

**FIFTEEN MINUTES OF SHAME: A MULTILEVEL APPROACH OF THE
ANTECEDENTS AND EFFECTS OF CORPORATE ACCOUNTING SCANDALS**

by

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Dedication

I dedicate this material as a humble gift to the massive effort of those who helped me walk through this journey. I hardly believe there could be a more valuable gift from a person to their family than the one done with love and one's own hands. This is my gift to my family.

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Fifteen Minutes of Shame: A Multilevel Approach of the Antecedents and Effects of Corporate Accounting Scandals

Abstract

by

JESUS RODOLFO JIMENEZ-ANDRADE

The commonality of corporate scandals and the quest for who should be accountable motivates this investigation. I used a mixed method multilevel design that combines qualitative and quantitative data from organizations, executives, and capital markets, to address the research question of who is accountable in reputational scandals. The evidence suggests that reputational risk exposure increases when organizations' and executives' values are not aligned. Managers' values mediate the implementation of organizational values toward risk assessment. This counterintuitive finding suggests that securities value is not automatically depressed after scandalous events. Instead, shareholders dissipate potential doubt about the stability of firms, guided by analysts' revised expectations rather than judging ethical implications. As a consequence, executives may not face investors' disapproval, which would encourage them to focus on preventive efforts. Organizations and executives must align their ethical values to proactively protect their organizations' reputations. Financial performance indicators of firms do not influence the behavior of investors after scandals.

Keywords: corporate scandals; organizational values; risk assessment; reputational risks; executives' compensation; capital market response; analysts' opinions

CHAPTER 1: RESEARCH PROBLEM, QUESTION, AND MOTIVATION

Research Problem

The world more than ever is witnessing corporate reputational scandals from companies they trust and rely upon. Disappointingly, some events have an accounting related component that in many instances compromise also the whole profession. There should not be a higher concern than society habituates to witness these events.

Eradication was promised after the Enron's scandal with a new set of rules that inhibit business wrongdoings. Yet, everyone wishes that such a promise would be truthful.

In the public's lens debate, someone must be accountable for leading the company through such social scrutiny. In the accusations, the blame could be posited in either the companies, individuals who work inside, or even regulators. Anyone who could be linked somehow to the event is potentially liable. Public scrutiny attempts to entail who has the fault with arguments such as deception or negligence. The argument of deception commonly refers to the betrayal of certain expectations, not mentioning fraud or falsehood. For example, "X" company misbehaved this way, or "Y" individual intentionally did that. Negligence, in contrast, denotes everything else that could be done to prevent the event from happening. Both arguments rely upon not only the vulnerability of the organizations that allowed the causes to become an actual scandal but also on the individual's behavior leading to that in the first place.

The social debate on whether organizations or individuals are or should be responsible for their actions exists in the academic realm as well. Heugens and Lander (2009) clearly articulate this debate. Academic researchers focused on institutions argues that organizational structures in the quest legitimacy shape isomorphically overtime, and

failures can be explained by the inability to achieve healthy operational environments because of aspects such as conformism or bureaucracy (DiMaggio & Powell, 2000; Oliver, 1991). The counterargument narrative explains organizational success as the sum of agents' initiatives. Failures are explained by the incapacity of aligning individuals' and organizations' thriving that lead to entrepreneurial behavior (Eisenhardt, 1989; Fama & Jensen, 1983a; Jensen & Murphy, 1990). This material recalls on both practitioners' and academics' concerns about who should be accountable for organizational failures that have particularity to the reputational component subject to social scrutiny.

Research Questions and Motivation

The social and academic debate of who is responsible and what could be done to prevent the event motivates this research by analyzing the nature of the antecedents and effects of those reputational events. Specifically, this study investigates the role of organizational structures and the individual's involvement in the process of publicly known organizational failures. So, the overall research question (RQ) explores: Who has accountability in corporate reputational scandals?

To address this central concerns, this dissertation focuses first in understanding the nature of the events from the organizational lens because in the public's eyes, it seems that they represent the first who could be accountable for the events by questioning (RQ₁): What is the experience of organizations attending to and mitigating reputational threats attributable to themselves or to external parties, whether or not they are affiliated with the organization? Then, I investigate the involvement of the individuals responsible to operate those organizations with the question (RQ₂): Do agency theory predictions—align incentives and monitoring—adequately address ways of effectively attending to

reputational threats facing high and low reputational scandal probabilities? And finally, the study centers the attention on firms' capital market investors to understand (RQ₃) how this group responds to these reputational events since they represent who has the most at stake as owners of the company.

The overall structure of this material follows a multilevel approach to explore the antecedents and effects of reputational events. This chapter represents the research introduction and research questions and motivation. Chapter 2 offers a detailed literature review applicable to the overall objectives. Chapter 3 explains the research design. Chapter 4 inquiries into organizational systems dynamics involved in the reputational maintenance process. The behavior of those individuals in charge of the firms' reputation is analyzed in Chapter 5. Chapter 6 focuses on the capital markets reaction to one specific reputational event. Dissertation findings, conclusions, and limitations are presented in the final chapter, Chapter 7.

CHAPTER 2: LITERATURE REVIEW

Introduction

Under traditional ongoing business, Penrose (2009) explains that organizations have an intrinsic ability to grow. Organizational growth thrives from the organization's capacity to adapt to circumstances. In contrast, an organizations stagnation occurs due to incompetent management, low fundraising capability, lack of adaptability, an expensive judgment, or random bad luck. These components that compromise growth exist during a reputational crisis. This chapter elaborates the theoretical foundation to explain the delicacy and fragility of organizations' reputations, and specifically, the theoretical justification of why executives who are in charge of decision-making processes must deal with the responsibility to successfully protect firms' names and to prevent any reputational disaster because the tragedy of failure manifests in others (victims) affectations.

Organizations are complex environments where multiple human relationships interact simultaneously (Meyer & Rowan, 1977; Perrow, 1972). During the timeframe of reputational crisis, multiple entities react abnormally (out of the traditional context). In this sense, publicly listed organizations, which leverage funds from the trust of others, have to realize that such trust-bonds create a link that raises the level of the environmental complexity.

This piece explores using the current available theoretical framework to explain how the concept of reputation evolved over time and how the evolution reached the quality of theory. Then, we focus on the interrelation between top executives' actions, the ongoing circumstances during the reputational crisis, and the value that investors place on

firms' reputations. In order to do so, the structure is: first, the theoretical explanation of the reputation, then managerial behavior, followed by the theoretical analysis of the capital market responses and the dynamics of the responses.

Building the Concept of Reputation

Reputation and Players

In recent times, the effect of reputation or common people's opinion became widely observed and analyzed by economists in the early 1980s. The original intent for defining such concern derived from the economic perspective in the form of game-theoretic models presenting an experience for others of the company's behavior (Kreps & Wilson, 1982: 253; Lewis, 1986: 152).

Further studies modeled a two-player game pricing competition for the coffee industry between major firms (P&G and Maxwell House) that explained how corporations behaved as a "tough" or "benevolent" player from the predator perspective. But in those sequential games, like in any other game, the behavior was defined by the payoffs, implying that the perceived reputation of others may alter the outcomes of the game behavior (Camerer & Weigelt, 1988: 27; Milgrom & Roberts, 1982: 281).

Reputation and Customers

The first implication of reputation as a differentiator in people's opinions of corporate perception involved a link with corporate strategy. The first related study was based on quantitative price-quality research about the goods contained in the consumer reports in 1963 and 1964 in order to reveal that the public built trust with firms, if the quality of the product meets the expectations from the customer-supplier perspective—originally defined as corporate credibility (Nelson, 1970). Moreover, but shaping and

specifying the concept of corporate reputation, the customer-supplier quality relation was presented as an incentive not only to those customers but also to other competitors. Such action of sending messages or information to the market implying any type of strategy, behavior, or reaction, that is observable by others was defined as market signaling; in this case, creating a quality reputation competitive scenario between participants with the objective of social status maximization (Spence, 1974).

However, the theoretical concept of corporate reputation that links consumers' perceptions with product quality derived to non-advertising effects was defined by the level of expected product quality that consumers acknowledge to signals of potential quality referrals—like refund policies, warranties, among others—with limited extent for monopolist activities, where additional product information played a significant role in quality perception (Ausubel & Deneckere, 1989; Shapiro, 1982: 21).

In the same vein, but theoretically modeled, customer behavior with the implication of reputation presumed that high product quality companies tend to attract and retain more consumers because of the lower level of dissatisfaction, encouraging other customers to spread the word-of-mouth (Rogerson, 1983: 508), empirically tested with consistent results by a sample of 89 observations of the large-scale nationwide industrial survey of General Electric Supply using estimating catastrophe models (Oliva, Oliver, & MacMillan, 1992).

Reputation and Financial Markets

Another area of study explored the concept of reputation derived from building a conceptual relation for corporate behavior with financial markets perceptions. The theoretical explanations about one of the mechanisms of market efficiency that derives

from asymmetry in information from public investors and actual companies performance suggests that corporations borrow other's reputations, like investment bankers, as a reputational intermediary at the moment of trading the companies' securities for mitigating any existing asymmetry (Gilson & Kraakman, 1984: 618). Such a theoretical approach was empirically qualitatively tested with newly enlisted companies¹ with consistent results about the fact that intermediaries borrow their reputation to corporations; especially if there is a presence of intense asymmetry from adverse selection and moral hazard in Initial Public Offerings (IPOs). The model referred that newly enlisted companies and the market relied on the investment bankers' reputations (Beatty & Ritter, 1986: 227; Carter & Manaster, 1990: 1062; Carter, Dark, & Singh, 1998: 302), the security analysts' reputations (Stickel, 1992: 1831), and the auditors' reputations (Balvers, McDonald, & Miller, 1988; Beatty, 1989: 620); suggesting that markets react to those participants reputations to increase the level of knowledge from new enlisted companies.

Reputation and Stakeholders

These earlier studies indicated a corporate action and individual market reaction—by consumers, competitors and financial markets—until reputation was integrally studied from the stakeholders' positions. The theoretical explanation suggests that the level of success of the reputational effort as a part of meeting the stakeholder's expectations is manifested itself in the form of a company's assets in which firms' and individuals' investments required them to analyze short-term or long-term benefits challenged by the ex-ante and ex-post investment (Wilson, 1985). Confirming such

¹ All of those research focus in all the enlisted companies, but in different periods of time and approaches.

corporate reputation stakeholders' approach, assuming information asymmetry, was empirically analyzed through a quantitative survey that included approximately 4,000 executives of the 292 Fortune's corporations with conclusive results about the fact that corporate reputation is defined by managers as a firm's market competition for reputational social status, because the stakeholders construct the corporate reputation from a mix of several performance signals: accounting, institutional, market and strategy signals (Fombrun & Shanley, 1990: 234).

Moreover, an empirically quantitative research based on America's Most Admired Corporations made by Fortune 1000 firms results implied that superior-performing companies have more opportunities for maintaining such superior-performance for longer periods if they hold a relatively worthy reputation (Roberts & Dowling, 2002: 1990).

The concept of corporate reputation is considered as the corporate action of market signaling that influences market perception that creates an asset based on strategy and performance subject to a non-static building process with a certain level of status (Podolny & Phillips, 1996: 455) that delivers valued outcomes to its stakeholders from a competitive process (Fombrun & Shanley, 1990: 234).

Reputation Management

Advertising

Under the scope of the original concept of corporate reputation, there are many adjacent implications, especially with the role of the corporations facing its own reputation. Previous qualitative studies of the Fortune 1000 list reflect from the perspective of stakeholders that media does not necessarily contribute to explaining

corporate reputation (Wartick, 1992: 78). Although it has been studied through an empirical quantitative research with 416 students from a required business course and social psychology that advertiser reputation and claim have a positive relation with product evaluation, it is only supported when reputation is positive (Goldberg & Hartwick, 1990: 178).

In relation to positive reputation, one of the results of the last section of research suggests that, in fact, media scrutiny has a strong effect on firm reputation because of the communication alignment with the corporate image, except for diversified firms (Fombrun & Shanley, 1990: 253).² One explanation that has often been stated is that the corporate reputation and corporate communication have to be aligned in the same direction of the company's public perception, in that sense that the resulting effect supports the reinforcement of the company's image, according to a qualitative study of 170 graduate MBA and Executive MBA students (Dollinger, Golden, & Saxton, 1997: 10).

Intermediaries and Resources

In other lines of research, some internal activities represent evidence that companies' reputations are managed from the inside. As it was theoretically modeled, corporations with reputable financial intermediaries selection process become critical for mitigation of moral hazard information asymmetry, especially in IPOs (Chemmanur & Fulghieri, 1994a: 76). A qualitative research evidenced such particularity with historical data of 2,292 enlisted companies in a six-year period, with consistent results about the

² Research described in last section.

theoretical model, suggesting that the better rank of the investment bankers, the longer were the future returns of the companies trading security prices (Carter et al., 1998).

An analogous influence of adverse selection and moral hazard mitigation and the relation with corporate reputation was theoretically modeled through the lens of cost of debt and reputation, that suggested that the cost of financing has a relation with corporate reputation (Diamond, 1989). A similar theoretical model, but from the lens of the credit channel, suggested that a credit channel's ability to acquire a strong reputation as an information reviewer creates an incentive to allocate more inside resources to the information production process about firms—especially applicable to those firms with financial distress, considering that non-distress companies tend to assess debt from financial markets (Chemmanur & Fulghieri, 1994b: 476). Such models were then empirically supported by a quantitative and qualitative research of 2,338 new publicly traded financing debts, presenting evidence that reputation improves information asymmetry mitigation process of lenders and borrowers. The results evidenced that cost of debt has strong explicability with the company's reputation, and that credit channels relied on their ability to build a strong reputation as an information reviewer (Denis & Mihov, 2003).

Monitoring

Concerning perception of reputation and product characteristics, theoretical models suggest that permanent product quality monitoring processes contribute to reaffirming the company's reputation if the consistency of the expected product quality is repeated over time (Milewicz & Herbig, 1994: 43). An empirical quantitative study between twenty-four graduate students contributes to supporting such model establishing

that rendered services and products that are permanently quality monitored for assuring consistency and repetition contributes to a sustainable positive reputation (Herbig, Milewicz, & Golden, 1994: 30).

