985).

Our analysis extends the definition of structural holes to include managerial behavior that
bridges such holes by *illegitimately* exploiting information to gain resource benefits that will advance managers’ careers and incomes. Illegitimate exploitation of information includes, for example, violating the intent of an accounting rule or understood practice such that the balance sheet is inflated or risk is concealed. Such behavior may include capital transfers among corporate entities that conceal losses or place debt or high-risk financial instruments in corporate entities intended for low-risk investments. Absent information on these capital transfers, investors do not have an accurate understanding of corporations’ financial conditions or risk levels.

**HISTORICAL ANALYSIS: REDEFINING POLITICAL-Legal ARRANGEMENTS**

In response to increased capital dependence in the 1970s and 1980s, corporate capitalists employed neoliberal ideology to legitimate redefining the political-legal arrangements in which corporations are embedded. Corporate political activists asserted the superiority of neoliberal ideology and criticized embedded liberalism, the political-legal arrangements in the mid-twentieth century (Ruggie 1982) that limited managements’ capacity to use certain organizational structures and financial instruments. As in other periods of economic crisis (Polanyi [1944] 2001), supporters of neoliberal ideology asserted that social, economic, and political problems could be solved by market fundamentalism, that is, extreme faith in the capacity of markets to regulate corporations (Stiglitz 2002).

*The Tax Reform Act of 1986 and the Multilayer-Subsidiary Form*

One of corporate capitalism’s primary agendas was to reduce dependence on debt financing (i.e., bank loans) by making greater use of equity financing (i.e., securities issuances). By 1985, a political coalition of 250 large corporations, led by the Tax Reform Action Coalition, convinced the Reagan administration and Congress that current tax laws (e.g., high depreciation allowances) created incentives for corporations to keep their investments in poorly performing assets (e.g., aging manufacturing facilities). Among the most important outcomes of this lobbying effort was a provision in the Tax Reform Act of 1986 that eliminated the New Deal tax on capital transfers inside a corporation. Roosevelt’s administration enacted the capital transfer tax in the 1930s to deinstitutionalize the holding company and control the spread of financial malfeasance.

Soon after this legislation passed, many of the largest U.S. corporations transformed their divisions into subsidiaries. This *multilayer-subsidary form* has a parent company at the top of the corporate hierarchy that operates as a financial management company, with two or more levels of legally separate subsidiary corporations embedded in it (Prechel 2000) (see Figure 1). In contrast to divisions, which are legally part of the same company as the general office (Chandler 1962), subsidiaries are legally independent from the parent company.

Greater property rights is an important difference of the multilayer-subsidiary form compared with the multidivisional form. Because subsidiaries are legally independent corporations, management in the parent company can sell up to 50 percent of the subsidiary’s stock while retaining ownership control (i.e., control through majority voting interest, typically determined by common stock). By 2004, 84.7 percent of the 2002 *Fortune* 500 companies were structured as the multilayer-subsidiary form. The concentration of economic power in this corporate form is not readily understood, however, because many subsidiaries, especially those acquired or merged, have unrelated names that give them identities independent of the parent company.4

Three interrelated characteristics of this corporate form increase managements’ opportunities to engage in capital transfers and conceal
them from oversight agencies and the investing public. First, because parent companies can sell up to 50 percent of the stock in their subsidiary corporations, management can use this capital to increase a firm’s size by expanding existing facilities or engaging in mergers and acquisitions. During our study period, the mean assets held by corporations in our study group more than doubled, from $16.46 billion (1994) to almost $39.4 billion (2003). Second, corporations increased their number of subsidiaries. By 2004, the mean number of subsidiaries among the 2002 Fortune 500 was 39. Of these companies, 37 had more than 100 subsidiaries that were hierarchically structured in up to eight levels. Of the 37 companies with more than 100 subsidiaries, 10 had more than 200 subsidiaries and 2 had more than 300 subsidiaries. The multilayer-subsidiary form’s size and complexity create more opportunities for management to engage in internal capital transfers. Third, eliminating the capital transfer tax removed a source

Figure 1. The Multilayer-Subsidiary Form
of information that oversight agencies (e.g., the Internal Revenue Service) could use to monitor financial transactions.

Despite the radical nature of these changes and the increased opportunities for financial transactions in this corporate structure, few government oversight laws or regulations were enacted to monitor these transactions. For example, accounting rules governing how to incorporate legally separate corporate entities into corporations’ financial statements are based on the general principle of ownership control. Thus, if a company owns more than 50 percent of another corporation’s common stock, that company is considered a subsidiary and is consolidated into the parent company’s financial statement. If no investor controls a voting entity, it is not consolidated and the corporation files an independent financial statement. This definition is based on the general accounting principle that consolidated financial statements combine “the financial statement of a parent company . . . with those of its subsidiaries, as if they were a single economic entity” (Counterparty Risk Management Policy Group III 2008:40–41). This accounting rule was enacted when most corporations were organized in multidivisional form, but financial experts continue to assume that this method provides the most useful decision-making information to users of financial statements.

The multilayer-subsidiary form’s embeddedness in neoliberal political structures created networks rich in structural holes. Exploitable opportunities exist because these structures permit managers to transfer capital among corporate entities that are hidden from investors and oversight agencies. Furthermore, management can exercise discretion when establishing the value of its wholly-owned subsidiaries (i.e., those where no stock is issued or traded in the market). These organizational and political structures create incentives for entrepreneurial managers to exploit information and bridge structural holes to raise stock valuations; managers gain (1) direct resource benefits such as promotions and salary increases and (2) indirect resource benefits such as increasing the value of their stock options.6

The Realignment of Corporate Elites and Proxy Rule Changes

During this period, changes in organizational and political structures also changed the relationship between corporations and financial intermediaries (e.g., banks, institutional investors, and insurance companies). Between the 1940s and 1970s, stable economic growth generated adequate profits to finance most corporate expansion strategies with internal sources of capital. By the mid-1970s, however, internal capital flows were insufficient to finance corporate expansion, and management became increasingly dependent on capital controlled by financial intermediaries.

