Analyzing Illegal Corporate Behavior

Effectiveness of the Sarbanes-Oxley Act

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Abstract

This research will examine the effects of organizational environmental factors on firm illegal corporate behavior. Alternately, this research will examine the ability of the Sarbanes-Oxley Act of 2002 to moderate the relationship between prior violation committed and future illegal corporate behavior. Corporate Socially Responsible (CSR) behavior within business organizations will also be examined to determine its relevance in predicting illegal corporate behavior. Moreover, this research will provide an organizational level, five year pre and post historical analysis of legal behavior across Fortune 500 firms. Additionally, this research aims to determine if antecedents of illegal corporate behavior can be identified and if a corporate governance mechanism such as the Sarbanes-Oxley Act of 2002 can be an effective legislative tool impacting firm behaviors. The Sarbanes-Oxley Act itself will be analyzed as an event to determine its appropriateness in promoting ethical and legal behavior and effective corporate governance.

This research will examine Baucus and Near's (1991) model of the illegal and corporate behavior process to test its ability to predict illegal behavior within historically corrupt industries. Moreover, CSR as an embedded theme within specific firms and its implications towards both ethical and legal firm practices will also be examined.

Introduction

Many studies have identified the lack of strong corporate ethics and the need for evolutionary changes in current management and business practices both nationally and internationally. However, very little research has been conducted to determine how oversight mechanisms of corporate governance and a firm's adherence to socially responsible behaviors directly impact corporate corruption itself.

The lack of strong corporate ethics and fiscally responsible behaviors within corporations over the last decade created the need for the enactment of more external corporate controls, to include enforcement of regulations to monitor and control private industry financial practices. This need for greater corporate accountability is demonstrated through recent acts of U.S. corporate corruption. Additionally, this need is further evidenced by the fact that U.S. corporate corruption has become rampant and efforts to attain great wealth have led to unethical business practices. Furthermore, the focus on the attainment of wealth has led some firms to engage in both irresponsible and/or illegal firm behaviors to achieve their ultimate goals. Thus, indicating a need for greater corporate accountability. Therefore, an organization's overall decision to comply

or not comply with legislation to guide ethical and legal practices may prove highly contingent upon the respective firm's: behaviors, composition, resources and the socially responsible behaviors of the firm members themselves. Therefore, the theoretical analytical framework for this research will be examined through the lenses of identified antecedents to illegal corporate behavior – environmental antecedents, internal antecedents and situational antecedents (Aldrich, 1979) that facilitate firm activities. Moreover, the antecedent conditions that describe a firm's environment will be examined theoretically through an analysis of Baucus and Near's model of the illegal behavior process. This theoretical analysis will provide a conceptual structure outlining the environmental dimensions of corporate firms.

Recent Acts of U.S. Corruption and Corporate Crime

Several U.S. companies to include Adelphia, Healthsouth, McKeeson, Tyco, Refco, and Quest have recently been investigated for fraudulent activities (Brickley, 2003). "These investigations have led to criminal charges against over ninety corporate owners, executives and employees, and the investigations are still ongoing (Brickley, 2003, p. 358)". In addition to these findings, by August 2003, 18 Enron executives had been indicted for acts of corporate fraud. It should be noted, however, that pragmatic implications of the relationship between firm size and an organization's likeliness to engage in illegal corporate acts within respective industries has not been clearly identified.

In response to unethical corporate practices demonstrated by several American Chief Executive Officers (CEOs) and Chief Financial Officers (CFOs), the U.S. federal government developed legislation to strictly govern corporate fiscal behaviors. This action was a strategic response based on the recognized need for a higher degree of compliance to both ethical and legal corporate standards. Moreover, this was a reaction based on the need to implement a strategic initiative to address inadequate processes of measurement and control due to weaknesses in laws, regulations and pronouncements in external control measures (Heier, Dugan, & Sayers, 2005). Likewise, the need for further legislation is reflective of a lack of public trust in not only corporate executive officers to govern their corporations not only ethically, but also legally and responsibly. Likewise, it also indicates a lack of trust in corporate governance boards to appropriately oversee firm activities.