Collective Reputation

A different theoretical approach establishes that reputation viewed as an intangible asset by collective reputations in associations or groups, implies that the individual reputations of each member are determined by collective reputations, and back and forth. Where individual members have incentives to sustain strong positive reputation for the sake of the reputation group if not, leave the group (Tirole, 1996: 18), and in order to maintain the group reputation, groups tend to select individual new members based on reputation (Tadelis, 1999: 28). Two different empirical studies were conducted to demonstrate the above. The first one is a qualitative study related with the quality of the apples Red Delicious produced from the State of Washington during a twenty year period that demonstrates that individual incentives were not aligned with the overall quality outcome (Winfrey & McCluskey, 2005). The latter was based on 240 surveys about the carrot consumption in Italian supermarkets, concluding that the acceptance criteria for new producers was the heterogeneity of the product quality as a driver of carrot collective reputation quality (Scarpa, Thiene, & Marangon, 2008).

Reputation Risk

The original intent of the theoretical risk definition is placed under gambling and uncertainty decisions among alternatives with a probability distribution (Fisher, 1922: 323). Based on such uncertainty, it has been theoretically suggested that individuals and organizations seek to maximize the expected utility in the gambling process (Hicks,

1931; Marshall, 1920). The maximization of the expected value derived from alternatives involving risk situations (Neumann & Morgenstern, 1947). From all the possible alternatives, theory suggests that decision-makers are willing to accept a premium for a moderate level of risk, without being too high or low (Friedman & Savage, 1948) according to the relative level of income and other factors from the perspective of individuals (Arrow, 1951: 405).

Corporate Risk

Just as individuals are willing to accept a premium for some level of risk, corporations are willing to absorb a 'prima'; with such level of 'prima', firms are forced to invest and obtain income. The unpredictability of income has been theoretically defined as risk-return (Tversky & Kahneman, 1974). Moreover, a quantitative analysis based on 288 enlisted companies suggested that the relation between income performance and facing risk has an inverse relation, stating that corporate income is subject to a mitigating variance process (Bromiley, 1991).

Empirical quantitative and qualitative research of 435 IPOs, presented evidence that the riskier the firms, managers will have less managerial incentives and compensations for a riskier decisions. In this case, it is implied that managerial incentives are aligned to avoid riskier scenarios for greater compensations, unless incentives are align to riskier decision (Zajac & Westphal, 1994).

Reputation Risk

Based on the definition of reputation mentioned above, when the stakeholder's expectation of received value is not being met, the negative effect for the company's reputation eventually impacts the economic performance of the company, and eventually

a loss of economic and stakeholders value, unless those expectations are being met again. Such fluctuation between economic value and stakeholder's—market—expectation value has been theoretically defined as reputational capital (Fombrun, Gardberg, & Barnett, 2000: 87). Therefore, the theoretical definition of reputation risk that has been suggested implicates the range of possible gains or losses in reputational-capital (Fombrun et al., 2000).

Organizations and Agents

Perrow (1972) introduces the agent problem within organizations. An agent–manager operates as the responsible person for the decision-making process of organizations. This person occupies the functions that principals (or owners) cannot perform. The tension arises when agents' and principals' interests differ. Ross (1973) articulates the principal-agent conflicts in the moral hazard terrain. Principals invest their trust in agents to maximize their benefits. But agents may not share the same goals inadvertently to the principal (Hölmstrom, 1979). To compensate such disassociation, Jensen and Meckling (1976) separate ownership and control within organizations and propose the alignment of financial interest through equity compensations.

Yet, through the alignment of financial interests (or risk-bearing), executive performance also plays a determinant portion of the overall managerial performance. Fama (1980) elaborates on the agent conflict that financial interest only represents one part of the conflict, while monitoring performance represents the second major piece. To address this issue, this seminal material introduces the concept of efficient monitoring. Managers' behaviors as organizational controllers require attention. Because not every investor can exercise the supervision role, the collective body designates a governance

board in charge of the managers' monitoring (Fama & Jensen, 1983b). This board serves the representative duties of diligently oversight managers' performance.

Managers' Risk Behavior

In the principal-agent theoretical world, organizational issues could be explained as a conflict-interest problem. But, if managers' incentives are aligned with the principals' interests and the board monitors the executives' performance, why do organizational misconducts that lead to scandals still exist?

With equity agreements, managers share with investors some of the financial preference utility function (Arrow, 1984). Interest in capital gains motivates both principal and agents. In essence, their financial benefits will derive from economic growth, profitability, and securities holding period (Fama, 1970). In order to achieve such goals, managers make organizational decisions expecting future organizational financial profits (Simon, 2013). Investment decisions include risk-bearing business opportunities (McConnell & Muscarella, 1985). Traditional business decisions include mergers or acquisitions, R&D developments, new business-line investment, etc. Any financial decision involving uncertainty to expect future gains contains an element of risk. Managers analyze the likelihood of success or failure based on the risk assessment. The risk-bearing managerial decisions are the first major component of this theoretical foundation. Managers are paid not only to perform their daily responsibilities but also to pursue the similar interests of owners, including the risk-bearing investment decisions.

Role of Board of Directors in Managers' Behavior

The second component to induce an adequate executive behavior is the monitoring duties of the Board of Directors. Boards install policies and regulatory

environments within organizations (Meyer & Rowan, 1977). In such a regulatory environment, boards filter managers' decisions to improve potential success. Weak regulatory environments decrease internal control effectiveness (Meyer & Rowan, 1977). The effects of weak control translate into ineffective monitoring. The adequacy of managerial decisions suffers as a consequence. For example, boards with limited financial involvement may not require strict controls in the financial statement preparation process. Flexible controls open the possibility to questionable executives' behaviors.

Capital Market's Reactions

Traditionally structured organizations operate as coordinated systems with common grounds (Meyer & Rowan, 1977). They evolve and grow over time (Perrow, 1972). In order to accomplish the original design, organizations raise funds from outsiders. They can do so by issuing equity into the capital markets. Stock prices fluctuate over time with respect to the financial organizational performance (Ball & Brown, 1968). Fama, Fisher, Jensen, and Roll (1969) draw an analysis where investors expect to obtain profits from buying and selling securities. But the willingness to trade derives from the expected rather than the actual performance. This is largely because of the time-gap from the acquisition time and the issuance of the financial information. Capital market users estimate potential gains from organizational public news.

The process operates under certain efficiency since everyone has the same access to information (Fama, 1970). Security prices reflect such information. Fama (1991) explains that this particular process of adapting prices to new information evidences the effectiveness of the markets. Prices incorporate good and bad financial news.

Organizational capital investments have positive effects in the markets as signs of growth and stability (McConnell & Muscarella, 1985).

Efficient market theory also suggests that investors make decisions from selecting an optimal portfolio based on their risk profile (Fama, 1991). The optimal selection explained by Lintner (1965b) argues that investors select which specific securities will be part of their portfolios (named as the problem of selecting). Investors have multiple risk profiles and preference (Grinblatt & Keloharju, 2001). Maximum levels of risk-averse prefer risk-free investments. In contrast, less risk-averse profiles have much more diversified portfolios. The portfolio composition depends on the risk profile (Subrahmanyam, 2008). So far, the bond between investors and portfolio selection has not been widely explored by the academic literature. Besides the optimal risk portfolio selection, there is little formal documentation about investors' qualitative preference for brand name or organizational activities as selection criteria.

Bondt and Thaler (1985) suggest that capital markets overreact after dramatic or unexpected news. The overreaction argument stands in the pre-portfolio selection process. Capital market users forecast expected returns based on the historical performance of the organizations. The expected returns include risk-premiums such as financial or systematic. Investors select financial firm value to make those predictions (Kothari, 2001; McConnell & Muscarella, 1985). The overreaction from capital markets is a consequence of not including in the estimations unexpected or sudden events. After the news announcement, high risk-averse and investors may turn into risk-free investments because of the overreaction if they consider that the announcement will not perform in the future as expected.

Not all investors will leave the organizations. Those who are less risk-averse can hold losses until potential gains. They maintain the investment for longer periods. Losing portfolios are more reluctant to dispatch investments (Bondt & Thaler, 1985). By avoiding short selling, prices stop from larger dramatic falls (Lintner, 1965b). As time goes on, prices will negatively adjust to bad news as the capital markets become aware (Fama et al., 1969), and the opposite with good news. Investors' reactions to scandals is still unexplored and a matter of this manuscript.

Corporate Accounting Scandals

Reputational scandals challenge organizations' stability. In an ongoing traditional business context, organizations develop and evolve in stages or life cycles. Scholarly literature divides the life cycle stages into birth, growth, maturity, and revival (Miller & Friesen, 1980). Scandals, as an organizational failure, may occur at any moment across life cycles endangering organizations, shareholders, and stakeholders (Gillespie & Dietz, 2009).

The definition of corporate reputational scandals stands in the disposition to speak of an informant (internal or external) who do not agree with the outcome of a decision maker (Molotch & Lester, 1974). Such information may spread using media, governmental agencies, or social networks. The type of scandal differs in substance and essence. This proposal covers scandals related to accounting malpractices, tax lodging, information security breaches, malfunctioning products, and corporate environmental practices.

Accounting Malpractice

Commonly referred to as accounting scandals, these types of scandals derived from an inappropriate behavior during the preparation of financial statements. In this piece, the applicable accounting malpractice refers to financial statement restatements (Agrawal & Chadha, 2005; Chakravarthy, DeHaan, & Rajgopal, 2014). Although restatements may not be a necessary intentional behavior to deceive capital markets, those practices reflect a serious accounting reporting irregularity (Hennes, Leone, & Miller, 2008). Restatements document corrections to such accounting errors (Gertsen, van Riel, & Berens, 2006; Palmrose, Richardson, & Scholz, 2004). As a consequence, capital markets negatively react to those restatements (Wilson, 2008).

FCPA Violations

FCPA investigations represent violations of Section 13 of the SEC Act and the FCPA. Authorities initiate prosecution of confidential whistleblowers' claims. The legal actions are conducted under secrecy to the public as established on internal procedural protocols. Their inquiry focuses on analyzing the involvement of organizational personnel in domestic or international bribery practices to obtain certain benefits in exchange for an economic compensation.

Examples of the acquired illegal benefits are unusual awarded contracts, special permits, or uncommon bargains to the organization outside the United States. Although the agents' motives for incurring in such illegitimate practices could be vast, the ultimate consequence benefits their firms financially. Authorities veto and prosecute these unlawful extra profits by sanctioning those involved as well as the companies. Usually, the fine tends to be substantially higher to firms.

Although the investigation process rarely ends with a jury trial, the final press release informs the absolution of the criminal charges under an economic settlement. This is because regulators and firms tend to prefer the certainty of a settlement or ‘resolution vehicle’ rather than a noxious and subject to scrutiny jury trial (Koehler, 2010). The amount to be paid is fixed by authorities and firms’ managers without disclosing to the public any details of the calculation basis.

Scarce is the academic literature concentrated in understanding the social consequences of FCPA violations. Most of the available materials emphasize the relevance of prevention to avoid unnecessary legal contingencies. For example, Huskins (2008) emphasizes the potential legal liabilities that may affect firms’ economic performance because of a weak control environment that could allow bribery practices if detected by authorities. Karpoff, Lee, and Martin (2014) document that after the prosecution of an FCPA violation, firms’ net present value is negative contrasting with ex-ante values because of the associated costs such as the settlement. However, once these violations reach to the public domain and investors become aware of the investigation details revealed by the SEC or the DOJ, their reaction and their motivators remain unexplored.

Academic literature articulates how securities’ prices adjust to public news under normal conditions. Fama’s (1991) narrative illustrates that investors exchange such titles in keeping with their expectations which are shaped as new information about the investment performance (good or bad) becomes available. Financial outperformance enhances value; underperformance decreases the price. Good news reflects organizational achievements, which makes others willing to invest, thus creating the opportunity for

capital gains. Other investors' desires create a window for such gains. In light of the information flow, capital markets operate under an essential premise: everyone outside the firm has access to the same information (Fama, 1970, 1991).

Under the principle of general access to information, organizations' disclosure obligations cover both financial and nonfinancial aspects relevant to investors (Verrecchia, 2001). Failure to comply represents a violation of access rules especially when organizations engaged in illegal practices, such as FCPA violations, somehow obtain benefits. However, in this type of violation, not only the illegal practices are ignored by the market, the investigation itself is ignored as well. Yet, this information is known by authorities and executives involved in the process.

The secrecy of the FCPA investigation process creates an asymmetry of unknown information to the market. Information asymmetry tends to repress securities value once negative events are known (Healy & Palepu, 2001). For example, financial statements fraud with artificially inflated numbers diminishes the value of securities once discovered because of the revaluation of non-financial costs such as reputational losses associated to the event (Karpoff, Lee, & Martin, 2008a, b). In this sense, the first theorized hypothesis predicts the influence on investors' behavior of non-financial costs. Once markets become aware of the investigation, its implications, and the resolution, investors will respond to such new information. Since the event represents a legal violation, the reputational penalty will trigger a negative reaction in stock returns.

Tax Misbehavior

Reputational scandals concerning tax issues occur when media uncover tax aggressive strategies (Hanlon & Slemrod, 2009). This aggressive strategy refers to

shifting or ‘lodging’ corporate earnings from one taxable regime to a lower corporate tax rate regime (Desai & Hines Jr, 2002b). Desai and Hines Jr (2002a) documents that, organizations reduce taxes by modifying their corporate structure in order to shift major earnings to lower taxable regimes by changing fiscal domicile. Everything remains equal but with a different tax regime and lower corporate tax rate. The ultimate purpose of the strategy ends with a reduction in their consolidated tax expense.

Although not necessarily an illegal practice, but ethically arguable, tax lodging strategies create a debate in the academic literature. One side argues that shareholders positively reward organizations that minimize corporate tax expenses (Davidson & Worrel, 1988; Desai & Dharmapala, 2009; Dyreng, Hanlon, & Maydew, 2008). The contrasting perspective suggests that aggressive tax schemes create unnecessary contingent liabilities to organizations subordinated to authorities legitimate criteria (Hanlon & Slemrod, 2009; Slemrod & Yitzhaki, 2002).

Information Security Breaches

Breaches in organizations’ security often represent a common observable event in media. This type of reputational scandal occurs when outsiders or insiders perpetrate an organization’s security protocols (Bulgurcu, Cavusoglu, & Benbasat, 2010; Campbell, Gordon, Loeb, & Zhou, 2003). Criminals seek vulnerable weaknesses in the security systems with the objective of extracting data for obtaining illegal profits (Cavusoglu, Mishra, & Raghunathan, 2004). The stolen data tends to be sensitive private, legally protected information about the organization, its clients or stakeholders (Goel & Shawky, 2009; Telang & Wattal, 2007). Two different scandals partition the data breach:

confidential and non-confidential (Campbell et al., 2003). This proposal narrows the analysis of confidential information breaches.