Dependence on these organizations increased financial managers’ power and influence inside corporations because they had the knowledge to negotiate public offerings of subsidiaries’ securities with the investment bankers who underwrote the transactions. Financial managers also had the expertise to explain corporations’ financial strategies to investors. Corporations’ regulatory environment, however, which restricted communication between management and investors, limited the capacity of inside financial managers to interact with financial intermediaries.

To overcome this obstacle, financial intermediaries and large investors mobilized politically to redefine the rules governing corporate investor relations. In response, in 1992 the Securities and Exchange Commission (SEC) and the FASB relaxed the rules governing communication between managers and investors. Allowing investors to meet with management created opportunities for managers and large investors to identify and articulate their mutual interests and goals (Krier 2005). These exchanges resulted in asymmetrical information between management and large investors on the one hand and small investors on the other.
Managerial autonomy was further enhanced when investors’ rights were weakened by a set of court decisions and legal reforms that reduced investors’ capacity to bring class action lawsuits against lawyers, managers, and advisors responsible for directly engaging in or collaborating on financial malfeasance. Corporate managers’ first major legal victory occurred in 1991 when a Supreme Court decision required shareholders to bring legal actions within one year of discovering a violation and not more than three years following a fraud. Then, in 1994, a Supreme Court ruling limited investors’ ability to hold lawyers liable for giving advice that aided and abetted white-collar crime (U.S. Congress 1994). By protecting lawyers who approved an illegal act (e.g., providing advice that resulted in stock fraud), the Court’s decision made it more difficult to find managers guilty of committing a crime.

Despite corporate managers’ victories in the courts, a coalition of corporations lobbied Congress to further weaken shareholders’ rights. Lead by the financial services industry, this political coalition maintained that securities and racketeering laws permitted unwarranted and meritless securities fraud litigation. They pressured Congress to protect managers, lawyers, and financial advisors from “frivolous” investor lawsuits (U.S. Congress 1991, 1994). Although the Republican-controlled Congress passed this legislation, President Clinton vetoed the bill because it created a high barrier for investors bringing lawsuits against management. Congress overrode Clinton’s veto, however, and passed the Private Securities Litigation Reform Act of 1995, which prohibited investors from using securities laws to bring lawsuits against corporate managers, accountants, lawyers, and advisors who made speculative statements about corporate finances. The aiding-and-abetting liability under the general provision of federal securities laws was now largely eliminated (Congressional Quarterly Weekly 1995). By making it difficult to hold the managerial class accountable for their behavior, these political-legal arrangements reduced the risk to managers for engaging in transactions that mislead investors.

The Gramm-Leach-Bliley Financial Services Modernization Act

Throughout the 1990s, decisions by the Federal Reserve Bank and the Treasury Department weakened the 1933 Glass-Steagall Act and the Bank Holding Company Act of 1956; public policy permitting commercial banks to diversify into financial services (e.g., investment banking and insurance) was fully reversed in 1999 when Congress passed the Gramm-Leach-Bliley Financial Services Modernization Act. Soon, financial conglomerates (e.g., Citigroup) emerged to provide a wide range of financial services to the same corporate client, including loans, stock analyses, underwriting of stocks and bonds, advising on mergers and acquisitions, insurance, and investment advice.

These organizational structures create the potential for multiple conflicts of interest. For example, because the same corporation can provide advice and financing for a corporate merger, managers in a financial services subsidiary have an incentive to set a higher price on a merger’s value because it would result in a larger loan by the lending subsidiary. This behavior can result in overvaluation of newly acquired subsidiaries, which affects a parent company’s stock value because stock is the primary asset held by parent companies. In short, the Private Securities Litigation Reform Act reduced the disincentives for giving bad advice, and the Gramm-Leach-Bliley Act created incentives and opportunities for managers to inflate parent companies’ balance sheets.
The Commodity Futures Modernization Act of 2000

In the 1970s, the energy industry began to argue that deregulation was necessary to increase market efficiency. Initial deregulation, however, had the unintended consequence of lowering profits. In response, energy companies argued that cumbersome regulations still restricted the use of financial instruments necessary to further develop this market. To advance their agenda, the industry mobilized politically to change the rules governing how energy trades could be conducted. Lead by Enron, the industry maintained that natural gas contracts were really derivatives (i.e., a bundle of options or futures contracts between two or more parties whose price is derived from the value of another underlying security or commodity). In this case, the contracts are derived from the projected future price of natural gas. Energy companies, however, were not permitted to engage in derivatives trading.

To advance their agenda, immediately after Clinton defeated George H. W. Bush in the 1992 presidential election, the energy industry lobbied the Commodity Futures Trading Commission to permit energy companies to engage in futures trading. In response, Wendy Gramm, the head of the commission, proposed that energy trades be removed from the Commodity Exchange Act’s jurisdiction. A week later, the commission voted along party lines; the Republican majority passed the provision by a 2 to 1 vote, paving the way for energy companies to enter the derivatives trading market.

The next major effort to deregulate derivatives emerged in the late 1990s when Congress was due to reauthorize the Commodity Exchange Act. By the late 1990s, financial derivatives were widespread and the global derivative market had grown to $88.2 trillion; oversight agencies and several members of Congress expressed concern over these financial instruments’ increased risks for capital markets. In response, financial firms, including investment banks and financial services corporations, joined energy companies and launched a well-financed lobby campaign to allow derivatives futures to be traded on unregulated markets. After advocates in Congress made several unsuccessful attempts to enact this legislation, Senator Phil Gramm (R-TX), the senior Republican on the Senate Banking Committee, and Republican leaders in the House attached the Commodity Futures Modernization Act of 2000 to the 11,000 page Consolidated Appropriations Act for FY2001. This omnibus budget bill passed with a 290 to 60 vote in the House and by unanimous consent in the Senate, with virtually no discussion of the attached unregulated derivatives trading legislation. Clinton signed the bill into law on December 21, 2000.