The SOX act may prove to be a significant piece of legislation moderating corporate ethics. However, little research has been conducted to determine the ability of SOX to moderate the ethical corporate behaviors of firm's within historically corrupt industries. Likewise, whether or not SOX moderates socially responsible business practices and ethical and legal firm behaviors has yet to be determined. Additionally, the influence of SOX as an effective mechanism of corporate control on firms within historically corrupt U.S. industries themselves has yet to be explored.

The theoretical background for this prospectus will be antecedent conditions to illegal behavior as described by Aldrich (1979) and Baucus and Near's (1991) model of predicting corporate illegal behaviors and the illegal corporate behavior process. Aldrich (1979) identifies three key environmental dimensions representing firm characteristics independent of leader personality variables. These variables are described as scarcity, dynamism, and heterogeneity (Aldrich, 1979). Furthermore, Baucus and Near (1991) introduced situational variables that are related directly to instances of firm illegality.

Environmental Antecedents

Aldrich's (1979) formulation has shown to be important in understanding the role the environment plays on adaptive organizational behavior. Baucus and Near's (1991) research examined Aldrich's (1979) assertions through studying the illegal acts committed by all *Fortune 500* companies between the periods of 1974-1983. The authors compared this sample with 104 randomly selected non-convicted firms to compare firm similarities and differences by industry. This study revealed five key findings: 1.) illegal activities occur under uncertain conditions, 2.) large firms are more likely to commit illegal acts than small firms (although probability increases when sources become scarce), 3.) illegal behavior is prevalent in fairly stable environments, but is more probable in dynamic environments, 4.) membership in industries with a repeated history of wrongdoing are associated with illegal acts, and 5.) the type of illegal activity may be dictated by the environmental and internal conditions under which the firm operates (Baucus & Near, 1991). The authors conclude that environmental munificence, environmental dynamism, firm size, industry**,** three or more prior violations, and type of violations could be utilized to predict illegal corporate behavior. A significant relationship has been found between these organizational environmental factors and the performance, structure, and strategy of organizations (e.g., Keats & Hitt, 1988; Davis, n.d.). Moreover, corporate corruption has identified complex environments as conducive to illegal activity (Baucus, 1994). Two concepts hypothesized within this dissertation to significantly impact illegal corporate behavior are munificence and dynamism.

Munificence

Castrogiovanni (1991) defined environmental munificence as the scarcity or abundance of resources available in an environment and demanded by one or more firms (Davis, n.d.). Organizations competing in environments characterized by high levels of dynamism may need to show more flexibility to adapt to the changing environment, and to assist in ensuring the organization's survival (Mascarenhas, 1986).

Dynamism

The construct of dynamism is comprised of numerous variables including: 1.) speed in which the environment is changing (stability-instability), 2.) turnover rates, and 3.) predictability and unpredictability contributing to uncertainty (Davis, n.d.). Organizations competing in environments characterized by high levels of dynamism must have greater flexibility to adapt to a changing environment (Mascarenhas, 1986). Moreover, Mascarenhas (1986) posits that dynamism is an important factor that assists in ensuring an organization's survival.

Study Purpose

The purpose of this study is two-fold, to explore the SOX act's ability to function as a corporate governance mechanism to moderate corporate socially responsible behavior and ethical firm behaviors, and to determine if illegal corporate acts (leading to corporate corruption) can be predicted. Historical data of illegal criminal corporate behavior will also be gathered to test the antecedents of Baucus and Near's (1991) model of predicting corporate illegal behaviors. Moreover, this research will provide a historical analysis of firms criminally prosecuted five years prior to, and five years after Sarbanes-Oxley act implementation. This historical analysis of Sarbanes-Oxley corporate activities will be utilized to determine the overall influences of SOX and its ability to moderate the relationship between corporate social responsibility and other behaviors specific to firms.

Research Objective

Through this study, this researcher will attempt to answer the research question: How are antecedents to illegal firm activities impacted by corporate governance mechanisms (i.e. SOX) and corporate socially responsible behavior?

Significance of Study

This study contributes to the advancement of the corporate reform literature by providing an analysis of the composition and characteristics of historically corrupt industries. Moreover, it examines the fundamental composition of U.S. firms to study antecedents of corporate corruption. Additionally, this study will serve as a five year pre and post event analysis of the effectiveness of the SOX Act to perform as an effective corporate control mechanism.