The scholarly literature documents serious economic consequences of confidential data security breach scandals. Capital markets adversely react to data breach announcements (Campbell et al., 2003; Kannan, Rees, & Sridhar, 2007). Associated costs of the breach relate not only to the actual event (short-term) but also to subsequent periods (long-term) after the event (Cavusoglu et al., 2004). Some of the costs include a decrease in business interactions and productivity, containment, repairmen, legal resources allocation, and a long-term cash-flow reduction as consequence of the loss of trust (Campbell et al., 2003; Cavusoglu et al., 2004).

Product Quality

Product quality (or malfunctioning) represents those reputational scandals associated with a defective component (or the whole product) that prohibits a product to run as originally designed. If malfunctioning products have potential negative affectations to consumers' health, those products require withdrawal or 'recall' from the market (Jarrell & Peltzman, 1985; Zavyalova, Pfarrer, Reger, & Shapiro, 2012).

Consumers negatively perceive organizational product recalls (Rhee & Haunschild, 2006). An overall deception reigns from the implicit social contract (of expected quality) breach between clients and organizations (Morrison & Robinson, 1997; Zavyalova et al., 2012). Shareholders also react to malfunctioning products. Capital markets anticipate a decrease in cash-flow as a consequence of the scandal (Hoffer, Pruitt, & Reilly, 1988; Jarrell & Peltzman, 1985).

Social Responsibility Scandals

Social responsibility³ (or sustainability⁴) related scandals evidence an unethical misbehavior or wrongdoing from an organization to their business environment (Wooten & James, 2004). Scandals of this nature emerge as a consequence of wealth maximization driven activities compromising stakeholder value.⁵ Scandals begin once an insider(s) denounce(s) communication to others about the organizational misbehavior.

Although an ongoing academic debate on whether social responsibility practices improve organizational financial performance (Sen & Bhattacharya, 2001), scholarly literature firmly stands on the consequences social irresponsibility. For example, irresponsible activities to society affect stock market returns once proved illegal (Davidson & Worrel, 1988).⁶ Consumers penalize corporate irresponsibility by decreasing economic interactions (Brown & Dacin, 1997; Sen & Bhattacharya, 2001).

³ The most used definition for CSR reflects on “the social responsibility of business encompasses the economic, legal, ethical, and discretionary expectations that society has of organizations at a given point in time” (Carroll, 1979: 500).

⁴ Social sustainability practices is contextualized by the most applied definition as “the overall social responsibility of business, evolving from the principles of legitimacy, public responsibility, and managerial discretion” (Montiel, 2008: 252).

⁵ Carroll (1979) documents as social issues “consumerism, environment, discrimination, and occupational safety among others.”

⁶ Davison & Worrel (1988) focus on events once the scandal occurs in the time horizon, but the legal consequences are announced some time later.

CHAPTER 3: RESEARCH DESIGN

Mixed Method Design

Because the research objective is to understand the corporate scandal phenomena using a multilevel analysis, the overall research design first (Study 1) gathers and analyzes real organizational experiences to question under what circumstances they successfully (i) prevent and (ii) overcome a reputational event. Then (Study 2), we induced actual executives to a reality simulation to understand their individual incentives facing potential scandals. The last segment (Study 3) analyzes collected data from the capital markets about real reputational incidents to understand how investors judge the circumstantial outcomes. The overall findings report is presented in the final portion of the research. The research data analysis follows the QUAL→QUANT→QUANT methodology.

Findings integration analysis contrasts the organization's perspective with the executives' behavior prior the event. Organizations provide the overall contextual diagram using a qualitative analysis. Then, results represent the contextual scandal circumstances that serve as support for the experimental instrument which is administered using a reality simulation scenario to individuals. This experiment uses quantitative data for analyzing executives' behavior. Quantitative findings from the experiment of individuals' behaviors are contrasted with the organizational qualitative results. This process helps to better understand the differences between organizations' and individuals' behaviors regarding the factors that precede reputational events. Then, a similar analysis is performed; but once the event happens, and between the organizations' anecdotes and the capital markets. The purpose is to triangulate the organizations',

executives' and investors' perceptions pertaining to a comprehensive examination of the corporate scandal phenomena.

Study 1: Qualitative Research

The qualitative piece of this study draws from an overview of the full research design. Because managers are the ones who went through the event, we postulate the research question: What is the experience of organizations attending to and mitigating reputational threats attributable to themselves or to external parties, whether or not they are affiliated with the organization? The primary objective is to understand the organizational perspective of what happened and how they responded after the event.

Data was derived from 27 different organizations and experiences using semi-structured interviews. The collection process consisted of recording and transcribing de-identified interviews. Then, using a qualitative data comparative analysis commonly known grounded theory, I coded line-by-line to allow the patterns to emerge. I looked specifically for those aspects that trigger the event, such as organizational failures, ethical misbehaviors, or any other signal that could potentially lead to a better understanding of the phenomena, and how they respond to such an event. Also, I looked for those elements that enabled organizations to prevent events.

Once I allowed the concepts to emerge, I compared with the current theoretical understanding of the scandals phenomena. Because there is little in the academic background, I used part of the model the current practitioners' guidelines for assessing organizational assurance. The guideline that applies to a better risk assessment is denoted as COSO Internal Controls Integrated Framework. By doing so, the closest theoretical understanding refers to how organizations design and implement internal controls to align

the objectives of the organizations with those of shareholders and stakeholders (Bedard & Graham, 2011; Biggs & Mock, 1983; Caplan, 1999; Krishnan, 2005).

Separately, because organizations are also aware of their environment and the relevance of their identity, I also ground this research in the burden of the management of their reputation. By increasing the levels of awareness of the value that creates the identity or name of the organization, shareholders value is maintained long-term (Fombrun & Shanley, 1990). Adding this theoretical component allows us to ground that going through a negative reputational event may compromise firms' value (Suchman, 1995). Although so far, the awareness of scandals is not yet explored in the managerial arena, the notion of avoidance negative events as the opposite of the relevance of reputational value applies into the organizational mindset (individuals' aversion to scandals is explored in Study 2). Deeper details of the study, the collection process, and the findings are presented in Chapter 4.

Study 2: Quantitative Experiment

Once I understood the overview of scandals, I then explored the executives' behavior towards corporate events. The analysis of their behavior consists in inducing executives into a reality simulation experiment to analyze under what circumstances they are more likely to proact and prevent a potential corporate reputational event. To analyze their responses, the setup consisted of understanding the individual's motives behind the managerial decisions. Specifically, the simulation included different potential downturns in their expected personal losses and distinct risk bearing scenarios. Real executives had to agree or disagree with a specific strategic response in light of a potential scandal.

The idea behind the personal losses and potential reputational risk stimuli come mainly from the academic literature concentrated in explaining agents' behaviors towards risks. The previous chapter elaborated that agents will be willing to align their incentives with the organizational incentives using compensating mechanisms such as equity-based remunerations (Eisenhardt, 1989). This indication is tested in light of facing potential reputational risk scenarios because the executives' responses may not necessarily align with the goal of the firms' maximum value.

I argue that executives' responses to mitigate potential reputational events largely depend on two fundamental elements. Individuals' attitudes towards risk in terms of mitigating the likelihood of the event is also a function of gains and losses (March & Shapira, 1987). The first element (or the gains) depends on the severity of the risk. Under highly severe scenarios, managers may opt for a more aggressive response because of the likelihood of an event to become real motivates such a reaction. There is an intangible gain of preventing the event; therefore, the reaction should be in order to protect the firm's reputation. Less severely intense threats may not be sufficient for individuals to respond.

The second element (or the losses) represents the potential cost of making a decision under uncertainty. Low levels of losses cheapen the alternative of making decisions. However, with high losses, in concrete high personal losses, the risk attitude could become less aggressive. Allowing the threat without an effective managerial response will allow the potential negative event to occur. In this case, the potential outcome of the alternative of not doing anything results more affordable to managers (March & Shapira, 1987).

These two substantive elements are the basis of the theorized process in Study 2, presented in Chapter 5. The interaction term is also analyzed as an integral component because it is common to observe that the severity and the decision cost be present simultaneously to executives. In addition to that, this study connects not only the qualitative data using the general overview that lead to a real scandal, but also includes one the organizational components in charge of the assurance of the business continuity. In this sense, the study includes the role of internal auditors.

Internal auditors have the oversight responsibility of the investors in firms (Spira & Page, 2003). Their responsibilities include the monitoring the overall firms' activities and the adherence of individuals to the internal regulations that serve as guidelines in the organization's values. In other words, they represent a fundamental element in the corporate governance of organizations. Internal auditors' involvement in the daily activities has a primary focus the organizational stability. They do so by detecting potential breaches from individuals in the compliance environment (Bedard & Graham, 2011). I tested and compared their responses facing reputational threats with those responses from executives. The theorization process is widely explained in Study 2 in Chapter 5.

Study 3: Quantitative Archival Research

For the third component of the dissertation analysis, I selected a single reputational event that contained the elements of Study 1. The study seeks to understand how investors in the capital market respond after a reputational scandal. Having this objective, the research question is: How do capital market' returns reflect the consequences of corporate scandals? This question seems convenient because it helps to

not only understand the relevance of reputational breaches in investors' mindset but also exemplify the evolution of reputational event from the reputational threat until the final consequence to investors. Specific details of the study are presented in Chapter 6.

In order to address such a question, first, I used the overall description from Study 1 to understand the factors that promote such events. In this storyline, the reputational event selected was international corruption violations regulated in the United States. The phenomenon fits with the logic of the analysis because the event is informed by society in one day. Jurisdictional agencies operate the investigation under secrecy. Therefore, the public is not informed about the event, the investigations, or any details that may link to prejudice the event. Also, the event itself, because of the involved firms and the story, has the potential to attract the media. Besides these two informational components, the scope of the regulatory agencies includes publicly traded companies listed in the local securities market. Because the whole market is informed in a single moment and evidence from misbehaviors such as fraud indicate a negative response from capital markets, I theorize that the stockholders' returns will be negative after the event.

Due to the details in the press release that communicates to the public about the investigation, the analysis could include a potential economic effect on the overall market response. The selected violations have a tendency to end in a legal settlement that avoids a public trial. This information represents the first theorized hypothesis in the analysis. Under the traditional securities' valuation, the effect of unexpected expenses that will be recognized in future profits decreases the value of the assets. Therefore, the next hypothesis includes the downturn in stockholders' returns due to the economic penalty.

Because there is a belief component inside of the valuation of assets, I include the influence of experts in the decision-making process of investors. Financial analysts represent the closest experts available to investors. The opinion of these characters has been widely explored in the study of capital market reactions. They represent not only the field experts, but because of their high involvement in the firms' daily activities, the credibility in the capital markets has great influence. The third hypothesis states that how analysts perceived the event influences the final outcome in the stockholders' returns.

The last hypothesis acknowledges effects of both the economic settlement and the analyst's influence beliefs into the final effect over the stockholders' returns. This hypothesis is grounded in the revised expectations that investors must exercise to simultaneous sources of information. The press plays a determinant role in informing about the event, but investors may not judge the event until they have confirmation of the one who has their trust and confidence. The interaction of effect is the basis of the final hypothesis.

Triangulation Methodology

I triangulate the overview of the qualitative findings in two moments. The first sequence compares from the qualitative with the experimental research findings. Such comparison is done before the real emergence of a reputational event. The second momentum compares the finding from the qualitative piece, but with the capital market research and the experimental findings. Then, the last stage integrates and triangulates the three studies.

The three studies are connected in the settings. From the qualitative piece, I selected the experience of one of the participants to create the experimental reality

simulation scenario. I selected the launching of a new product from a pharmaceutical company. This story was told similarly in two different versions from participants. Although there were some major discrepancies between the two stories, the commonality is that when a product has a major defect, the product should be recalled. However, when the product does not have a major defect, it is at the discretion of the firms' policy whether or not to recall the product. This setting served as a guide to develop the general overview of the settings. The experiment manipulated the side effect of a new product defect.

However, in the qualitative stories, I did not observe the presence of personal intentions in the overall process. During the interviews, participants referred to the organizational welfare, values, risks, and experiences. They did not include personal feelings or motivations. Therefore, the experimental design included a component of personal economic costs. The manipulation of expected losses allowed the consideration of individual incentives in the analysis of risks mitigation. The manipulation included higher or lower personal decision costs depending on each circumstance.

Then, this last manipulation connects with the capital markets research because the stimulus referred to personal expected losses. In the experiment, expected losses represent a downturn in their stock option compensations anticipating the financial costs reflected in the stock prices (Fama, 1991). In the archival study, the dependent variable represents the stock returns in a certain horizon (three and eight days) of the event. Therefore, the experiment links with the archival research in the expected returns from the capital markets.

The capital markets research is also connected with the qualitative research because the selected scandal in the archival research represents FCPA violations. These international bribery acts are scandals informed by the SEC or the DOJ. In their official report, the authorities detail the evolution of the firms' misbehavior. I triangulate how the events evolved over time with the findings of the qualitative research.

From this triangulation process, I validate the consistency and the sequence of the stories from the qualitative inquiries. Then, I also validated the experimental setup as realistic because it also matches with real events. Finally, the stock prices performance is also consistent in the experimental research and the archival research. Therefore, findings across the research are not only integral and valid findings, but reliable across them as a single mixed method research.

CHAPTER 4: QUALITATIVE ANALYSIS OF ORGANIZATIONS' EXPERIENCES WHILE DEALING WITH REPUTATIONAL SCANDALS

Introduction

Scandals which jeopardize the reputations of major corporations occur constantly and may be directly caused by the corporations' own actions or triggered by external parties. One high-profile example, which did serious damage, occurred in 1998 when Nike was accused of child slavery⁷ based on the fact that underage workers were employed by outsourced Asian manufacturing firms. A more recent example is the 2013 accusation faced in Europe by Burger King,⁸ one of whose principal meat suppliers allegedly mixed horse meat with the beef used in hamburgers. Burger King's reputation was severely affected as a result.

Organizations often respond to such a scandal by making public announcements citing their governance environment (Chakravarthy et al., 2014; Zavyalova et al., 2012). The most appropriate governance standards instrument available to corporate managers is COSO (2013);⁹ paradoxically, however, most of these announcements reference improvements to governance made *after* the event. Nor have such scandals disappeared after the most recent guidance was issued in 2013: such events continue to occupy news headlines and damage corporations' reputations.