A provision of the Commodity Futures Modernization Act of 2000, which became known as the “Enron Loophole,” exempted many high-risk derivative trades from regulation by permitting corporations to create over-the-counter energy and financial derivatives markets removed from public scrutiny and government oversight (U.S. Congress 2002). Several large energy corporations followed Enron in setting up their own electronic trading floors to create a derivatives futures market for energy products (e.g., electricity, natural gas, and wind). The financial sector, which was permitted to trade certain derivatives (e.g., currency exchange rates) under the previous regulatory structure, created a range of new financial derivative products. By 2008, the unregulated derivatives market, which included mortgage-backed securities, reached $684 trillion, making it the largest derivatives market in the global economy. Because this market had the potential to generate very large profits and was hidden from government oversight, it created incentives and opportunities for financial managers to engage in high-risk financial transactions.
The Spread of Off-Balance-Sheet Financing

These organizational and political structures also increased opportunities for corporations to use off-balance-sheet entities. This method of financial accounting allows corporations to place financing and assets in special-purpose entities (SPEs) that do not appear on the parent company’s financial statement (Oxford 2006:469). The general rule governing use of off-balance-sheet entities is that they must hold passive assets, that is, assets that are not actively managed and are held over the long term and expected to generate predictable returns.

This arrangement assumes an asset (e.g., a factory leased to another company that pays rent to use it) will retain its value and provide a steady source of income to investors. Off-balance-sheet entities are typically structured as partnerships, which are loosely regulated because there are no stockholders and the gains or losses are transferred to the owners. Partnerships are easily created and integrated into the multilayer-subsidiary form because, like subsidiaries, they are legally independent entities (see Figure 1). By the late 1990s, management used these entities for many purposes.

Off-balance-sheet entities are prone to information asymmetries. For example, after the Commodities Futures Modernization Act of 2000 permitted energy companies to trade energy derivatives, Enron began to lose money on many of these trades because they contained price assumptions that were not consistent with price shifts in the market. To give the appearance of having a strong balance sheet, management placed some of these financial instruments in off-balance-sheet entities and created other off-balance-sheet entities to raise capital. In some instances, managers illegitimately exploited information asymmetries by reporting fictitious capital transfers from off-balance-sheet entities to the parent company (i.e., debt was transferred and reported as income), thereby distorting the parent company’s balance sheet. After Enron’s bankruptcy, government investigations revealed that many of these entities were not eligible for off-balance-sheet treatment because they did not meet the required assumptions (U. S. Congress 2002).

Oversight agencies did not detect illegitimate use of these corporate entities because a small network of managers at Enron used their social capital (i.e., networks) to bridge structural holes with managers in financial intermediaries (e.g., Citigroup and Goldman Sachs). Together, they used their human capital (i.e., skills and knowledge) to create off-balance-sheet entities. When the financial instruments held in these entities began to lose money, incentives existed to keep them off-balance-sheet because incorporating them would negatively affect firms’ financial performance, decrease the probability of promotion and salary increases for the managers responsible, and put downward pressure on the firms’ stock prices and the value of managements’ stock options.

HYPOTHESES

We develop the following hypotheses from organizational-political embeddedness theory and historical contextualization. We focus on restated financial data that management submitted to government regulators. Although financial restatement can occur for legitimate reasons (e.g., a change in accounting standards), the data we use exclude these cases (U.S. General Accounting Office 2002). Focusing on financial restatements is an innovative way to study financial malfeasance, which is difficult for researchers to observe but occurs often. We found that over 21 percent of the largest U.S. corporations restated their finances at least once, and some as many as seven times, during our study period. These restatements represent huge losses for the investing public.
Dependence and Incentive Hypotheses

Profits and financial malfeasance. Corporations’ profit-making agenda has been a central concern in white-collar crime literature for decades; however, the findings are mixed. Some studies suggest that corporations experiencing financial strain are more likely to violate federal antitrust predatory pricing and price-fixing laws (Simpson 1986) and environmental laws (Yeager 1991); others suggest that corporations in financially strong industries are most likely to violate federal laws (Baucus and Near 1991).

Organizational-political embeddedness theory suggests that these conflicting findings are explained by historical variation in the relationship between corporations and the state. Specifically, political structures that prevailed during the study period, which was characterized by deregulation and lax enforcement, embedded corporations in political-legal arrangements that created incentives and opportunities for management in lower profit firms to risk falsifying their financial statements by reporting higher profits. This leads to the first hypothesis:

**Hypothesis 1**: Rate of return on equity is negatively associated with corporations’ likelihood of restating financial statements.

Shareholder value and financial malfeasance. To reduce their dependence on expensive debt financing, many corporations changed to the multilayer-subsidiary form and issued securities in their subsidiary corporations (Prechel 2000). This shift from debt financing by banks to equity financing resulted in a decline in the corporate debt market.12

The change from debt to equity financing did not eliminate capital dependence; instead, it created another form of capital dependence. This historical contingency increased institutional investors’ power, which in some respects made corporate management more vulnerable to external influences. Unlike banks, which tend to be satisfied as long as corporations make their debt payments, institutional investors and wealthy individuals have so much capital invested in individual corporations that it is often not viable for them to move it elsewhere. Moreover, investors’ interest is not limited to broad profitability measurements. Instead, investors prefer that managers pursue profit maximization goals that directly affect the value of their stock portfolios; this leads them to pressure corporate management to increase shareholder value (Useem 1996).

To test the effects of investors on financial malfeasance, we develop two measurements of shareholder value. Organizational-political embeddedness theory suggests that capital dependence on large investors creates incentives for management in firms with lower performing stock to inflate financial statements to retain access to these capital markets. This leads to the following hypotheses:

**Hypothesis 2**: Earnings per share is negatively associated with corporations’ likelihood of restating financial statements.

**Hypothesis 3**: Change in share price is negatively associated with corporations’ likelihood of restating financial statements.

Shareholder value strategies and financial malfeasance. Organizational-political embeddedness theory maintains that relationships between corporate management and large investors create incentives for management to enact strategies designed to raise the price of corporate securities. During the 1990s, investors favored mergers and acquisitions because they are associated with laying-off workers, reducing costs, and raising stock valuations (Krier 2005).

These strategies, however, have a contradictory dimension because they strain corporations’ cash flows, which creates incentives for managers to conceal losses to satisfy investors. This is consistent with strain theories of white-collar crime, where research shows
that rapid growth rates are associated with violations of product quality and workplace safety laws (Clinard and Yeager 1980) and fraud (Tillman and Pontell 1995).