This study is important because it may assist corporate boards and government legislators to understand factors influencing illegal corporate behavior. Additionally, this study intends to examine the impacts of corporate reform efforts on specific firm behaviors. Moreover, SOX Act criminal punishment provisions will be examined to determine their impact on firm adherence to external and internal ethical and legal provisions. The impacts and consequences for failure to meet expected government standards of compliance under SOX will also be examined.

Relevant Studies in Corporate Corruption

Clinard and Yeager's (1979) study revealed that, between the years 1975-1976, 60% of the largest U.S. public corporations (n=582) had criminal actions initiated against them, and nearly half of all firms were alleged to have committed multiple violations. Additionally, Simpson (1986) conducted a longitudinal study examining anti-trust criminal activity of 52 U.S. firms over a fifty-five year period. Her research specifically examined the effects of corporate corruption on the larger economy.

Baucus and Near's (1991) research examined antecedents of illegal firm behavior through studying types of criminal acts committed by 88 convicted *Fortune 500* firms from the period of 1974 to 1983. The authors used a comparison group sample of 104 non-convicted *Fortune 500* companies. Alexander and Cohen (1996) expanded the literature on corporate illegal behavior through their examination of criminal acts of 77 public manufacturing corporations between the period of 1972 to 1994. The authors' utilized a variety of archival data to provide an exhaustive review of the legal literature including the following sources: Wall Street Journal Index, Corporate Crime Reporter, keyword searches on Lexis-Nexus legal data base, Anti-trust Trade and Regulation Reporter, and a periodical report by the U.S. Environmental Protection Agency (Alexander & Cohen, 1996). The authors' research suggests that larger corporations with larger sales transactions and higher numbers of employees typically have more opportunities to engage in criminal acts. Their research revealed a total of 120 convictions of 101 U.S. public corporations convicted between the time period 1975-1992, including 55 fraud conviction cases (Alexander & Cohen, 1996). Through their research, the authors' found two significant findings as follows: 1.) larger firms are more likely to engage in crime than smaller firms, and 2.) low rate of sales and employment (or employment growth) by a firm is a good predictor of environmental crime (Alexander & Cohen, 1996).

Utilizing Baucus and Near's (1991) model of the illegal corporate behavior process, this researcher intends to explore antecedents to illegal corporate behaviors indicating corrupt practices within the context of U.S. corporate (*Fortune 500*) companies.

The hypotheses utilized within this study are listed as follows:

H1: Firms having a high degree of environmental munificence (abundant resources) will have lower levels of illegal corporate behavior.

H2: Firms having high levels of environmental dynamism will have a high degree of illegal corporate behavior.

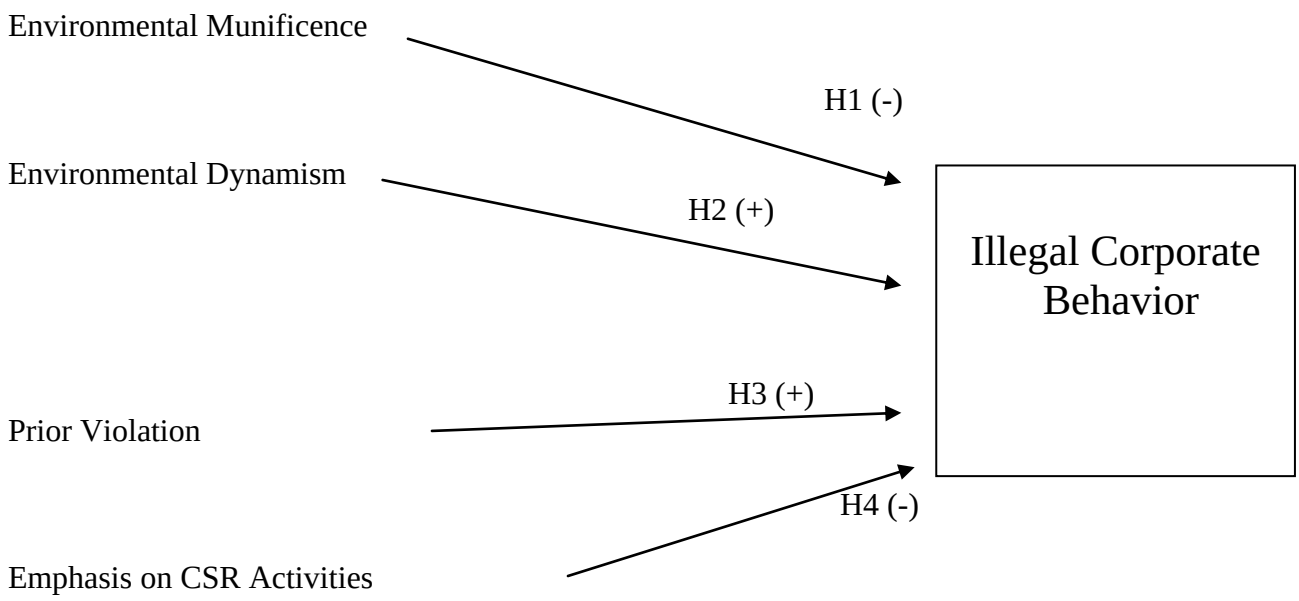
H3: There will be a negative correlative relationship between seriousness of violation committed and illegal corporate behavior.