The available literature explores the effects which negative reputational have on organizations' performance (Davies, Chun, da Silva, & Roper, 2004; Dellarocas, 2003;

⁷ *The N.Y. Times* (May 13, 1998): <http://www.nytimes.com/1998/05/13/business/international-business-nike-pledges-to-end-child-labor-and-apply-us-rules-abroad.html>. Accessed [April 15, 2015].

⁸ *The Huffington Post* (February 6, 2013): http://www.huffingtonpost.com/2013/02/06/burger-king-uk-reputation-horsemeat_n_2631445.html. Accessed [May 7, 2015].

⁹ "Internal Control, Integrated Framework" (2013) by the Committee of Sponsoring Organizations of the Treadway Commission. Hereafter, the reference for this material is COSO (2013).

Ghose, Panagiotis, & Sundararajan, 2009; Keh & Xie, 2009; Kotha, Rajgopal, & Rindova, 2001; Mahon & Wartick, 2003; Solove, 2007; Walsh, Mitchell, Jackson, & Beatty, 2009). Stakeholders such as consumers and suppliers decrease or eliminate business interactions (Demiroglu & James, 2010; Dollinger et al., 1997; Helm, 2007); likewise, shareholders and lenders in capital markets are forced to react in such scenarios (Armour, Mayer, & Polo, 2010; Black, Carnes, & Richardson, 2000; Chung, Eneroth, & Schneeweis, 2003; Perry & De Fontnouvelle, 2005). Persistent negative reputation could mean the end of the organization as a viable entity (Molotch & Lester, 1974).

Most prior scholarly research regarding reputational threats has examined what creates and sustains such threats. The main focus verses on organizational efforts to meet consumers' expectations (Dawar & Parker, 1994; Dellarocas, 2006; Fitzgerald, 1988; Fombrun & Van Riel, 1997; Hsiao-Ti & Chin-Yeu, 2012; Keh & Xie, 2009; Page & Fearn, 2005). The approach of analysis describes reputation as a nutriment process between an organization and stakeholders (Fombrun, 1996; Fombrun & Rindova, 1998; Fombrun & Van Riel, 1997; Herbig & Milewicz, 1993; Herbig et al., 1994; Milewicz & Herbig, 1994; Tadelis, 1999; van Riel, 1995). A typical response follows for the affected company to try to manage media coverage after some negative event (Chakravarthy et al., 2014; Deephouse, 2000; Fombrun, 1998; Goldberg & Hartwick, 1990; Mailath & Samuelson, 1998; Tadelis, 1999; van Riel, 1995; Wartick, 1992; Zavyalova et al., 2012).

The overall assumption in literature encapsulates that reducing the gap between quality expectancy and quality delivery is the key to managing crises. This approach has limits in terms of usefulness in preventing scandals. After all, the unit of analysis applies the effectiveness of the quality systems facing their own processes; it does take into

adequate consideration the external interactions, such as with suppliers or vendors, which may cause or contribute to the situation. In the Nike case, the company was not accused because of the quality of their products; they were accused because others had an odious contractual relationship.

The objectives of this research are to inquire as to how organizations attend to the reputational threats attributable both to themselves and to external business interactions. The research considers whether the interpretation of regulatory compliance and COSO (2013) guidance provides the intended support to managers, and to what extent reputational scandals are actually prevented. Because corporations employ specialists to handle reputational threats, this study focuses on how these individuals conduct their work with respect to managing the organization's reputation when facing such threats. The research question, therefore, is: What is the experience of managerial officers attending to and mitigating reputational threats attributable to themselves or to external parties, whether or not they are affiliated with the organization?

To address such objectives, this study applies grounded theory. Such methodology proved convenient because, unlike materialized scandals, managing reputational threats cannot be adequately researched using only archival resources. The gathered data for understanding the broad phenomena derived from 27 participants and provided valuable insights into individuals' experiences, activities, or reactions as members of organizations facing reputational threats.

This material is structured by providing relevant literature that details the conceptualization of reputation and how scandals are understood, then by an explanation of the application of internal controls in the reputation caretaking process. Correlating

methodology with the main findings is explained in detail and concludes with a wide discussion.

Selected Literature

Reputation

The understanding of the reputation phenomenon originates in the economics and management fields. Scholars framed reputation in game-theoretic models. Two players observed each other's behavior categorizing them as 'tough' or 'benevolent' players. Based on a dynamic labeling process, observers react differently in sequential games. The process of identification, labeling, and reaction represents the theoretical foundation of reputational studies (Camerer & Weigelt, 1988; Kreps & Wilson, 1982; Lewis, 1986; Milgrom & Roberts, 1982). The managerial foundations rely on consumers' brand selection. Consumers bond with reputable quality brands (Nelson, 1970). Consumers selective process translates into a competitive advantage to organizations¹⁰ (Spence, 1974). Spence (1974) argues that organizations prioritize the consumers' preferences among their core objectives as sustainable strategic advantage. Related studies uncover that the emotional bonding refers to quality as a main driver of consumers' loyalty rather than advertising (Ausubel & Deneckere, 1989; Rogerson, 1983; Shapiro, 1982, 1983).

Scholars also include in their observations the effects of reputation in financial markets. Capital markets also bond to reputable organizations. Investors prefer reputable organizations (Balvers et al., 1988; Beatty & Ritter, 1986). As to lenders, lower yields associate to reputable organizations as risk indicator (Diamond, 1989, 1991). Lower levels of uncertainty are present in highly reputable organizations (Carter et al., 1998).

¹⁰ The term 'organizations,' is used in this research instead of companies, corporations or firms for denoting one single identifiable entity as a set of combined resources to achieve a common goal as a unit of analysis.

In order to create and maintain an organization's reputation, scholarly literature on reputation management offers a few empirical examples. Since quality is the determinant, permanent monitoring systems contribute to reaffirming an organizations' reputation (Cohen, 1993). But this only occurs when the expected quality consistently repeats over time for positively reputable organizations (Goldberg & Hartwick, 1990; Wartick, 1992). This because the bond reinforces (or reduces) depending on the media exposure as a primary source of information for stakeholders¹¹ (Carroll, 2004; Carroll & McCombs, 2003). Consequently, to manage reputational issues, organizations focus on sustaining the bond from consumers because of the strategic value creation to others—shareholders and stakeholders (Fombrun & Shanley, 1990).

Reputational Scandals

Scholarly literature defines reputational scandals in multiple ways. One of those definitions resides on the willingness to speak of an informant that do not consider as appropriate the outcomes of a decision maker (Molotch & Lester, 1974). A different perspective states that scandals represent ethical flaws from a few 'rotten apples' (Cohen, 1993). To encapsulate both approaches, the suggested operational definition of scandals consists in a reputational threat that becomes materialized. Reputational threats denote sudden unexpected events that endanger the endowed trust in the organizations' activities (Carroll, 2004; Coombs, 2007).

Scandal effects in stakeholders reduce their bonding levels. The effects vary from a decrease in the economic interactions up to a complete withdrawal that affects the organizational financial performance (Jonsson, Greve, & Fujiwara-Greve, 2009). Once

¹¹ The term stakeholders refer to those that can be affected by the organizational behavior (Agle et al., 1999; Bryson, 2004).

broken the bond between organizations and stakeholders transforms into rejection. A generalized rejection that can lead to the end of the organization (Suchman, 1995).

Preventive Efforts

Although the organizations' internal efforts to avoid scandals remain unexplored, several participants in the U.S. have combined efforts to prevent such events. From the regulatory perspective, agencies such as the SEC¹² with the Sarbanes-Oxley Act focuses on mitigating financial accounting scandals (Bedard & Graham, 2011; Ribstein, 2002). The FDA¹³ observes quality in health-care products and services (Stafford, 2008). The OCC¹⁴ supervises financial institutions behavior (Solomon, 1999). The IRS designed and implemented several detection mechanisms for preventing taxpayers fraud (Mills, 1998). Outside the U.S., the SEC, applying the FCPA, enforces transparency for avoiding international corruption scandals (Koehler, 2010). These represent just a few examples of how government regulatory bodies' observance pursue prevention.

In terms of non-governmental standard setters, the COSO represents the organism in charge of issuing the conceptual framework and guidance regarding risk management, internal controls and fraud deterrence (COSO 2013). Although in their efforts do not explicitly include reputational maintenance or threats attendance, the latest guidance offers five main components for organizational design: control environment, risk management, control activities, information and communication and monitoring activities. Each component contains principles enlisted in Appendix B. As stated in the

¹² SEC anachronism of Security and Exchange Commission.

¹³ FDA anachronism of Food and Drug Administration.

¹⁴ OCC anachronism of Office of Comptroller of Currency.

guidance, by mandatory complying with the COSO principles, organizations should not only increase the assurance, stability, and reliability but also respond adequately to the overall risks mitigation process, including those related with reputational issues.

Even though the latest guidance differs from the original issued in 1994, scholars have conducted several studies about the effectiveness of adhering to those principles. Designing internal controls based on COSO guidance have proven its preventing efficacy in aligning some key organizational activities. For example, depending on the board of directors composition, the likelihood of financial statement fraud can be reduced (Beasley, 1996). Another area of prevention includes the strengthening of controls inhibiting managerial frauds (Caplan, 1999). As stated in the study objectives, the purpose focus on understanding whether—and under which conditions—adhering to the COSO principles serves to organizations in the process of reputational maintenance.

Methodology

This research explores real experiences from people within different organizations. Inside experiences derive from organizations under permanent media scrutiny because of the familiarity with reputational issues (Fombrun & Shanley, 1990). Latest reputational studies explorer scandals based on archival sources using public announcements (Chakravarthy et al., 2014; Zavyalova et al., 2012). Yet, some assumptions limit the conclusions. Announcements as data source represent a public intention from organizations or media to inform the general public. Such data sources ignore unpublished internal managerial reactions *pre-* and *post-*event.

Although some studies implemented qualitative field techniques, such as case-studies, the conclusions derived from using one specific organization (Heugens, Van

Riel, & Van Den Bosch, 2004). One contextual environment as a unit of analysis provides a specific perspective of an overall effect. For example, the Nike scandal's source arose from an outsourced company and the HSBC's scandal from money laundry customers.¹⁵ In both contexts, the managerial efforts for dealing with threats may differ.

In order to avoid such limitations, the study design collects experiences from individuals of different organizations to allow behavior patterns emerge. The methodological approach that analyzes real qualitative experiences through comparison between individuals is grounded theory (Glaser & Strauss, 1967). The goal is achieved by conducting semi-structured interviews with those individuals (Charmaz, 2006). Because this study seeks to understand the specific phenomenon of scandals, the selected individuals were involved in the reputational maintenance processes of their organizations. In the business environment, reputational managers have those responsibilities. When that position is absent, similar areas such as internal auditors, compliance officers, brand managers or risk managers cover those functions.

Sampled organizations are publicly traded in the U.S. securities market. The sample criteria obey section 404 of the Sarbanes-Oxley Act enacted in 2002, including accounting firms subject to the PCAOB permanent revisions. Those organizations are: (1) in the process or fully implemented COSO (2013); (2) involved in any scandal prior or during the implementation of COSO (2013); and (3) in case of international organizations the interview was conducted in English.

The final selected sample consisted of 27 individuals representing different organizations. Because the study design pursues the understanding of different

¹⁵ The Guardian (February 26, 2015): <http://www.theguardian.com/business/2015/feb/25/hsbc-scandal-horrible-damage-reputation-chairman> Accessed [May 21, 2015].

experiences, participants represent three of the most media-exposed industries in the economy: financial services, consumer goods, and professional services. Each group contains nine participants. The sample size in 2014 exceeds \$8.7 trillion in assets. The revenue for the closing year in 2014 ascends to \$1.1 trillion. On average, the size of assets per organization is approximately \$322 billion.

A basic archival analysis was conducted prior each interview. The objective was to corroborate that the public media stories of the reputational event associated with each interview were consistent with the collected experiences. If the reputational event was not mentioned during the interview, participants were asked directly using a probing question as detailed in the interview protocol in Appendix A.

Prior to each interview, participants had to approve an informed consent of confidentiality. The interviews were recorded and transcribed de-identifying names or organization for preserving the confidentiality of the participants. As expected, the collected data was vast and rich (Charmaz, 2006). Although many inquiries can be drawn, the extracted data for analysis focused only in which directly applies to the research question and its implications. The collected sample in terms of theoretical relevance (Glaser & Strauss, 1967) is presented in Table 1.

Table 1. Participants by Industry and Classification

	Education	POSITION	Industry	Classification
1	Masters	Assistant controller	Equipment and machinery	Goods
2	Bachelor	Chief financial officer	Heavy construction	Goods
3	Bachelor	Risk manager	Money Center Bank	Financial
4	Masters	Compliance officer	Money Center Bank	Financial
5	Masters	Chief financial officer	Property and Casualty Insurance	Financial
6	Masters	Head of global sales	Textile - Apparel Footwear & Accessories	Goods
7	Bachelor	Compliance officer	Private Equity	Financial
8	Bachelor	Chief risk manager	Pharmaceutical	Goods
9	Masters	Chief financial officer	Scientific & Technical Instruments	Goods
10	Bachelor	VP Financial controller	Personal Products	Goods
11	Masters	Chief sales officer	Communication Equipment	Goods
12	Bachelor	Global reputational partner	Accounting Tax Business Advisory Services	Services
13	Bachelor	Operations manager	Air Delivery & Freight Services	Services
14	Masters	Chief sales manager	Discount, Variety Stores	Services
15	Bachelor	Reputational managing partner	Accounting Tax Business Advisory Services	Services
16	Masters	Senior global Partner	Accounting Tax Business Advisory Services	Services
17	Masters	Sales manager	Money Center Bank	Financial
18	Masters	Compliance manager	Security & Protection Services	Services
19	Bachelor	Managing partner	Accounting Tax Business Advisory Services	Services
20	Masters	Chief controller officer	Money Center Bank	Financial
21	Bachelor	Chief internal auditor	Foreign Money Center Bank	Financial
22	Masters	Compliance manager	Investment brokerage - National	Financial
23	Masters	Operations manager	Power plants	goods
24	Masters	SVP Risk manager	Accident & Health Insurance	Financial
25	Masters	SVP Asset and investments	Asset Management	Services
26	Bachelor	Global sales manager	Textile - Apparel Footwear & Accessories	Goods
27	Masters	VP Controller	Discount, Variety Stores	Services

Once the data was collected from over 355 transcribed pages of interviews, the data was analyzed in three stages. The first stage consisted of an initial or open coding line-by-line without any pre-established coding and no logical order (Glaser, 1992). From this stage, 1,728 codes were drawn. Open codes were compressed into axial codes in the second stage. The compression stage presented an intense comparative analysis of participants' responses (Corbin & Strauss, 1998). Only codes with consistent patterns were selected. The process included similar events comparison under one set of codes across organizations. From the compression process and comparative analysis, 34 axial codes were drawn. Those codes represent a logical pattern across the participants' organizations. The last stage includes the identification of the theoretical or selective codes in a hierarchical abstraction form. This selection emerges from observed patterns across participants' responses (Corbin & Strauss, 1998). Three key results denote the study findings.¹⁶

Findings

The principal finding from the collected experiences elucidates that not all threats become actual reputational scandals. Organizations develop a governance intelligence that enables the mitigation of scandals. The intelligence is improved by channeling governance structures for threats identification. An organization's ability to avoid scandals resides in their skill at and preparation in identifying such threats. The detection and monitoring mechanisms, the inclusiveness of the ethical environment, and the adherence to compliance regulations are key predictors for identifying such reputational

¹⁶ Inter-rater reliability consisted in a secondary blind coding process of six interviews—three of each group. The blind coding was performed by a Ph.D. student. Coding differences represented less than 5%. The reconciliation process did not reflect major relevant differences.

threats. Scandals occur when at least one of those three structural elements is vulnerable to a threat.