Following this theoretical logic, Hypotheses 4 and 5 maintain that growth and mergers and acquisitions create incentives for management to file misleading financial statements. Opportunities exist to falsify financial statements because many of the costs associated with these strategies are subject to management discretion (Krier 2005), which makes them difficult for oversight agencies to identify and challenge.

**Hypothesis 4:** Mergers and acquisitions are positively associated with corporations’ likelihood of restating financial statements.

**Hypothesis 5:** Growth is positively associated with corporations’ likelihood of restating financial statements.

**Opportunity Hypotheses**

The multilayer-subsidiary form and financial malfeasance. Organizational-political embeddedness theory maintains that the multilayer-subsidiary form creates opportunities for management to make internal capital transfers that inflate parent companies’ balance sheets. For example, in 1996, Enron acquired Mariner Energy and organized it as a wholly-owned subsidiary. Using a legal, but aggressive, accounting technique known as “fair value,” management restated the value of this subsidiary on several occasions when the parent company did not reach its earnings target. By 2001, management had increased the book value of Mariner to $367.4 million. The post-bankruptcy review shows that management inflated this subsidiary’s assets by $256.9 million (McLean and Elkind 2003).

In another instance, Enron’s management shifted $200 million in losses from its energy services subsidiary to its very large and profitable wholesale energy-trading subsidiary, which could absorb these losses because it generated large profits that year. This capital transfer allowed the energy services subsidiary to conceal losses and report $40 million in revenues (Jones 2006), giving investors the false impression that Enron’s highly touted energy services subsidiary was profitable.

In other cases, Enron managers exploited information asymmetry by using social capital (i.e., networks with financial managers in investment banks and other financial intermediaries) to bridge structural holes by creating off-balance-sheet entities that these financial intermediaries invested in. To encourage these financial managers to cooperate, Enron managers guaranteed a return on their investments. Enron managers then transferred capital from these off-balance-sheet entities to the parent company, where it was reported as revenue when, in fact, it was debt (Boies and Prechel 2002). In other instances, management shifted poorly performing assets into off-balance-sheet entities.13

In short, the multilayer-subsidiary form created multiple structural holes that managers could bridge, engaging in financial transactions that distorted the parent company’s balance sheet. These financial transactions were undetected because they were hidden from oversight agencies and the investing public. The following hypotheses test the multilayer-subsidiary form’s effects on financial malfeasance:

**Hypothesis 6:** Parent companies structured as the multilayer-subsidiary form are more likely to restate their financial statements.

**Hypothesis 7:** Subsidiaries are more likely than other corporations to restate their financial statements.

Figures 2 and 3 provide preliminary evidence to support our hypotheses that the multilayer-subsidiary form increases the risk of financial restatements. Figure 2 shows that during the study period, 5.6 percent of parent companies organized in multilayer-subsidiary form restated their finances, compared with
Figure 2. Percent of Corporations Restating Financial Statements by Multilayer-Subsidiary Form

Figure 3. Percent of Corporations Restating Financial Statements by Total Number of Subsidiaries (Quartiles)
3.2 percent of companies not organized in multilayer-subsidiary form. Figure 3 places the companies in our population into four quartiles based on their total number of subsidiaries and provides further support for our hypotheses: restatements increase as the number of subsidiaries increase.

Political action committees and financial malfeasance. Organizational-political embeddedness theory suggests that political action committees (PACs) provide opportunities for corporations to manage their environment by engaging in buffering (i.e., strategies to reduce the effects of the political-legal arrangements in which corporations are embedded) (Boies and Prechel 2002). PACs’ capacity to buffer corporations from regulatory oversight increased in the 1990s when corporate PAC contributions reached record levels. PAC contributions from the financial services sector alone increased from approximately $11 million in 1990 to almost $93 million in 2000.

Hypothesis 8 suggests that PACs constitute a critical part of corporations’ buffering strategy because financial contributions provide access to government officials who can limit regulatory oversight and enforcement. PAC contributions are thus positively related to corporate financial statements:

Hypothesis 8: A positive relationship exists between corporate PAC contributions and financial restatements.

RESEARCH DESIGN

Sample

The study group consists of the 500 largest U.S. publicly traded parent companies in 2001, as identified by Fortune magazine (2002). We follow this group of corporations backward to 1994 and forward to 2004 to compile an 11-year panel dataset. We use 2001 as the sample selection year because several companies that engaged in financial malfeasance were eliminated from the Fortune 500 after that year (e.g., Enron, Tyco, and WorldCom).

Several corporations were excluded from the Fortune list because they were partnerships, private companies, or subsidiaries of foreign corporations. Partnerships and private companies are not required to adhere to the same financial disclosure requirements as public companies. Foreign corporations’ subsidiaries may engage in different behaviors because their parent companies are governed by different political-legal arrangements. When two companies in the population merged during the study period, we attribute the consolidation to the company that obtained managerial control. Because we could not anticipate companies that went private or filed for bankruptcy after the study began, we exclude companies with these characteristics to maintain consistency in the population of corporations. The final population includes 464 companies.

In contrast to many studies of corporate malfeasance that focus on specific industries, our study examines the largest U.S. corporations from a wide range of economic sectors. The study group includes companies that have effects on most spheres of society. We selected our sample on corporations’ total assets rather than sales, because this measure of size is less vulnerable to fluctuations in the market.

Dependent Variable

The dependent variable, financial malfeasance, is a dummy variable measured as whether a corporation filed a restatement of its financial data for a given year: coded 1 if a company restated its data for the year and 0 if it did not. We examine the year of the misstated data because that is when the malfeasance occurred. We obtained data for restatements that occurred between January 1, 1997 and June 30, 2002 from the U.S. General Accounting Office (GAO) (U.S. GAO 2002). We replicated the GAO’s methodology to collect data on restatements.
occurring between January 1, 1994 and December 31, 1996 and between July 1, 2002 and December 31, 2004 (U.S. GAO 2002). The GAO data focus on the date a restatement is announced. Our interest, however, is the date of the restated data, because that is the date of the purported malfeasance. We thus collected data for all restatement announcements (in the data collected by both ourselves and the GAO) on the date of the restated data. Corporations often restate several years of data with one announcement. When this happens, we code each year of restated data as a separate event.