H4: There will be a negative correlative relationship between a strong emphasis on corporate socially responsible firm activities and illegal corporate behavior.

H5: The Sarbanes-Oxley act will positively moderate the relationship between seriousness of violation committed and illegal corporate behavior.

Thus, I propose enhancements of Baucus and Near's (1991) as indicated in Figure 1 below:

Figure 1 - Factors Leading to Illegal Corporate Behavior



***SOX Act of 2002 (corporate governance mechanism) – Moderating Variable**

Environmental Munificence	The scarcity or abundance of resources available in an environment and demanded by one or more firms.
Environmental Dynamism	Speed in which the organizational environment is changing from stability-instability and the

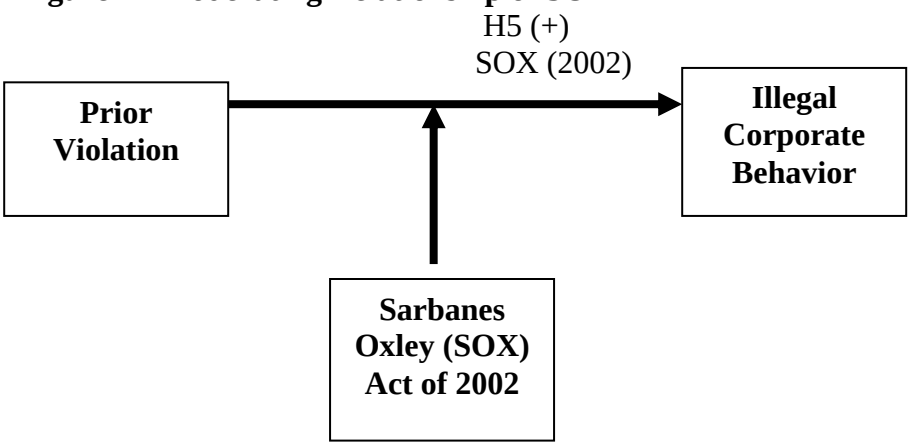
	predictability and unpredictability of this change contributing to uncertainty
Prior Violation	The level of offense classification of firm violation resulting in criminal prosecution and conviction.
Emphasis on CSR Activities	A firm's commitment to embrace behaviors that promote corporate social responsibility.
Illegal Corporate Behavior	Corporate behaviors resulting in illegal acts committed by firms leading to criminal conviction for violations of legal compliance standards.
Sarbanes-Oxley Act of 2002	Federal legislation developed as a mechanism for corporate governance regulation/ standards compliance.

Control variables = firm size; industry membership; prior violations

Figure 1 above outlines this study's independent variables, dependent variable and the direction of the proposed relationships.

Figure 2 below describes the hypothesized moderating relationship between prior criminal incidents and illegal corporate behavior:

***Figure 2 - Moderating Relationship of SOX**



Moderating variable = the Sarbanes Oxley Act of 2002 as a corporate governance mechanism

Prior Violation	The level of offense classification of firm violation resulting in criminal prosecution and conviction.