Once the event occurs, organizations have to design and implement a damage-restore management plan. Such a plan consists of the organizational activities pursuing an effective response to scandals in order to mitigate the associated damages. Four types of focus in organizational activities were identified: financial, operational, public trust, and stakeholders' perception.

Finding 1. Organizations develop a governance intelligence that increases the ability to prevent scandals.

Finding 1.1. Detection and monitoring controlling structures increase organizations' ability to identify sources of reputational threats.

The first component in the organizational intelligence skills includes the solidness of the detection and monitoring structures. In order to prevent the occurrence of reputational events, organizations rely on the internal ability to identify potential reputational threats. The applicable controls systems for risk-source identification represent the installed detecting and monitoring. Participants informed that scandals were prevented successfully because the reputational threat was detected before anyone else.

One participant from the pharmaceutical sector that identified a threat explained:

We detect it because we have checks and balances. We have a very detailed system to check the quality because all our products are used on people, so we have very strict controls over the quality.

In the identifying efforts, participants designed and implemented sophisticated detection mechanisms. The observed reputational threat detection mechanisms derive from the operational controls. The sector with financial statements controls calibrated to identify reputational-treats encompasses the audit services group. In both cases,

operational and financial statement controls, the detection mechanisms serve for assuring quality and safety of products or services. Organizations detect threats in several stages of the productive process. Threat detection ranges from the production orders of suppliers or subcontractors to the follow-ups with final consumers.

Each participant provided one or more experience that exemplifies the sophistication of the detection mechanisms. One participant in the consumer goods industry (after detecting a malfunctioning product) informed, “We control it; we track it; we know where every product is before we made the call.” Financial sector operates similarly. An informant said, “So, I'm not saying it will prevent those issues at all, but it surely helped us to detect it, to come forward early in the process.” She explained how her company pro-acts against money-laundering issues. In the services industry (cargo and transportation), one participant said, “We have very high safety standards... there's lots of testing,” to assure that the transportation packages do not contain hazardous materials.

The observed monitoring mechanisms focus the behavior of employees- and external actors (third parties such as suppliers and vendors). The monitoring mechanisms analyze the reliability of the environmental players. Monitoring structures serve a dual purpose: identification and deterrence. Monitoring mechanisms inquire unusual activities. Then organizations can proact. Participants explained the efforts of the threats identification process. One of them exemplified how third parties are monitored:

Vendors, for instance, we ensure that whenever they board our boats or are doing work on our boats, we ensure that they're abiding by all our safety rules and regulations. They're supervised so that if they're doing something that's unsafe or aren't abiding by regulations, they're immediately kicked off the boat and sanctioned if they're practicing anything that is unsafe.

One participant explaining an employees' monitoring system said:

Employees need to disclose any type of financial holding or investments outside of the company. Those have to be reported. Not only the middle managers receive the report but also the executive of the organization may receive the report. So, that they all know of those other investments.

All of the participants have robust internal audit departments for monitoring. In financial services, one participant detailed, "Our internal audit which audits all areas of the bank to uncover anything that could be a potential risk that endangers our reputation." The reputational pivot orientation of the internal auditing departments resulted equally across the industries. The difference between the three studied sectors relies on the strategic vulnerable areas. For example, those participants in consumer goods have more reputational exposition to product quality than organizations in the financial sector. To mitigate the vulnerability, organizations channel not only internal audit departments for reliability but also related areas to observe others behavior. One of the largest participants in services (retail organization) mentioned, "We monitor everything that is being said about us on the internet," to explain the intense monitoring efforts. Meanwhile, one participant in consumer goods explained the internal process to monitor key advertising players, she described:

We have a pretty sizable (omitted name) department and a lot of people who get paid to pay attention. It's their job to handle that. So, they better know what the person is doing sometimes before they even think about doing it. Our reputation is on the line.

Finding 1.2. Inclusive environmental ethical systems increase the organizational governance intelligence.

Organizations with embedded ethical statements in the culture and tied to the code of conduct anticipate and inhibit better potential reputational threats. Two levels of scope integrate the ethical systems: local or inclusive. The local ethical system scopes

employees, board members, and shareholders, just as one of the participants in the consumer goods sector responded:

Like other organizations, we have core values that we use to calibrate our actions. One of our core values is the golden rule; so, we want to treat people like we would like to be treated ourselves, and if our positions were reversed, we would like it if someone else is looking out for us making sure that we wouldn't get hurt.

In the global ethical system, organizations incorporate not only employees and shareholders but also external stakeholders such as suppliers or consumers (actual or potential). Global ethical inclusiveness allows organizations to better identify and elude misconducts. To exemplify the ethical inclusiveness, one participant in consumer goods explained:

As a company, our main suppliers have to take certain compliance training. One of those modules or classes or web-based trainings is code of ethics. There's code of ethics. Then we routinely test that they permanently comply with those codes.

Participants also detailed that the ethical inclusiveness structure adheres to the type of relationships in the business environment. Organizations make connections with other players when both share similar ethical systems. In order to avoid reputational threats, organizations segregate to those unwilling to share similar values. For example, one participant expressed:

Whenever we go into a relationship with an (external party name omitted), they sign a contract that clearly represents that behavior that we expect from them. Along with that is a code of conduct expectation...We expect them to behave in a certain way, and if they don't, contracts can be voided.

Sometimes the ethical codes explicitly include external entities. For example, one participant in the goods sector said, "The code of ethics applies not to only employees but also to contractors as well as to suppliers or vendors." Other times, the inclusiveness is

not explicit in the ethical code, but organizations segregate implicitly. The business segregation occurs on an expected behavior basis. For example, one participant in financial services said, “We like to partner or sync up or work with people or companies that hold similar values.” Another participant from the professional service sector explained as segregation efforts the following:

We make sure that everyone sees our company as an ethical company with hardworking employees that embody some of the values that the corporation has, which provides a good fit for society. So, we expect everyone surrounding us, to behave the same.

Finding 1.3. Adherence to regulations enables organizations to prevent potential reputational scandals.

Regulators and regulations are determinant in the organizational threats identification process. The sampled organizations provided several examples of prevented scandals due to regulatory compliance. Although regulation compliance is mandatory, organizations’ conservative approach increases the threats identification skills. Most authorities, regulatory bodies, and standard setters, in principle, oversee the overall good to society. Adherence to that compliance reduces the occurrence of unexpected events. All organizations in the sample comply with the SEC. But most of them are subject to a specific set of regulations. For example, one participant in consumer goods (pharmaceutical organization) described how a major scandal was avoided due to regulatory adherence:

Because we are in compliance with FDA we found an issue with a component, we recall only a part. Our patients want the products. It's just a recall ... it wasn't a full recall it's just a portion of our one batch. It was one particular batch that we had an issue with rather than the whole product.

Another example occurs with participants from the financial services sector regarding their compliance activities. The regulator requires categorizing the associated

risk to some financial activities. Adhere to such, allows them self-identified under which risk-type organizations are facing. One participant mentioned:

Some things have to get reported to the OCC. We never really want to be on the OCC list. You don't want them to be involved unless they have to be. There are some things that require that we report, if there is some data breach of some sort of magnitude that has to be reported. Then they issue their grades and assessment on the financial institution we always want to be on the more positive end as opposed to the negative end.

A different set of adherences prevented major reputational scandals. Some sampled organizations with foreign transactions comply with anti-corrupting regulations. Proactive compliance with such regulation deters media scrutiny. Adherence avoids major reputational scandals. For example, one participant explained how their strict compliance prevents major scandals. He said the following:

Our risk assessment is doing business in China. We make sure that we are compliant with the Foreign Corruption Act; we ensure our compliance with all local regulations. If we are non-compliant, then it all becomes public information and therefore that can damage our reputation.

Finding 2. Reputational scandals occur because at least one of the organizational governance intelligence elements fails.

Organizations detailed several types of scandals. Those events occur when reputational threats materialize into scandals. The observed pattern in that process represents the failure of at least one element in the governance intelligence. Scandals occur because of weak detection and monitoring systems, misbehavior of an involved third party, or the organizational failure to comply with certain regulations.

Finding 2.1. Detection and monitoring systems failure.

Some of the observed scandals derive from a failure of the detection and monitoring systems. Organizations' structures for detecting potential processes flaws did not reveal an inconsistency above the normal levels. But, an external individual or entity

detected the abnormality. Such actor released the information to the public. The scandal derived from an undetected threat. The detection failure could be found in a product quality, safety, or any moment across the productive process. From the experiences related to the origin of the threat, the common pattern was “it was a safety issue,” or “An evaluation system failed to that component.” Just as common was “The FDA discovered,” or “we don't know how it came out to the media.”

For example, one participant in financial services (Private equity organization) explained a due diligence overlooked failure. The acquired company resulted toxic. The participant described:

With one company we also had a risk due diligence, a risk assessment, whereby our risk consultants analyzed the whole company and then assessed the biggest risks and left away the smallest ones. The small thing grew... The European Commission detected.

Similar to a detection failure, monitoring systems can also fail in advertising organizations regarding the menace. The menace source could derive from an employee, supplier, customer or anyone with corrupt intentions. Scandals occur because organizations fail to elude and observe the misbehavior. To one participant in services, the BOD disregarded the CEO's misbehavior in an early stage. Another participant's organization (in consumer goods) unnoticed the main supplier's misconduct in Asia. A financial institution ignored an information leak from inside employees. A different participant in the financial system neglected to inspect a financial terrorist customer's transgression, for mentioning some collected experiences. Although most of these examples involve an ethical component, organizations failed to detect and observe the misbehaviors.

Finding 2.2. Unenforced or restricted ethical environments.

Most scandals have a component of ethical misbehavior. However, the difference between actual scandals and those successfully prevented relies on the application and scope of the ethical environment. The observed pattern persists in soft and restricted ethical environments. Unforced ethical codes encourage internal trespassers. Ethically restricted environments expose organizations to outsiders' misconducts.

For example, one participant in consumer goods said, "Our biggest client had this scandal in which some of their managers and senior managers were accused of corruption." Her organization was accused by association. Another example occurred to one participant in financial services with a joint venture. He said: "One of our joint ventures was accused of money laundering." His organization was the face of the scandal. Three sampled participants in consumer goods experienced similar situations with suppliers in Asia. Before the scandal, those organizations contained limited or restricted ethical inclusion.

Finding 2.3 'Play by the line' compliance.

Some experienced scandals occur due to regulatory compliance. Organizations internally decide whether to comply rigorously or minimally. The latter approach triggered the sampled law compliance scandals. Organizations searched for competitive advantages. In the sample, the pursuit of competitive advantages created incentives to behave questionably. The 'play by the line' attitude increased the participants' exposition. For example, one participant in financial services described one issue with one venture:

A few years ago, we were fined by the Commission (European Competition Commission) for antitrust violation by one of our portfolio

companies. By following up (referring to the fine) on the developments in various compliance fields, including anti-competition...

A participant's experience in professional services illustrated, "The client was accused of abusing of tax-shelters, but the authority blamed us as a firm, so as the media did." Another participant in services mentioned, "The government fined us because our clients used our services for illicit transporting their products." Her organization randomly complied with federal regulations. A similar case happened with one financial services participant. He said, "We didn't track the money before." The bank was accused of money laundering.

Finding 3: Four major damages arise after scandals: financial, operational, public's trust, and stakeholder's signaling. To mitigate those, organizations design a damage-restore management plan.

The last finding represents the reactive efforts of organizations to restore the damages caused by reputational scandals. After the event, organizations performed an internal evaluation of actual damages. Then, they develop and implement a strategic plan for mitigating and restoring those damages. Four activities represent the main damages: financial, operational, trust, and stakeholders' perception.

Finding 3.1 Financial damages recognition and transparency.

Organizations performed an evaluation of the financial damages. The analysis seeks to identify and quantify those damages. This evaluation includes the financial performance post-scandal, especially to the economic impact disclosed in the financial statements, and in internal budgets and estimates. The consequence of the financial damage assessment translates into accounting recognition, forecast adjustments and revaluation of financial goals. Organizations had two financial targets: intensify transparency and demonstrate the long-run financial stability.

One of the participants explained the financial adjustments transparency reactions after a major scandal and the perceived effect in the capital markets. She said:

As soon as we thought these securities were impaired we did a market to market impairment. We reported numbers monthly. In mid-October, we said, we had taken a billion dollar charge, and after taking the hit the stock price went up since.

Organizations tended to include in the transparency efforts conservative accounting disclosures as short-term restoring activities covering long-term concerns. Those restoring activities aimed the prevention of further additional losses from sequential damages, as one participant in the financial services sector denoted:

The right thing to do, ultimately, was to incur a known short-term financial loss as opposed to gaining some revenue but having the chance of a potentially horrible loss to our reputation several years from now.

One participant in consumer goods detailed her experience to avoid higher sequential damages after one scandal. She said:

This was a catastrophe because our biggest client stopped opening stores and stopped buying from us. We needed to adjust all our supply system. We needed to adjust the forecasts, all of our orders for products to get to the factories. We needed to adjust, and of course, to recognize sales downturn.

Another example of a similar long-term concern from organizations derived from one participant in services. She explained:

I can't tell if it was a good or a bad economic decision, but it was a choice to forego short-term profits for something that we believed would help us in the long run. No one will ever know whether we made the right decision or not.

Finding 3.2 Operational repairing and reallocation of resources.