The analysis begins in 1994 because FASB issued a ruling requiring fuller disclosure of corporate balance sheets in that year. It ends in 2004, giving management a sufficient amount of time to respond to the 2001 Sarbanes-Oxley Act, which strengthened provisions in the Securities Act of 1933 and the Securities Exchange Act of 1934 by requiring management to provide investors with sufficient information to make informed investment decisions. Sarbanes-Oxley also created incentives for managers to adhere to these laws.

Financial restatements are an appropriate measure of financial malfeasance for several reasons. First, the GAO includes only restatements that occurred because of improper accounting. For example, the GAO data exclude misstatements that researchers determined occurred due to changes in accounting principles, the number of outstanding stocks, or the application of accounting standards (U.S. GAO 2002). As stated earlier, we replicated this methodology in the data we collected. Second, the Sarbanes-Oxley Act required CEOs and CFOs to sign statements attesting to the accuracy of firms’ financial statements. In the event of falsely certifying the accuracy of a financial statement, executives are held personally responsible for up to $1 million and subject to a jail sentence of up to 10 years for knowing of violations and 20 years for willful violations. In addition, if a company is required to restate its financial statement due to misconduct, its executives can be forced to forfeit bonuses and profits obtained from selling company stock. These conditions limit the risk of underreporting because they provide substantial incentives for executives to refile misleading financial statements. Furthermore, because this measurement entails self-identification by executives who mislead investors, there is little risk of overreporting.14

Independent Variables

We measure political activity by the dollar amount parent companies and their subsidiaries contributed to political action committees, in thousands of dollars. We obtained these data from Open Secrets, which compiles corporate PAC contributions from data obtained from the Federal Election Commission.

Data on corporate structure come from several sources. We use a dummy variable to indicate whether a corporation was a multilayer-subsidiary form (i.e., a corporate form with a parent company at the top of the corporate hierarchy that operates as a financial management company with two or more levels of legally separate subsidiary corporations embedded in it). We measure this multilayer-subsidiary form as having one or more domestic subsidiary corporations at the second level. All corporations with second-level subsidiaries have at least one first-level subsidiary. This operationalization captures two salient characteristics of the multilayer-subsidiary form: multiple subsidiaries and multiple levels of subsidiaries. A dummy variable denotes whether a corporation was a subsidiary at any time during the study period. We collected these data from Dun & Bradstreet (1995 to 2004), the SEC, and corporate Web sites.

Measurements of corporations’ financial characteristics come from Compustat. We measure growth as the percent change from the previous year in total assets. Rate of return on equity (i.e., profits) is the percent rate of return. We measure change in common stock price per share as the percent change at the end of the year from the previous year’s closing price.
Earnings per share is measured before extraordinary items and discontinued operations. We count the number of mergers and acquisitions a corporation took part in each year. These data come from Securities Data Company.

We include several variables to control for the effects of corporate characteristics that researchers suggest are relevant to understanding white-collar crime. For example, previous research suggests that capital dependence on banks affects corporate behavior (Prechel 2000). We include size as a control because research suggests that large organizations are more likely to engage in illegal activity (Clinard and Yeager 1980; Grant et al. 2002) and that illegal activities are encouraged or condoned in large corporations because their taller managerial hierarchies distance top management from illegal acts (Tillman and Pontell 1995). We include age as a control variable because research suggests that younger corporations are more likely to commit financial fraud (Crutchley, Jensen, and Marshall 2007). We use the number of divisions in each corporation to control for corporations’ use of the multidivisional form (we obtained these data from Dun & Bradstreet). We measure size by total assets and capital dependence on banks with long-term debt as percent of assets (data obtained from Compustat). We measure age as the year of founding (data come from Dun & Bradstreet and corporate Web sites).

We also include controls for industrial sectors that underwent rapid growth because this creates opportunities to engage in fraud and corruption (Clinard and Yeager 1980; Tillman and Indergaard 2007; Tillman and Pontell 1995). These sectors include FIRE (i.e., finance, insurance, real estate) and New Economy firms (i.e., energy, telecommunication, information, and information processes). We use standard industrial classification (SIC) codes to control for corporations in these economic sectors.

Estimation

We use a generalized linear model with a binomial distribution and a logit link function to analyze the data. We lag the effect of the independent variable on the dependent variable by one year to avoid simultaneity bias. The effect of causes typically does not occur immediately in large corporations. Managers must acknowledge that a problem is sufficiently serious, develop a strategy, and implement the strategy before actual change occurs. Moreover, decisions to engage in financial malfeasance are rarely based on a single event because corporations are unlikely to undertake the risk of falsifying financial statements unless the problem is sufficiently serious. Our data span 1994 through 2004, with a one-year lag (i.e., our independent variables begin in 1994, and our dependent variable ends in 2004). We thus analyze the event of restatement over a 10-year period, between 1995 and 2004.

FINDINGS

Soon after Congress passed the Sarbanes-Oxley Act, corporate financial restatements increased substantially. Whereas the number of corporations listed with the New York Stock Exchange declined between 1998 and 2002, the number of corporations that restated their financial statements increased from 83 in 1997 to 220 in the first six months of 2002. A total of 845 companies restated their financial statements between 1997 and 2002 (U.S. GAO 2002). Moreover, between 2002 and 2005, 16 percent of the companies listed on the three major stock exchanges announced restatements (Tillman and Indergaard 2007).

Table 1 presents the descriptive statistics. Because we analyze a panel dataset, the unit of analysis in this study is company year. The descriptive statistics are for the 3,955 company years included in the final analysis; 4.9 percent of the company years involve restated financial data. Although this percent is relatively low, the total number of companies restating during the study period is substantial (i.e., 21 percent). Moreover, because our study group consists of
the largest U.S. corporations, they represent a significant amount of the publically traded stock. Therefore, the potential impact of inaccurate financial statements by these corporations is substantial.