Sarbanes-Oxley Act of 2002	Federal legislation developed as a mechanism for corporate governance regulation/ standards compliance.
Illegal Corporate Behavior	Corporate behaviors resulting in illegal acts committed by firms leading to criminal conviction for violations of legal compliance standards.

Sample Selection

A search of prosecution and conviction data of Fortune 500 firms convicted of 'white collar' crimes from the above sources for the years spanning 1990-2007 resulted in the identification of 50 convicted firms and a total of 126 convictions for crimes designated as 'white collar'. This sample of 50 identified firms convicted by the courts was drawn based on available conviction data obtained through the information sources listed above. Each instance of corporate corruption will be treated as a separate observation. Moreover, multiple data sources will be utilized to triangulate data source findings and identify all incidences of firm convictions. Additionally, a list of comparable non-convicted Fortune 500 firms (matched based on industry type and firm size) will be generated to create a matched pair dataset of both convicted and non-convicted firms. Likewise, the sample of 50 non-convicted Fortune 500 firms was randomly selected (based on firm size and respective industry type for the time period 1990-2007 (total sample size - N=100). This time period will provide a total of 1,800 firm year's worth of financial data. The four-digit SIC industry code will be utilized to indicate the number of both convicted and non-convicted firms identified by major industry type. The four-digit industry code was selected within this research to further describe firm types and specify what sector within industries individual firms operate within their primary markets.

Matched pair design was utilized within this study to create pairs of firms that are similar in both industry type and sales (firm size). Matched firm pairs were constructed by pairing each of the identified convicted firms (n=50) with a comparable non-convicted firm match (n=50), (total sample size - N=100) based on the following characteristics: firm size (dummy code: 1 = small, 2 = medium, 3 = large); industry type (designated by use of the four digit SIC code); firm sales (per million). Additionally, firm matches will be created at the same point in time. For example, a firm with a conviction in the year 1990 will be matched with a non-convicted firm at the same point in time based on the above aforementioned characteristics. Each of the qualifying non-convicted firms eligible for consideration based on the above criteria will be assigned an identifying number. A random generator calculator will then be utilized to select each individual non-convicted firm to create matched firm pairs.

The four digit Standard Industrial Classification (SIC) code will be utilized to categorize each industry and delineate each firm's membership within its respective industry.

Table 1 below operationally defines key variables utilized within this research. Moreover, this table describes the statistical methods to be utilized to test each respective variable as well as applicable data collection sources.

Table 1: Variable Data Sources, Definitions and Measures

Variable	Type of Variable	Hypothesis	Direction of Relationship	Scale	Operationally Defined as:	Source	Measure(s)
Environ-mental Munificence	Independent	*H1:* Firms having a high degree of environmental munificence (abundant resources) will have lower levels of illegal corporate behavior.	negative (-)	Interval/ Ratio	The scarcity or abundance of resources available in an environment and demanded by one or more firms.	Industry sales data obtained from the *U.S. Statistical Abstract* (1990-2007) (Wiersema & Bantel, 1993) and Standard and Poors' Compustat II database (Sutcliffe, 1994).	Growth in total sales (revenues) calculated by dividing the regression slope of the coefficient by the mean value of sales of firm across each respective industry, through two distinct time periods (1990-2001; 2002-2007) (Keats & Hitt, 1994; Dess & Beard, 1984; Sutcliffe, 1994).
Environment al Dynamism	Independent	*H2*: Firms having high levels of environmental dynamism will have a high degree of illegal corporate behavior.	positive (+)	Interval/ Ratio	Speed in which the organizational environment is changing from stability-instability and the predictability and unpredictability of this change contributing to uncertainty.	Industry sales data obtained from the *U.S. Statistical Abstract* (1990-2007) (Wiersema & Bantel, 1993). Return on Equity information obtained through Standard and Poor's COMPSTAT II.	Regression of collected sales (revenue) data and ROE of *Fortune 500* firms through two distinct time periods (1990-2001 and 2002-2007) (Keats & Hitt, 1998).
Prior Violation	Independent	*H3:* There will be a negative correlative relationship between seriousness of violation committed and illegal corporate behavior.	positive (+)	Interval/ Ratio	The level of offense classification of firm violation resulting in criminal prosecution and conviction.	*LexisNexis* – USDOJ; Corporate Fraud Task Force. Event history analysis of *Fortune 500* industry firms convicted of illegal corporate acts (by type) - 1990 to 2007; USDOJ Corporate Fraud Task Force federal conviction data.	Historical analysis of violations committed resulting in criminal prosecution and conviction between 1990 and 2007.