Organizations respond after scandals mitigating operational losses. Although each participant's experience differs from the rest a consistent pattern emerged. From the

comparative process, organizations mitigate operational damages based on the ability to design creatively strategic solutions based the reallocation of resources. Sometimes participants interrupted production lines. Other times, organizations absorbed a certain quantifiable amount of losses. For example, after a major scandal, one participant said, “So we destroyed the cars instead of trying to sell them for scrap.”

In all the sampled experiences, participants maintained the best interest in the organizational reputation. One participant described some of the efforts to mitigate operational damages. He said:

“We had to shift focus ... A lot of our boats were no longer able to work. We looked for other opportunities, maybe in other markets or other service opportunities may be, that were outside of the gas and oil industry. We looked at Mexico, Brazil and any other operations that were in another company because our boats, essentially, couldn't do what they were built to do in the Gulf of Mexico.”

One of the participants also explained, “The company decided not to go forward with that particular product, and used those plants for different purposes,” after a defective malfunctioning product scandal. Subsequently to another scandal, one participant explained how the organization responded to operational damages, he said:

The company has responded to lawsuits and to actions taken by consumers in a way that hopefully, the consumer will be able to recover as much as possible, or at least, to be able to get back on a good footing as much as possible.

One participant in the financial services industry, after one scandal, explained how they absorbed some of the operational losses. He said:

My company has done its best to ensure that those homeowners affected can stay in their homes as much as possible with alternative payment plans or some sort of arrangement that's feasible or that the company can find the best solution for the customers.

Finding 3.3 Restoring public's trust.

Organizations included regaining public's trust in the restoring activities. Participants referred to the repairing efforts to recuperate any loss of confidence and reliability. One participant said, "We were deemed to be untrustworthy and so had to go back and rebuild that trust." He explained how the public's mindset shifts after scandals and where to focus the efforts. To restore public's trust, organizations improved the quality of the experience. For example, a participant in financial services exemplified the restoring efforts after one scandal versing:

The thing that is really the difference marker, or that differentiates us now, and it sounds cliché but is still true, is the people and customer experience. The difference now is how you feel when you walk into a (Omitted name) branch as opposed to a (Omitted name) branch bank.

Another participant in services explained the organizational intentions for improving public's opinions. The experience was:

A lot of efforts are set forth to make the customer experience as good and as stress-free as possible. We have a customer advocacy number, an email, and different ways, that if you have a problem, just address it, so you don't have to bounce the customer around from department to department.

Another participant in consumer goods explained how her organization now has a scandal specialized area. She exemplified the organizational devotion as follows:

We have a very robust global relations department, and some very capable people; really, really smart and really proactive. There are strategies that are already in place that are more proactive around how we handle scandals.

Finding 3.4. Signaling to stakeholders.

As part of the damage assessment plan, organizations included a strategic information communication. The pursuing to signal effective responses to stakeholders operated through honesty about the overall restoring activities. The main observations,

rather than an increase in the advertising exposure, participants referred to increase transparency, such as one said:

We want people to know what we're doing about it.' So, you started to see it show up in our annual reporting.

Organizations increased transparency informing operational activities and financial information. To exemplify the type of after scandal signaling activities, one participant reported, “We opened up our books on a (omitted act) basis, no one copied that.” Another participant said, “So, we decided to make us a little bit more transparent to everyone.” One of them also mentioned, “We opened the reports because we can, and we have nothing to hide,” after one scandal.

Discussion

Not all reputational threats become scandals. Organizations prevent scandals on a daily basis. They do so by channeling their corporate governance structures. With those structures, they create a ‘gold triangle’ of prevention. A triangle designed to identify reputational threats. Once identified the threat, organizations anticipate and attend to prevent potential scandals.

Organizations that have inhibited scandals, presented solid and serious attention to their ‘gold triangle’ of prevention: (i) solid internal controls systems focused on observance procedures such as detection and monitoring; (ii) adherence to regulatory compliance; and (iii) strong and inclusive ethical control environments. The three elements enabled organizations to realize potential threat sources. These procedures served to attend automatically and systematically to reputational threats sources prior the occurrence. Consequently, sampled organizations aligned the internal controls structures

to not only protect the measurable (and quantifiable) assets but also attend to proactively the issues of negative reputational events before the occurrence.

In contrast, scandals occur when the governance structures are vulnerable to the business environment. Structures may exist, but they are not designed to identify reputational threats, whether internal or external to organizations. Without such identification, organizations can do little to contain the scandal. Even when the threat is triggered by the organization or others, organizations can become the face of scandals. One participant said, “How did we let that happen?” in the board meeting after the scandal.

In the repairing stage ‘or after the fire,’ surviving organizations proactively restore the damages with internal managerial activities. They recognized economic injuries with financial transparency. Organizations assessed and mitigated operational damages with reallocation of resources. Meanwhile, internal efforts focused on the restoration of the public’s trust. Also, managers concentrated communication actions to stakeholders signaling honesty. As one participant said, “we turn around things forever.”

This section focuses on discussing each one of those managerial activities strengthening the organizational governance intelligence for preventing scandals. Also, an explanation is added of the factors that resulted in scandals and concludes with a discussion of the restoring actions that organizations performed when those reputational threats become real events.

Preventing Efforts

The principal discovery of this study centers the managerial efforts to prevent scandals. As the concepts emerged, three activities in the domains of the internal control

systems were identified. Jensen (1993) argues two flaws in the internal control systems while dealing with crises: too late and long reaction. Yet, the pattern across participants' experiences that have prevented scandals successfully evidences functional and operational control systems. In fact, the design of the systems enabled organizations to anticipate before the event. Control systems oriented to identify reputational threats, with or without crises, inhibit the occurrence of scandals. The general observed cause of scandals was that the controlling systems were not designed for identifying certain threats. One of the participants in the consumer goods explained, "We even control the type of gifts our personnel is allowed to receive." But this organization could not anticipate a supplier's misbehavior. They had controlling systems, but the design does not serve as threats identification mechanism. Organizations prevent scandals when the control systems design match with the menace. The ability to prevent scandals relies in the adaptive capacity to mitigate the systems vulnerability by adjusting the controlling systems to identify reputational threats.

Because of the unpredictability of the threats sources, the design challenge is everything but easy or simple. The design task of the control systems contains some level of uncertainty. March and Shapira (1987) explain to address uncertainty that the element of past experience determines the predisposition of the design attitude. However, while dealing with scandals previous experience does not necessarily imply the full accomplishment of the preventive efforts of the control systems. The innovative characteristic of the reputational threats sources subordinates the complexity of the business world. The menace may derive from any unexpected source. To that natural and reasonable obliviousness, these findings suggest that organizations tend to rely on the

adaptive capacity of regulators—specifically, to filter those threats that regulatory bodies aimed to prevent. Under-regulated activities, the compliance itself covers some of that unpredictability. But only by faithfully adhering to regulations, organizations adapt the control systems to unexpected sources of threats. For example, organizations that adhere to product safety regulations better handle potential product malfunctions. The control system targets both compliance and malfunctioning detection. The same reasoning applies to activities of financial institutions, professional services, and consumer goods. When an activity becomes regulated, the compliance efforts cover some of that uncertainty.

Unregulated activities pass through the ethical filters of organizations. Although the ethical behavior of individuals inside organizations constitutes a fundamental element in the academic literature (Fombrun et al., 2000; Holmes, Langford, Welch, & Welch, 2002), these research findings expand the scope and applicability in the reputational caring process. Outsiders' ethical inclusion within the organizational conduct standards increases the scandals mitigation ability. By calibrating others' ethical behavior, organizations not only inhibit potential misconducts but also set the ethical pace of others. Those with feebleness ethical regimes have to adapt or face segregation from the organization's business activities. Then, by enforcing and segregating—internal and external members—organizations create and protect ethical stable environments safer for business interactions.

Restoring Efforts

Conversely to prevention, after reputational threats become real events organizations have to restore the negative effects of scandals. They do so by developing a

damage-restore management plan. The restoring plan encompasses the managerial activities for repairing the reputational damage. Organizations identified and addressed differently financial, operational, public trust, and stakeholder's perception damages.

Organizations increase financial transparency for many reasons, mostly to match outsiders' expectations (Healy & Palepu, 2001; Verrecchia, 1983). Verrecchia (1983) argues that organizations voluntarily disclose financial information with the minimum quality to match capital market users' expectations. Collected managers' experiences, while dealing with the consequences of scandals, illustrated an intensification of financial transparency to tackle financial damages. They did not attempt to elide or hide financial responsibilities (or obligations). In fact, the conviction that prevailed was 'telling the truth' results better than avoiding or omitting ownership of the problem for repairing financial damages. The quantification of losses took a conservative approach. Participants adjusted estimates and forecasts to anticipate negative downturns Scandals details and financial consequence constitute part of financial statements, as one participant said: "we have nothing to hide." Consequently, the notion of minimum quality of the financial information to match others' expectation translates into a pursuance of maximum quality. Because capital market users' expectations damages remain uncertain to managers, they seek to recover lost confidence by increasing as considerable as possible the information quality.

Academic literature illustrates manager's incentives to manipulate earnings. Those incentives reflect on using accounting accruals or reallocating resources for stabilizing earnings variability to reduce the volatility of stock returns (Burgstahler & Dichev, 1997; Healy & Wahlen, 1999). After scandals, aforementioned findings

documented that organizations alleviate the variability with resources reallocation. The affectation of operational performance results as consequence of the event. Sometimes because consumers halt economic interactions, or authorities issue sanctions or moratoriums. To minimize the negative impact, organizations mitigate operational losses by reallocating resources. Unexpected operational inefficiencies are compensated as much as possible with other activities. If not, excesses in install capacity become disposable assets. In the collected experiences there were no traces of intentions to manipulate earnings using accounting accruals to avoid losses as suggests Burgstahler and Dichev (1997) under non-scandal circumstances.

Addressing the Paradox

The paradox about the governance intensification post-event rather than ex-ante obeys to design uncertainty. The original design of the internal regulatory structures relies on the speculation of potential circumstances that may occur. The occurrence of scandals symbolizes a specific structure vulnerability to an unforeseen circumstance. The response from the organization is as if they had designed to prevent the event. Participants' anecdotes referred to analyze what went wrong inside. So, they respond enduring the governance as an effort that the same event is not going to be repeated again. Those efforts served as justification that they cannot change the past, but the same event will not happen again.

Structure does not fail; what fails is the adaptive capacity of the organizations to what they do not know. Some circumstances are more obvious to predict than others, for example, the observance of internal 'rotten apples.' But others are more difficult to predict, especially those uncontrolled external elements, like stakeholders. The adaptive

capacity of their governance intelligence is a permanent improving process. Under static and exclusive processes, the vulnerability increases. Scandals are going to keep occurring because the nature of threats is changing. Organizations prevent scandals when they evolve faster than threats.

CHAPTER 5: EXPERIMENTAL APPROACH OF AGENTS' AND MONITORING-STRUCTURES' ROLE IN THE REPUTATIONAL MAINTENANCE PROCESS

Introduction

Organizations deal with reputational threats on a daily basis. Reputational scandals emerge when these threats remain poorly addressed. If executives holding stock options are also an affected party, why their efforts are not oriented to mitigate the occurrence of scandal? Under traditional management compensation practice, stock options are generally accepted as part of the executives' compensation packages for two major benefits. Offering equity to executives promotes risk-sharing with shareholders. This helps to maximize organizational performance alleviating some of the agency problems (Eisenhardt, 1989). Also, executives are financially stimulated to maximize their own interest and conversely investors' interest (Dalton, Hitt, Certo, & Dalton, 2007; Jensen & Meckling, 1976). Besides these two major benefits, a number of scholars have found several other benefits of such compensation mechanism, especially for executives of publicly traded companies (Certo, Daily, Cannella, & Dalton, 2003; Core & Larcker, 2002; Mehran, 1995; Yermack, 1997).

Yet, some scholars have also noted side effects of using stock-based compensations. Under these agreements, executives have an inclination to take riskier investments with extreme gains or losses—the latter the most common outcome (Sanders, 2001; Sanders & Hambrick, 2007). Related studies associate fraudulent behavior approaching the execution of the contracts (O'Connor, Priem, Coombs, & Gilley, 2006), and unhealthy manipulation of earnings (Bergstresser & Philippon, 2006). This material explores the associated managerial behavior between the compensation mechanisms and

the role of the governing monitoring structures while dealing with reputational threats. In other words, do agency theory predictions—align incentives and monitoring—adequately address ways of effectively attend to reputational threats?

To address this concern, I conduct an experiment which probes whether executives have sufficient incentives to attend to reputational threats *a priori* before an occurrence of a scandal even though attending to such threats may result in an economic penalty in their compensation package. I also examine the impact of internal auditors in the reputational caring process and the effects of the dyad exchange between auditors and executives in attending to established corporate governance principles. Then, I discuss to what extent the findings enrich the current understanding of how to inhibit reputational scandals, and how stock-option-based compensation has to be analyzed more carefully.

Literature and Hypotheses Development

Scholarly literature analyzes incentives and their role in coordinating the relationship between owners (principal) and executives (agent) in light of agency (Eisenhardt, 1989). Managers and owners do not fully share similar set of incentives and objectives (Fama & Jensen, 1983a; Fama & Jensen, 1983b). Shareholders' main concern is yield on returns. To align incentives, two mechanisms are the most commonly used: the use of stock-options; and corporate governance principles implemented by organization's Board of Directors (BOD), such as exercising the monitoring role of internal and independent auditors.

Executives represent organizational employees who investors deposit their trust on to act on behalf of them. Investors rely on executives' experience and skills in maximizing their investments. Executives' goals are likewise to maximize their personal

economic benefits. The difference in these goals constitutes the basic foundation and origin of agency theory—how do the principals control the agents and set up incentives in such ways that principals’ goals are achieved (Fama & Jensen, 1983a; Fama & Jensen, 1983b).

A common mechanism applied in the business environment to align the differences in goals coincides with stock-options compensation (Jensen & Murphy, 1990). Equity-based compensation grants executives the possibility to obtain financial gains from capital markets. To this end, owners offer an exercise-goal share price to executives (Hall & Murphy, 2000; Liljeblom, Pasternack, & Rosenberg, 2011) whereby executives’ compensation bears some of the investors’ risks. Yet, substantive differences in the risk structure between owners and executives exist. Owners mitigate risk in many ways such as diversifying portfolios investments. For example, owners have flexibility to change portfolio packages by varying risk type, industry, or country (French & Poterba, 1991; Goetzmann & Kumar, 2008; Lintner, 1965a; Markowitz, 1968; Sharpe, 1964). Even securities traders mitigate risks in a similar way (Treynor & Black, 1973). From the investors’ perspectives, capital markets access is practically unlimited. Such a benefit is distantly shared to executives. Losses in stock option agreements are normally limited (Liljeblom et al., 2011).