The mean return on equity is $11.32, the mean earnings per share is $6.19, and the mean annual change in share price is 62.34 percent. The mean number of mergers and acquisitions is 1.52, the mean annual change in asset growth is 17.8 percent, and the mean PAC contribution is $47,433. Finally, almost 80 percent of the cases are organized in multilayer-subsidiary form (79.3 percent), and 11 percent of the cases were subsidiaries at some time during the study period.

Table 2 presents the multivariate findings. Coefficients in Table 2 represent the exponentiated logistic coefficients, a transformation that allows one to examine the factor change in the odds that an event will occur. Each one-unit change in $x_k$ is expected to lead to a change in the odds by a factor of $\exp(\beta_k)$, holding all other variables constant. These coefficients can be used to compute the percentage change in the odds of event occurrence by computing $100[\exp(\beta_k) - 1]$, which represents the percentage change in the odds for each one-unit change in $x_k$, holding all other variables constant (Long 1997). This is the interpretation we use in the findings.16

Model 1 includes only the control variables (i.e., assets, age, divisions, long-term debt, and FIRE and New Economy sectors). Long-term debt has a statistically significant negative impact on the odds of restatement, and corporations in the telecommunications and information processing sectors are more likely to restate their financial statements than are corporations in other sectors.

Model 2 adds the three capital dependence variables: the standard measure for capital dependence, return on equity, and two measures of capital dependence on shareholders,
earnings per share and change in share price. Earnings per share has a statistically significant negative impact on the odds of restatement, which supports Hypothesis 2. Return on equity and annual change in share price are not statistically significant. Controls for the telecommunications and information processing industries remain statistically significant; debt is no longer statistically significant. This is consistent with our organizational-political embeddedness theory and historical contextualization, which suggests that debt financing became less important during our study period, as financial managers made greater use of equity financing.

Table 2. Exponentiated Coefficients for Predictors on Financial Restatement

<table>
<thead>
<tr>
<th>Variables</th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
<th>Model 4</th>
</tr>
</thead>
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<tr>
<td>Intercept</td>
<td>.033**</td>
<td>.042**</td>
<td>.037**</td>
<td>.020**</td>
</tr>
<tr>
<td></td>
<td>(.206)</td>
<td>(.225)</td>
<td>(.230)</td>
<td>(.293)</td>
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<td>Capital Dependence and Incentives</td>
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<td>Capital Dependence on Equity</td>
<td>Return on Equity</td>
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<td>1.000</td>
<td>1.000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(.003)</td>
<td>(.000)</td>
<td>(.000)</td>
</tr>
<tr>
<td>Capital Dependence on Shareholders</td>
<td>Earnings Per Share</td>
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<td>.942**</td>
<td>.941**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(.024)</td>
<td>(.024)</td>
<td>(.024)</td>
</tr>
<tr>
<td></td>
<td>Annual Change in Share Price</td>
<td>.998</td>
<td>.996**</td>
<td>.996*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(.002)</td>
<td>(.002)</td>
<td>(.002)</td>
</tr>
<tr>
<td>Management Strategies to Increase Shareholder Value</td>
<td>Mergers and Acquisitions</td>
<td>1.042*</td>
<td>1.044*</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(.019)</td>
<td>(.019)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Annual Change in Asset Growth</td>
<td>1.003**</td>
<td>1.003**</td>
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<td></td>
<td></td>
<td>(.001)</td>
<td>(.001)</td>
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<td>Opportunities</td>
<td>Organizational Structure</td>
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<td>Multilayer-Subsidiary Form</td>
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<td>(.236)</td>
</tr>
<tr>
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<td>Subsidiary</td>
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<td></td>
<td>1.583*</td>
</tr>
<tr>
<td></td>
<td></td>
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<td>(.219)</td>
</tr>
<tr>
<td></td>
<td>Political Behavior</td>
<td>PAC Contributions</td>
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</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(.001)</td>
</tr>
<tr>
<td>Control Variables</td>
<td>Total Assets</td>
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<td>1.000</td>
<td>1.000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(.000)</td>
<td>(.000)</td>
<td>(.000)</td>
</tr>
<tr>
<td></td>
<td>Age</td>
<td>1.002</td>
<td>1.001</td>
<td>1.002</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(.002)</td>
<td>(.002)</td>
<td>(.002)</td>
</tr>
<tr>
<td></td>
<td>Number of Divisions</td>
<td>.994</td>
<td>1.003</td>
<td>1.004</td>
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<tr>
<td></td>
<td></td>
<td>(.022)</td>
<td>(.022)</td>
<td>(.022)</td>
</tr>
<tr>
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<td>Long-Term Debt</td>
<td>2.664*</td>
<td>1.322</td>
<td>1.276</td>
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<td></td>
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<td>(.478)</td>
<td>(.609)</td>
<td>(.612)</td>
</tr>
<tr>
<td></td>
<td>FIRE Industry</td>
<td>1.108</td>
<td>1.142</td>
<td>1.205</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(.255)</td>
<td>(.263)</td>
<td>(.261)</td>
</tr>
<tr>
<td></td>
<td>Energy Industry</td>
<td>1.115</td>
<td>1.267</td>
<td>1.304</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(.243)</td>
<td>(.255)</td>
<td>(.256)</td>
</tr>
<tr>
<td></td>
<td>Telecommunications Industry</td>
<td>2.695**</td>
<td>2.852**</td>
<td>2.611**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(.323)</td>
<td>(.379)</td>
<td>(.387)</td>
</tr>
<tr>
<td></td>
<td>Informational Technology Industry</td>
<td>1.831**</td>
<td>1.837**</td>
<td>1.798**</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(.192)</td>
<td>(.199)</td>
<td>(.201)</td>
</tr>
<tr>
<td>N of Company Years</td>
<td>4,155</td>
<td>3,957</td>
<td>3,956</td>
<td>3,955</td>
</tr>
<tr>
<td>Likelihood Ratio X²</td>
<td>23.770**</td>
<td>33.195**</td>
<td>50.567</td>
<td>69.905**</td>
</tr>
<tr>
<td>X² Goodness of Fit Ratio</td>
<td>.997</td>
<td>.992</td>
<td>.996</td>
<td>.994</td>
</tr>
</tbody>
</table>

*p < .05; **p < .01 (two-tailed test).
Model 3 adds variables that give managers incentives to increase shareholder value: mergers and acquisitions and growth. Both variables are statistically significant and positively related to the odds of restatement, supporting Hypotheses 4 and 5. Change in share price has a negative impact on the odds of restatement, supporting Hypothesis 3. As in the previous two models, corporations in the telecommunications and the information processing sectors are more likely to file restatements than are corporations in other industries.