Emphasis on CSR Activities	Independent	*H4:* There will be a negative correlative relationship between a strong emphasis on corporate socially responsible firm activities and illegal corporate behavior.	positive (+)	Interval/ Ratio	A firm's commitment to embrace behaviors that promote corporate social responsibility.	CSR emphasis as indicated through company reporting of CSR Activities (Aupperle, Hatfield & Carroll (1985; 1983).	Measure of Central Tendency – Content analysis of described CSR terms reported through company web pages. A string search of the term 'corporate social responsibility' (and other related terms) will be conducted on each identified company's website.
Firm Size	Control	NA	NA	Ordinal	The size of the organization as recognized by industrial standards.	Fortune Magazine corporate firm size ranking for all *Fortune 500* companies (small, mid-sized, large) for convicted and non-convicted firms. Archival/historical analysis of *Fortune 500* firm size classification within industries from 1990 to 2007.	Dummy variable – coded 1 = small firm; 2 = medium sized firm; 3 = large firm
Number of prior violations	Control	NA	NA	Interval/ Ratio	The number of prior incidents resulting in reported violations against a particular firm.	*Fortune 500* industry firms convicted of illegal corporate acts - 1990 to 2007; USDOJ Corporate Fraud Task Force federal conviction data.	Measure of Central Tendency - descriptive statistics – number of convictions
Industry Membership	Control	NA	NA	Nominal	The type of business sector in which goods and services are sold or manufactured.	Four digit Industry Standard Industrial Classification (SIC) code representing respective industries (U.S. Census Bureau, 2008).	Analysis of *Fortune 500* firms by industry classification type - 1990 to 2007; *U.S. Statistical Abstract*

Prior Violation	Control	NA	NA	Ordinal	The classification of the firm violations resulting in criminal acts resulting in conviction.	USDOJ Corporate Fraud Task Force federal conviction and Corporate Crime Reported Conviction data. .	Expert panel analysis of prior firm violations committed through Historical analysis of Fortune 500 firm conviction abstracts. Used to assess seriousness of prior convictions by offense level and type for the period-1990 to 2007 utilizing Table 5: Seriousness of Offense Codebook (see APPENDIX A). Measured by identifying firms with three or more prior violations and performing using the identified violations against time
Illegal Corporate Behavior	Dependent			Nominal	Corporate behaviors resulting in illegal acts committed by firms leading to criminal conviction for violations of legal compliance standards.	USDOJ Corporate Fraud Task Force conviction data; *Lexis-Nexis* - historical analysis of *Fortune 500* industry firms convicted of illegal acts (by type) - 1990 to 2007	Logit regression analysis of covariates environmental munificence environmental dynamism for both convicted and non-convicted firms against time for two separate time periods (1990-2001 and 2002-2007). Coded : 1– non-convicted firm; 2 – convicted firm;
Sarbanes-Oxley Act of 2002	Moderating	*H5:* The Sarbanes-Oxley act will positively moderate the relationship between prior violation committed and illegal corporate behavior.	positive (+)	Nominal	Federal legislation developed as a mechanism for corporate governance regulation/ standards compliance.	USDOJ Corporate Fraud Task Force conviction data; Lexis-Nexis; Corporate Reporter	- Quantitative Analysis of SOX act's ability to moderate legal corporate behavior. - Scatterplot of number of reported convictions for Sarbanes-Oxley act offenses -Expert panel analysis of the heinousness of crimes committed both pre-and post SOX Act

							enactment. Dummy variable: Coded 1, post-Sox enactment, 0 otherwise.