Stock-option compensation consists in offering to executives organizational shares like those that public investors hold. The BOD bargains a baseline share price. In time, the baseline-exercise price varies according to organizational performance. In case share prices increase above the baseline, executives participate in similar financial benefits than those of investors. But in a price decreasing scenario, executives do not

fully participate in the securities losses. Organizations previously fixed a baseline price to ensure executives a minimum risk-bearing scenario (Liljeblom et al., 2011).

As part of the compensation mechanism, executives freely decide when to realize financial gains. This is a personal decision whether to trade their securities withdrawing gains or to hold expecting further gains. Sell or hold investment decisions follows personal risk-balancing concerns (McGuire & Matta, 2003). Personal unrealized gains accumulate when executives hold the investment. Potential losses in the accumulated gains are weakly preferred (Bergstresser & Philippon, 2006). Thus, executives have to deal on a daily basis with organizational decisions that maximize theirs and investors' financial benefits. Such decisions include dealing with reputational threats.

Reputational threats, as any other business event, challenge executives to decide from full ignoring up to absolute containment. Untreated or ignored reputational threats could become actual scandals. The likelihood of a scandal represents a function of managerial threat attendance and uncertainty. Ignoring threats signifies the continuity of the ongoing business as is. Embracing the threat diminishes the likelihood of the negative event. But the opportunity cost of containing threats represents the managerial decision cost of preventing. For example, in the case of a malfunctioning product, an organization can mitigate the likelihood of scandal by discontinuing or recalling products once the malfunction is known. By doing so, shareholders and stakeholders would have to deal upfront with expected decision costs because those groups absorbed positive or negative managerial decisions. There are multiple sources of expected losses such as potential negative stock performance, or sales decrease. Neither of the actual decision costs is accurately known since in this event order decisions go prior economic consequences.

Since the real decision cost of preventing is unknown, organizations tend to estimate expected decision costs under uncertainty. Executives then have to balance between full threat containment with associated decision costs, and personal preferences, especially, if personal financial gains are attached to those decisions.

Ignoring or poorly attending the reputational threat leaves the likelihood of scandal not only to chance, but also to the potential negative consequences. Consequences limited to executives (because of the stock option agreement) but not to investors. Therefore, the first prediction encompasses that executives are willing to contain reputational threats as long as the related costs do not compromise personal financial benefits. When accumulated personal capital gains become affected, and possibly diluted, through measures such as threat containment (expected decision costs), executives prefer (and then have to decide) to accept the uncertainty of the scandal. Because (the threat is not going to be contained and) their personal risk exposure reaches the limit of the stock option agreement. Considering the severity and the expected economic losses, I theorized the relationship of this components and its interaction term with the executives' response. Therefore, the first set of hypotheses verses as follows:

Hypothesis 1a. Corporate personnel will support more proactive scandal responses when the company is confronted with more severe threat situations.

Hypothesis 1b. Corporate personnel will support less proactive scandal responses when confronted with larger potential personal economic losses.

Hypothesis 1c. When scandal threats faced by an organization are more severe, the degree of potential personal economic losses will be less consequential in the support of a corporate response.

Scholars have also observed the delicacy of investors' trust over a single person—the CEO (Eisenhardt, 1989; Fama & Jensen, 1983a). That person is responsible for

managing a set of economic expectations from those confident enough to hire him. Naturally, and as a human being, without an oversight which observes a non-diligent behavior, that person will not necessarily honor such trust. The BOD, therefore, serves as an intermediary between the executive role and those investors (Fama & Jensen, 1983b). The board constitutes the main regulatory body in a publicly traded company. The responsibilities of the body include the corporate governance and surveillance of the CEO's behavior (Holderness, Kroszner, & Sheehan, 1999). But so few people cannot effectively oversee the enforcement of internal regulatory policies across the whole organization. In order to delegate the oversight functions to someone inside, boards appoint internal auditors for a broader coverage of the monitoring activities (Raghunandan, Rama, & Read, 2001).

In publicly traded organizations, internal auditors have a reporting duality.¹⁷ They report to the BOD and CEO, the former as primordial (sometimes the BOD appoints an audit committee). Internal auditors serve as an oversight intermediary between the BOD, the CEO, and the organization's working process (Raghunandan et al., 2001). Such a role exercises the monitoring of the adherence to internal regulations within the organization including the code of ethics or conduct (Archambeault, DeZoort, & Holt, 2008; Reynolds, 2000). That role enacts an ethical champion inside organizations, because of the assumed independence, integrity, objectivity and commitment to protect the interest of the BOD, shareholders, and other stakeholders such as regulators (Ahlawat & Lowe, 2004; Archambeault et al., 2008; Brody & Lowe, 2000; Reynolds, 2000).

¹⁷ Internal auditing standards and guidance correspond in a continuously updated document named *International Professional Practices Framework (IPPF)* edited and printed by Institute of Internal Auditors Research Foundation. The last applicable version of the document dates 2009. The newest updated version to date was approved in October 2016 effective January 1, 2017.

In the internal auditors' responsibilities stand the organization risk management (Beasley, Clune, & Hermanson, 2005; Spira & Page, 2003). Auditors' objectives emphasize to identify, assess and respond to potentially threatening events (Hillison, Pacini, & Sinason, 1999). To this end, they require identifying potential wrongdoings such as reputational threats that may damage the organizations (and subsequently investors' interests). Specifically, internal auditors must respond to potential events that may have an economic effect on those that they protect (Beasley et al., 2005). Internal auditors will respond intensively to reputational threats, because of the potential economic losses to those that he or she formally protects. Consequently, the second hypothesis predicts the following:

The accuracy of the threats response occurs when internal executives, auditors, and the BOD are willing to cooperate in equally protect the organization's reputation. Imprecise or erratic responses derive from unreconciled mitigating decision differences. BOD and internal auditors most likely cooperate because both follow similar ethical incentives as delegates of investors (Zajac & Westphal, 1996). Success and failure in their responsibilities translate into strong or weak governance enforcement. The BOD ethical responsibility focus on mitigating interest conflicts between the management and shareholders (Bathala & Rao, 1995). In contrast, executives, as those who are being observed, ethical preferences differ to the BOD's and internal auditors' preferences (Boyd, 1994). Executives' ethical value connection to investors is lower compared to other business connections, such as stakeholders (Agle et al., 1999). Agle et al. (1999) states that for executives, stakeholders are more important than shareholders. In contrast, internal auditors principal ethical advocacy commits to the welfare of organizations and

investors (Ahlawat & Lowe, 2004). These ethical-value preferences between both executives and internal auditors generate an ethical priorities dissonance. In a debate of a reputational threat response, the individuals' ethical mindset plays a determinant role in the final decision outcome. The final decision is aligned with the organization's, shareholders' or stakeholders' priority. The ethical preferences dissonance influences the accuracy of the response. An accurate reaction is concerned in guarding the best interest of the organization, investors, and stakeholders. Therefore, the next set of hypotheses predict the following:

Hypothesis 4a. High-level corporate executives' support for scandal decisions will be more influenced by potential personal economic losses than internal auditors in their support for those decisions.

Hypothesis 4b. Internal auditors' support for scandal decisions will be more influenced by relative severity than corporate executives in their support for those decisions.

Methodology

This study explores two different role's behavioral responses—executives and internal auditors—under similar conditions. Specifically, to conceive about behavioral factors that influence the prevention or realization of scandals.¹⁸ To understand such conducts the selected methodology follows an experimental design. Such methodology deems appropriate because documents reactions to threat-related stimuli under specific controlled scenarios. Explicit settings record a variety of reputational threats, managerial strategies, and related responses before the existence of a reputational event.¹⁹

¹⁸ Also, we selected and adapted the methodology of Demski and Feltham (1976) related to agency theory.

¹⁹ We followed the experimental design describe in Smith (2014) along with the quality criteria of Gibbings & Salterio (1996).

Research Design

Because one of the study objectives pursues the examination of *a priori* factors before the scandal occurs, the experimental context should mimic as much as possible a reality setting.²⁰ To do so, the neutrally adapted scenario simulates a new product launching. Participants encounter a defective component as a reputational threat.²¹ For the economic tension, participants have ownership benefits. Compensation packages include salary, a stock option plan, and other related benefits. Accumulated unrealized gains of the stock options plan ascend to 20% above the original baseline value. Unrealized gains create an economic incentive for avoiding personal financial losses. For the purpose of the simulation, the company's BOD is also involved as part of the context. The BOD suggests a course of action (total recall, partial recall, and no recall). Participants discern with a 5-point Likert scale (from 1 = strongly disagree to 5 = strongly agree) the BOD's *suggestion*. By doing so, the BOD does not impose any decision on participants. This allows both roles executives and auditors to express real intentions.

Participants

Sampled participants for the experiment included 180 professionals. Half of the participants are C-Suite executives with an average professional experience over 17 years. The rest were professional internal auditors with an average of 15 years of experience. By averaging over 15 years of experience, participants already passed through mastering specific skills and tasks processes (Csikszentmihalyi & Larson, 2014).

²⁰ We use reality simulation because of the outcomes similarities in the statistical results versus the 'real-world' (Ashton & Kramer, 1980).

²¹ The main reason for this choice obeys that malfunctioning products can be withdrawn from the market. The new drug used as a context is a hair-growing pill not yet launched in the U.S. market, though the product has been launched in South America, a more flexible regulatory environment (Chen, 2015).

All participated voluntarily without any compensation. Also, each one signed an informed consent document.

Procedure

The experimental procedure involved two respondent groups. Each participant responded two reputational threat scenarios and two of the economic stimuli. The challenge includes first the exposure to a *high* reputational threat with one fix economic stimuli followed by a *low* reputational threat with a random economic stimulus.²² The fix economic stimulus comprises an escalated expected stock price decrease (*from 22.5%, 7.5%, to no cost*). The random (or control) stimulus differs from the initially presented stimulus. Each participant could take the experiment only once. Manipulation checks integrated the last part of the instrument. The distribution of the instrument is either electronic (Qualtrics) or printed (during professional conferences). To observe the instrument, please refer to Appendix C.

The reputational threat scenarios illustrate the severity of potential side effects of the new drug—*extreme high or low* (low for control groups only) unexpectedly triggered by a third party during the ongoing business. Since the studied phenomenon simulates a pharmaceutical drug product, one of the frequent sources of pharmaceutical scandals occurs with products' side effects (Allen, 1984). In Allen (1984), high unexpected side effects associated with malfunctioning products compromise organizations' reputation because the consumer's expectation rationale includes the specified label side effects only. The reputational threat *extreme high* severity of the malfunction expresses, "*affect*

²² A first exposure to the theorized hypothesis followed by the low threat scenario allowed the design to control for method bias (Podsakoff et al., 2003).

sexual performance, nausea, headaches and somnolence for one out of six.” In contrast, the *low* severity treatment versus “*reduce the drug effectiveness for one out of twenty.*”

Independent Variable

The independent variable—expected personal financial losses (IV)—stands on the probable economic consequences given a managerial decision. I followed the negative losses connotation as the expected economic consequence from a decision making process argued in Kahneman and Tversky (1979). Such approach was convenient because participants face latent losses rather than actual losses. Particularly, the expected losses represent the underperformance in stock prices as a distribution of three escalated economic points (22.5%, 7.5%, and *no cost*). Accumulated capital earnings from the compensation package before the managerial decision ascends to 20%. Then, expected participants’ gains (losses) distribution with the potential downturn ranges: total (20% minus 22.5%), partial (20% minus 7.5%), and no (20% minus 0%) economic losses.

Dependent Variable

As theorized, the likelihood of scandal represents the endogenous component of the study. In order to inhibit a scandal, the reputational threat needs to first be addressed. To address reputational threats, organizations analyze and implement a strategic response mechanism. For the purpose of this study, the BOD suggests the response (DV)—*full*, *partial* and *no recall*. Participants defy such suggestion seeking for an optimal response given their expectations. The strategic response, based on the experiment context, immerses participants in a critical dilemma. The new release product has an unexpected malfunction. Participants have to decide whether *full*, *partial* or *no* withdrawal of the

product from the market with potential personal financial consequences versus the likelihood of a reputational scandal.

Moderation

As aforementioned, there are substantive differences between two different organizational roles assumed. The objective seeks to contrast those responses. Therefore, the multi-group moderator variable states role: executives versus internal auditors.

Control Groups

I controlled for treatment reaction and ethical concerns. The treatment reaction control relies on the *low* severity of the threat. Because the data derived from a single method, I controlled potential bias following Podsakoff et al. (2003) guidelines. Participants received also the low threat treatment. Controlling such responses enables consistency of the results to the threat manipulation of potential contamination from participants' skepticism about the instrument simulation. Also, one-third of the total group received an inconsistent BOD suggestion. The *no-recall* suggestion, although apparently contradictory, functions for controlling groups' compliance with the BOD *per-se* rather than owns' ethical beliefs. Therefore, positive statistical results in the controlling groups indicate higher reliability and validity of the overall results.

Manipulation Checks

I conducted three manipulation checks: product characteristics, severity of the threat, and expected variations in stock prices. Participants responded with 5-point Likert scale (1 = strongly disagree to 5 = strongly agree) about the relevance of the product to the market, "Hair loss represents a major concern among males," ($M=3.49$, $SD=1.08$). The additional questions address the independent and dependent variables, "Side effects

of drugs are determinant for consumers' preferences," ($M=3.93$, $SD=.97$) and "Variations in stock prices reflect companies' economic performance," ($M=3.88$, $SD=.82$).

Pre-test

The instrument was administered with two scenarios per each participant. Before the final launching of the experiment, the instrument was examined for any correlation between the first and the second scenario. To address any potential order sequential bias, the experiment was administered to 24 participants. From pre-test results, order of has no significant effect neither mean differences were found (see Table 3). Still, participants responded first the theorized hypotheses followed by the control scenarios for the robustness of the results.

Data Analysis

Because the hypothesis compares two groups' responses in different scenarios or analyzing the collected data, this study compares both responses within and in-between groups using one-tailed ANOVA. Within comparison, responses include *high* and *low* threat and *high*, *low* and *no* expected financial losses of each group. In-between groups' comparison responses contain an aggregate and partial one-tailed ANOVA comparison with the control groups and the theorized groups for each type of participant. The aggregate comparison analyzes both executives and internal auditors groups' responses simultaneously. The global analysis helps to address statistical validity while the partial analysis helps to identify specific differences in both executives and auditors.