Model 4 adds variables to test the impact of management opportunities to commit financial malfeasance through organizational and political structures (multilayer-subsidiary form, subsidiary, and PAC contributions monitored by the FEC). The variables added to this model are all statistically significant. Corporate structure has a large effect on the odds of a corporation’s filing a financial restatement. Being structured as a multilayer-subsidiary form increases the risk of filing a financial statement by over 100 percent (112.9 percent), supporting Hypothesis 6. This means that corporations structured as the multilayer-subsidiary form are more than 2 times more likely than other corporations to restate financial data. Also, being structured as a subsidiary increases the odds of restating a financial statement by over half (58.3 percent), supporting Hypothesis 7. This suggests that being structured as a multilayer-subsidiary form or as a subsidiary presents opportunities for financial malfeasance not available to corporations organized in other ways.

PAC contributions also have a positive impact on the odds of restatement, supporting Hypothesis 8. Each $1,000 increase in PAC contributions increases the odds of restatement by .2 percent, and each $10,000 increase in PAC contributions increases the odds by 2 percent. Given that some companies do not have PACs, while some contribute as much as $890,000 through PACs, corporations at the high end of the scale have a large effect.

The incentive variables, mergers and acquisitions and growth, continue to have statistically significant positive effects on the odds of a corporation’s filing a financial restatement, supporting Hypotheses 4 and 5. The odds of restatement increase by 4.4 percent for each one unit increase in the number of mergers and acquisitions in which a company engages. Also, each percentage increase in asset growth increases the odds of restatement by .3 percent. Earnings per share continues to have a statistically significant negative impact on the odds of restatement, supporting Hypothesis 2. Odds of restatement decrease by 5.9 percent for each dollar increase in earnings per share.

After entering incentive and opportunity variables into the model, only the information technology industrial sector variable continues to have a statistically significant effect on the odds of restatement. This is an important finding for two reasons. First, it suggests that with this exception, corporate characteristics explain more about corporate behavior than do industrial sector characteristics. Second, it suggests that financial malfeasance was a cause of the dot-com bubble in the 1990s. Furthermore, as in Model 2, the control variables, and one capital dependence variable, return on equity, are not statistically significant. Size and age are not important determinates of financial malfeasance in our analysis. This may be because all of the companies in the analysis are large. Although there is substantial variation in these companies, it may not be sufficient to affect the rate of financial malfeasance. Age’s lack of statistical significance contrasts with previous research that suggests younger firms are more prone to malfeasance. Although there is substantial variation in these companies’ ages, they tend to be older firms, which may explain the lack of statistical significance on this variable. The lack of statistical significance of divisions shows that the subsidiary structure variables have large effects, while controlling for the multivisional form that some corporations continue to use.
CONCLUSIONS

This analysis supports organizational-political embeddedness theory; we find that corporate and state structures enacted in the 1980s and 1990s created dependencies, incentives, and opportunities for managers to engage in financial malfeasance. The Tax Reform Act of 1986 made the multilayer-subsidiary form viable, and subsequent public policy changes and state structures created opportunities to form large and complex corporations consisting of a network of subsidiary corporations organized under a single parent company. These structures enabled managers to engage in and conceal financial malfeasance.

Creating these giant corporations required tremendous amounts of capital, much of which was raised by stock and bond issuances in subsidiaries. Although this corporate form permitted management to make greater use of equity financing, it did not reduce capital dependence. Instead, equity financing made management more dependent on large investors who purchased corporate securities, which in some respects made them more vulnerable to external influences: continued growth was dependent on steadily raising stock values to satisfy large investors. The incentive problem was compounded by the increased use of stock options as a form of executive compensation. When managers hold stock options, and benefit from increased stock values, they have a further incentive to misrepresent corporate financial statements.

While these public policies created dependencies, incentives, and opportunities for management to engage in risk taking, the 2000 Commodity Futures Modernization Act created opportunities for management to transfer much of the risk to unsuspecting investors by using complex financial instruments in unregulated capital markets. This public policy was followed by an explosive growth of “market-based credit,” where banks continued to initiate loans but were permitted to sell debt using complex financial instruments (e.g., derivatives and collateralized-debt obligations). Investors were often unaware of the risk embedded in these financial instruments. Information asymmetry exists because these transactions are bilateral and private; they are not required to go through a clearinghouse (e.g., stock exchange).

Managerial power and autonomy in this social structure are due to (1) the financial and organizational flexibility of the multilayer-subsidiary form; (2) the asymmetry of information between management and most investors; (3) management’s position of authority in the corporate hierarchy that provides opportunities to create network ties with other managers inside and outside the corporation; (4) the emergence of social structures that permit capital transfers hidden from oversight agencies and the investing public; and (5) the lack of regulatory oversight. These organizational and political structures have important implications for society because they create incentives and opportunities for the managerial class to illegitimately exploit information to raise stock valuations. By doing so, they gain (1) direct resource benefits such as promotions and salary increases, and (2) indirect resource benefits such as increasing the value of their stock options at the expense of the investing public.

The power of the managerial class is at a historic high point because a power imbalance exists between corporations and the state. This power imbalance is due to the ongoing corporate political pressure on the executive branch, Congress, and the Courts to restructure public policy in ways that increase corporations’ financial flexibility and permit greater use of the multilayer-subsidiary form to pursue financialization strategies. The multilayer-subsidiary form’s embeddedness in the emergent state structures allows managers to make unregulated capital transfers among legally independent corporate entities. These state structures also permit the expansion of the over-the-counter derivatives markets (e.g., energy and mortgage), which allow managers to make unregulated capital transfers between firms. Dependent on equity financing (e.g.,
stocks), these arrangements structure managers’ motives and actions to increase shareholder value. In the absence of countervailing power (i.e., state regulatory structures), these social actors pursue financialization strategies that take advantage of information asymmetries and bridge structural holes to advance short-term shareholder value that, in many cases, inflate corporate balance sheets.