Summary of Data Collection and Procedures

In summation, data collection for this research will include the collection of archival/historical conviction data from relevant reputable sources documenting corporate criminal acts. These secondary data sources include: 1.) Lexis-Nexus; 2.) 2002 Corporate Fraud Task Force; 3.) Corporate Crime Reporter. Data utilized to obtain firm corporate financial reportings will be acquired from the following sources respectively: 1.) Standard and Poor's COMPUSTAT II; 2.) U.S. Statistical Abstract. Additionally, data collected to examine the independent variable industry reputation for CSR behavior will be derived from content analysis of corporate website reportings of CSR related activities.

A search of Fortune 500 firms convicted by the courts during of the period 1990-2007 was conducted to determine the quantity and type of criminal violations committed by corporate firms. The four-digit SIC code representing each industry was utilized to indicate the illegal acts committed by each firm within its respective industry. A convenience sample of available conviction data of 50 convicted Fortune 500 firms was selected and compared with 50 non-convicted Fortune 500 firms (N=100). Logistical (logit) regression analysis techniques will be utilized to determine the maximum likelihood of predicting illegal corporate behavior utilizing two main explanatory variables – environmental munificence and environmental dynamism. Moreover, stepwise regression will also be utilized to model the data through two separate time periods to determine the impact of the SOX act of 2002 on illegal corporate behavior.

Limitations of the Research

Threats to Research Validity

Internal Validity

This research has several recognizable threats to internal validity. First, selection bias was inevitable based on the need to match all convicted Fortune 500 firms with a comparable firm within its respective industries. Likewise, industries that do not have a high degree of corporate convictions will be underrepresented within this research sample. Second, a social threat exists because this research attempts to test the mediating effects of the SOX act to foster legal corporate behavior. That is, it will be difficult to ascertain if the SOX Act itself fostered change within corporate America or if this possibly occurred as a result of other contemporaneous events. Third, due to the time-series focus of this study firm maturation will likely occur resulting in changes in corporate management. Fourth, using corporate websites as a proxy for assessing corporate firm CSR activities has some notable limitations. Due to the fact that CSR is broadly defined throughout literature streams, firm CSR activities can range from environmental protection activities to a firm's social, legal, ethical and philanthropic responsibilities to its various stakeholders. Therefore, the major CSR categories utilized to obtain these data within this body of research were adapted from Maignan and Ralston's (2002) CSR scheme. The authors' CSR scheme will be modified within this dissertation to distinguish between more broadly defined CSR activities reported by firms and social, ethical, and legal aspects of CSR impacting firms and their stakeholders. Therefore, CSR areas examined throughout this dissertation research will be limited to: corporate code of ethics, sponsorships, charitable donations, and employee volunteerism programs. Environmental aspects of firm CSR activities

will not be examined within this dissertation research as they are not within the purview of this study.

This researcher will attempt to control for threats to internal validity by: 1.) selecting a random assignment of non-convicted Fortune 500 firms that is comparable in industry and firm size (determined by volume of sales/revenue per million) -adjusted for inflation from year to year over the ten year period; 2.) describing in the limitations section of this research significant legislation and/or historical events that could otherwise explain extreme variance in research findings of both the dependent and independent variables.

External Validity

Several notable threats to external validity are apparent within this dissertation research. First, due to the fact that the research sample will lack industry stratification, the empirical findings of this research will only be of intrinsic value to specific industries. Also, this research is limited due to the fact that the sample of convicted firms selected was nonrandom. Moreover, due to this fact this study will lack generalizability across all Fortune 500 industries. Second, the random assignment of a matched sample of non-convicted firms may introduction selection bias into the research sample.

Conclusion

In conclusion, the lack of strong corporate ethics and fiscally responsible behaviors within corporations over the last decade has created the need for more external corporate controls, to include enforcement of regulations to monitor and control private industry financial practices. This need is promulgated by the need for greater corporate accountability, as demonstrated through recent acts of U.S. corporate corruption. Additionally, this need is further evidenced by the fact that U.S. corporate corruption has become rampant and efforts to attain great wealth have led to unethical and illegal business practices. This research aims to provide additional insights into antecedents to illegal corporate behavior, as well as identify industries where corporate corruption thrives. Moreover, this research intends to examine the relationship between corporate social responsibility and legal and ethical behavior corporate behaviors.

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