In some respects, contemporary political and corporate structures share characteristics with those that existed in the late-nineteenth and early-twentieth centuries. “Predatory businessmen” made widespread use of the holding-company subsidiary structure to advance their economic interests after state incorporation laws permitted its use in the 1880s and 1890s (Veblen [1923] 1967); by the 1920s, owners and managers used this corporate form to engage in financial malfeasance (Berle and Means ([1932] 1991). However, there are important differences in these historical periods. Unlike the early-twentieth century, contemporary information process technologies and financial instruments provide corporate management with more opportunities to mislead the investing public. Furthermore, a much larger portion of the public owns corporate securities either directly or indirectly through mutual funds. Contemporary conditions thus place a much larger portion of the population at financial risk.

These findings have important implications for public policy. The analysis shows that dependencies, incentives, and opportunities in the prevailing corporate and state structures explain financial malfeasance. This evidence paves the way for a shift in public policy away from market fundamentalism. Although incentives always exist to misrepresent corporate finances, the extreme faith in market solutions and the subsequent corporate and state structures seen in the late-twentieth century increases managerial autonomy, information asymmetries, and structural holes, which create opportunities for management to inflate corporations’ balance sheets. Laws and enforcement structures must be enacted to increase transparency of capital transfers between parent companies and their corporate entities and between corporations. In addition, public policies must be enacted that establish rigorous standards to determine financial risks and the value of corporate assets. Such interventions are necessary to recreate a balance between state power and corporate power in ways that limit managerial power. These interventions must constrain managers from externalizing the cost of their opportunism and financial malfeasance to society; increase protection for investors, especially small investors who are most vulnerable to the consequences of information asymmetry; and reduce the probability of future crises. This shift in public policy is an important step toward creating organizational and political structures necessary to restore economic and market stability and to facilitate a period of stable economic development.

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Notes

1. Although corporations are the unit of analysis, they cannot be separated from the conscious beings who make decisions that collectively contribute to corporate behavior. Even managers without sufficient power to directly engage in financial malfeasance are embedded in social structures that provide incentives to condone it.

2. The Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) attempted to impose limits on stock options, but in response to pressure from corporate lobbyists Congress passed a resolution that curtailed this effort.

3. This argument assumed that managers’ agendas, such as increasing the size of a corporation, conflict with shareholders’ agenda to maximize stock values.

4. One reviewer suggested that the multilayer-subsidiary form is similar to the conception of modularity in organizational analysis (Schilling and Steensma 2001). However, conceptions of modularity do not include property rights. This is critically important because independently owned firms have a much higher degree of autonomy from other members of the module than subsidiaries have from the parent company.

5. These amounts are in 2003 dollars, adjusted for inflation.

6. By 2000, financial speculation and stock overvaluation became so widespread in the multilayer-subsidiary form that some researchers questioned the capacity of the embeddedness of corporations in prevailing political-legal arrangements “to avoid events similar to those that preceded the stock market crash in the 1920s and 1930s” (Prechel 2000:265; see also Prechel 2003).

7. Glass-Steagall, a provision in the Banking Act of 1933, separated financial activities among commercial and investment banks. With the 1956 Holding Company Act, this legislation established barriers to bank and insurance company mergers.

8. The corporate lobby maintained that financial conglomerates could create effective “Chinese Walls” among corporate entities to ensure that decision-making information was not transferred among subsidiaries that had conflicts of interest.

9. During this campaign, financial firms contributed $6.7 million to political candidates. Enron alone spent almost $2 million lobbying government officials to permit energy trading on unregulated markets (Fox 2003).

10. These hypotheses are developed around the dependent variable of financial malfeasance, a single type of malfeasance; other forms of corporate malfeasance may reflect different causal processes and relations to the economic-political environment.

11. Between January 1997 and March 2002 alone, corporate financial restatements resulted in losses of approximately $100 billion in market capitalization (U.S. GAO 2002). Management benefitted substantially from misleading financial statements. For example, WorldCom’s CFO took approximately $35 million from stock sales prior to public exposure of financial malfeasance in the corporation (The Economist 2002).

12. To illustrate, commercial bank loans as a source of corporate debt financing were approximately 20.5 percent in 1980 and remained at approximately that level until 1986—the same year Congress enacted legislation to make the multilayer-subsidiary form viable. Corporate debt financing began to decline in 1987; by 1994, commercial bank loans represented only 14.5 percent of non-mortgage-related debt in nonfinancial corporations (James and Houston 1996).

13. Little was done by elected officials and oversight agencies to limit the use of off-balance-sheet entities in the post-Enron era. A report by a U.S. bankruptcy-court examiner concluded, for example, that prior to the 2008 bankruptcy of Lehman Brothers, the largest bank failure in U.S. history that set off the worst financial crisis since the Great Depression, management used “off-balance-sheet devices” to temporarily “create a materially misleading picture of the firm’s financial condition” by removing $38.6 billion from its balance sheet at the end of the fourth quarter in 2007 and $49.1 and $50.38 billion in the first and second quarters of 2008, respectively (Valukas 2010:732–33).

14. Given the incentives and opportunities for executives to restate data without punishment, we assume there are few cases where misleading financial statements were not restated. However, we are unable to test this assumption in our analysis and acknowledge this limitation.

15. One reviewer suggested we complete a trend analysis. However, we are interested in what occurred during this unique historical period characterized by deregulation, not whether a trend existed during it. Moreover, to properly model trends requires longer time series than we have here (McClearly and Hay 1980). A trend measure of the independent variables that includes the period of embedded and neoliberal political-legal arrangements would be interesting to explore, but it is beyond the scope of this article.

16. We performed an outlier analysis and found, using measures of Cook’s D, that none of the observations have a strong influence on the estimated coefficients.

References


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