Results

Manipulation Checks

To address instrument bias, the manipulation variables pursue the instrument's reliability measurement. Participants indeed considered that the simulation refers to reality with the product characteristics ($M=3.49$, $SD=1.08$, $t>1.96$, $p<.001$). In terms of the severity of the reputational threat (*high* or *low*), participants also responded consistently of potentially negative outcomes from side effects ($M=3.93$, $SD=.97$, $t>76.56$, $p<.001$). Last, participants positively reacted to expected variations in capital market from major organizational decisions ($M=3.88$, $SD=.82$, $t>1.96$, $p<.001$). This suggests that organizational product withdrawing would presumably have a negative consequence for the share performance. Consequently, based on these results the manipulations are stable for arguing reliability of the instrument and adequate mitigation of type I and II errors.

Hypotheses Test: H_{1a} , H_{1b} , and H_{1c}

H_{1a} and H_{1b} suggest the association between the expected executives' personal losses in stock option compensations and the likelihood of suffering a reputational scandal. For testing these hypotheses, we conducted a one-tail ANOVA within the groups of executives. The theorized comparison includes two severities of reputational threats (*High* and *Low*) and the distribution of expected personal losses (*High*, *Low*, and *No* losses). Findings represent the strategic response efforts to mitigate the likelihood of reputational scandal.

Results from the global ANOVA test were mixed to test hypotheses H_{1a} and H_{1b} . (see Tables 2 and 3). In hypothesis H_{1a} , I tested the severity of the threat and the

managerial response. Table 2 details the results of this main effect. Means of 2.93 for the first scenario (involving serious problems) and 3.00 for the second (involving less serious ones) were produced. These were not significantly different at the $p < .05$ level. Thus, no support existed for the first hypothesis.

Table 2. Executives' Responses Main Effects - Severity of the Reputational Threat (Low - High)

Panel A. Descriptive Statistics					
	Mean	SD	N		
Severity - Low	3.00	1.398	90		
Severity - High	2.93	1.364	90		
Panel B. Homogeneity					
	Levene's	F			
Based on Mean	0.076	0.783			
Based on Median	0.038	0.843			
Panel C. Main Effects					
	df	MS	F	P-value	η_p^2
Intercept	1	1584.2	830.3	<.001	0.823
Severity (Low - High)	1	0.2	0.105	0.746	0.001
Error	178	1.908			

*Bold numbers with significant statistical p-values <.001, <.01, and <.05

H_{1b} expected that the severity of such losses would be inversely correlated with the magnitude of support for extreme corporate reaction (that also would be most expensive option available). Table 3 shows the impact of personal economic losses through the impact of a recall action in stock value. Results confirm the support for the expected effect. Participants tend to lessen their support for the board of directors' position when they have information about a large reduction of stock value as a result. The difference in means is significant at $p < .05$.

Table 3. Executives' Responses Main Effects - Personal Economic Losses

Panel A. Descriptive Statistics					
	Mean	SD	N		
Economic Losses - 22.5%	2.27	1.287	60		
Economic Losses - 7.5%	3.43	1.125	60		
Economic Losses – No	3.20	1.436	60		
Panel B. Homogeneity					
	Levene's	F (2/177)			
Based on Mean	3.435	<.05			
Based on Median	2.742	0.067			
Panel C. Main Effects					
	df	MS	F	P-value	η_p^2
Intercept	1	1584.2	953.5	<.001	0.843
Economic Losses	2	22.9	13.8	<.001	0.135
Error	177	1.661			

*Bold numbers with significant statistical p-values <.001, <.01, and <.05

H_{1c} is an interaction effect involving the two main effects that are the subject matter of the first two hypotheses. Here the expectation is that the severity of the event will change the impact of economic loss on the position of support for the boards' decision. Table 4 details the tests of this expectation.

Table 4. Executives' Responses Main Interaction Effects

Panel A. Descriptive Statistics

	Severity - Low			Severity - High			Total		
	Mean	SD	N	Mean	SD	N	Mean	SD	N
Economic Losses - 22.5%	2.23	1.305	30	2.30	1.291	30	2.27	1.287	60
Economic Losses - 7.5%	2.67	.884	30	4.20	.761	30	3.43	1.125	60
Economic Losses - No	4.10	1.242	30	2.30	.988	30	3.20	1.436	60
Total	3.00	1.398	90	2.93	1.364	90	2.97	1.378	180

Panel B. Homogeneity

	Levene's	F (5/174)
Based on Mean	2.315	<.05
Based on Median	1.215	.287

Panel C. Main Interaction Effects

	Df	MS	F	P-value	η_p^2
Intercept	1	1584.2	1312	<.001	.883
Economic Losses	2	22.9	18.9	<.001	.179
Severity (Low - High)	1	.200	.1656	.685	.001
Economic Losses x Severity	2	41.9	34.668	<.001	.285
Error	174	1.2			

*Bold numbers with significant statistical p-values <.001, <.01, and <.05

As anticipated by our interaction hypothesis, the relative severity of the corporate scandal creates a different environment for the importance of personal economic losses for the study's participants. When severity is high, participants are less willing to accept personal losses ($M=2.3$, $SD=1.291$), even if this means questioning the board's recommendations. This effect is significant at the $p<.05$ level and provides support for H_3 . Along similar lines, one can say that lower severity allows participants the opportunity to bear their economic losses when given the opportunity to support or question the board.

Hypothesis Test: H_{2a} and H_{2b}

H_{2a} and H_{2b} predict that the higher the expected losses in internal auditors' stock options compensation compared to executives', the lower the likelihood of going through a reputational scandal. For testing H_2 , I also conducted a one-tail ANOVA test to internal auditors' responses (see Table 5). I expected that auditors would be less influenced by personal economic losses and would respond more strongly to the severity of the situation. The results show that occupational group differences are quite salient in the economic perspective. As summarized in Table 5, internal auditors much more readily agree to a full and costly product ($M= 4.28$, $SD= 0.976$) recall than did the executives ($M= 2.27$, $SD= 1.287$). Less extreme actions recommended by the board did not exhibit such sharp group disagreement. This first difference (significant at $p<.01$) is supportive of H_{2a} . Threat severity was roughly equivalently evaluated as important by both groups. Thus, H_{2b} was not supported.

Table 5. Roles' Responses Main Effects

Panel A. Descriptive Statistics

	Executives			Internal Auditors			Total		
	Mean	SD	N	Mean	SD	N	Mean	SD	N
Economic Losses - 22.5%	2.27	1.287	60	4.28	0.976	60	3.28	1.523	120
Economic Losses - 7.5%	3.43	1.125	60	3.43	1.212	60	3.43	1.165	120
Economic Losses - No	3.20	1.436	60	2.67	1.548	60	2.93	1.510	120
Total	2.97	1.378	180	3.46	1.424	180	3.21	1.421	360

Panel B. Homogeneity

	Levene's	F (5/354)
Based on Mean	6.828	<.001
Based on Median	3.595	<.01

Panel C. Main Interaction Effects

	df	MS	F	P-value	η_p^2
Intercept	1	3718.5	2276.2	<.001	.865
Role (Executives - Internal Auditors)	1	22.0	13.5	<.001	.037
Economic Losses	2	7.8	4.8	<.01	.026
Roles x Economic Losses	2	54.3	33.2	<.001	.158
Error	354	1.2			

*Bold numbers with significant statistical p-values <.001, <.01, and <.05

Table 6. Roles' Responses Main Effects

Panel A. Descriptive Statistics

	Executives			Internal Auditors			Total		
	Mean	SD	N	Mean	SD	N	Mean	SD	N
Economic Losses - 22.5%	2.27	1.287	60	4.28	.976	60	3.28	1.523	120
Economic Losses - 7.5%	3.43	1.125	60	3.43	1.212	60	3.43	1.165	120
Economic Losses - No	3.20	1.436	60	2.67	1.548	60	2.93	1.510	120
Total	2.97	1.378	180	3.46	1.424	180	3.21	1.421	360
Severity - Low	3.00	1.398	90	3.59	1.253	90	3.29	1.357	180
Severity - High	2.93	1.364	90	3.33	1.572	90	3.13	1.481	180
Total	2.97	1.378	180	3.46	1.424	180	3.21	1.421	360

Panel B. Main Interaction Effects - Economic Losses

	df	MS	F	P-value	η_p^2
Intercept	1	3718.5	2276.2	<.001	.865
Role (Executives - Internal Auditors)	1	22.0	13.5	<.001	.037
Economic Losses	2	7.8	4.8	<.01	.026
Roles x Economic Losses	2	54.3	33.2	<.001	.158
Error	354	1.2			

Panel C. Main Interaction Effects - Severity (Low - High)

	df	MS	F	P-value	η_p^2
Intercept	1	3718.5	1892.8	<.001	.842
Role (Executives - Internal Auditors)	1	22.0	11.2	<.001	.031
Severity (Low - High)	1	2.3	1.2	.276	.003
Roles x Severity (Low - High)	1	.8	.4	.523	.001
Error	356	2.0			

*Bold numbers with significant statistical p-values <.001, <.01, and <.05

Discussion

The research findings provide valuable information regarding the reputational caring process of organizations before scandals occurrence—particularly, about reputational threats management by the structures in line with the agency theory argument. Based on the findings (1) aligning executives' interests using compensation packages does not mitigate the propensity to reputational scandals—on the contrary, the likelihood increases; (2) The monitoring structures not only mitigate risk but also may compromise economic growth due to auditor's extreme risk-adverse position; (3) Scandals are prevented without compromising shareholders wealth when neutrality between roles is achieved. The latter is because executives' risk-incentives match or compensate an extreme risk adverse position of the monitoring structures. When one of the agency elements dominates, scandals occur or growth is compromised.

Executives' Expected Losses

The study evidence suggests that stock-options compensations are key determinants prior the scandals incidence. When executives' expected personal losses are compromised, they prefer the less (personal) 'costly' scenario. Even if by taking the least expensive decision, the levels of reputational uncertainty increase. Uncertainty translates into a higher likelihood of going through reputational scandals misaligning the incentives between executives and shareholders. Implying that executives are awarded to not only overpass ineffectively daily business operations (Yermack, 1995) but also to neglect while preventing scandals.

Findings support scholarly literature regarding risk aligning between executives and organizations when the expected personal losses are low or absent (Agle et al., 1999;

Eisenhardt, 1989; Fama & Jensen, 1983a; Fama & Jensen, 1983b; French & Poterba, 1991; Hall & Murphy, 2000; Jensen & Murphy, 1990; Liljeblom et al., 2011). Executives mitigate the likelihood of scandal incidents with corrective actions when the risk (severity) is high and inexpensive. When the risk (severity) is high but personally 'affordable', proper corrective measures are accepted. Incentives remain aligned and financial personal gains persist higher than expected losses. Gains are still earned by responding the threat. Gains shared with investors. Opposite effect occurs when preventive cost exceeds personal expected gains. Executives rather prefer the uncertainty of not adequately attend to the threat, facing the likelihood of becoming or not an actual scandal. In fact, the decision cost does not jeopardize the executives' incentives alignment. Both investors and executives seek and earn current profits by not responding to reputational threats. But the side effect of not attending to the expensive threat, increase the organization' reputational uncertainty. Without knowing, outside investors ignore that current profits have also a reputational uncertainty component promoted by the incentives aligning mechanism.

Monitoring Structures

Investors appoint monitoring structures such as BOD and internal auditors to observe executive's behavior (Fama & Jensen, 1983). I found that internal auditors as monitoring structures compensate some uncertainty of facing reputational scandals. I theorized that the amount of expected personal losses will trigger a behavioral reaction that mitigates the likelihood of reputational events. However, above-mentioned findings indicate that internal auditors are insensitive to expected personal losses. The behavior of those individuals manifested an extreme-ethical-conservatism orientation. Such behavior

inhibited the occurrence of scandals. The implication supports that internal auditors accomplish expected oversight functions (Brody & Lowe, 2000) as efficient monitoring insiders of shareholders' interests (Archambeault et al., 2008). As internal observers, they convey with the expected conservatism when the risk (Severity) of a scandal is high (Ahlawat & Lowe, 2004). They demonstrated less sensitivity with respect to personal financial losses (Dezoort, Houston, & Reisch, 2000). Suggesting that their behavior may be driven by an ethical component (Reynolds, 2000).

However, the ethical conservatism may also impede economic growth. Internal auditors' behavior presented an over-reaction under low risk (severity) of scandal. This group responded equally in the low and high-risk scenarios. Such myopic perception of risk may alter economic growth. My explanation to such reaction derives from the high potential financial loss outcome. Knowing that the potential implication of a decision may damage also investors, internal auditors prefer to ignore the risk threat category in light of responding to the threat.

Balanced Decision Process

Aforementioned findings also suggest that BOD, executives and internal auditors agree in many organizational decisions. Under some risk circumstances, those roles may face antagonistic positions. Although both contain reputational threats with high scandal risk (severity), executives only did with low decision cost (or even zero). I found that the strategic response consensus occurs when executives' financial expectations or concerns (Bergstresser & Philippon, 2006; Sanders, 2001) meet internal auditors' objectivity (Caplan, 1999) and both are aligned with a BOD protective intentions. The larger difference between groups is when decision costs of containing a reputational threat are

high. Executives' mindset focuses on personal losses meanwhile internal auditors in investors' stability. When I compare both groups, statistical results indicate that executives presented low levels of ethical-conservatism while addressing the threat with a high scandal risk (severity). Internal auditors showed an extreme conservatism under low risk (severity) but when expected investors' losses were high. The combined effect indicates that the optimal organizational response is when both groups balance their efforts in addressing reputational threats.

CHAPTER 6: EMPIRICAL ANALYSIS OF THE CAPITAL MARKETS' RESPONSES TO A SPECIFIC SCANDAL

Introduction

Vast academic literature emphasizes in their motivation the avoidance of corporate scandals such as Enron to illustrate the fragility of the bond between investors and corporations (Fombrun & Foss, 2004; Gertsen et al., 2006; Gillespie & Dietz, 2009; Hennes et al., 2008; Heugens et al., 2004; Ho, 2005). The word “Enron” appears in over 130,000 academic materials.²³ The common pattern of using this case references the environmental consequence of corporate scandals (Agrawal & Chadha, 2005; Ashbaugh-Skaife, Collins, Kinney Jr, & LaFond, 2008; Fich & Shivdasani, 2007; Hennes et al., 2008). Media also takes profits from accounting scandalous event (Miller, 2006). However, the Enron case refers specifically to financial statements fraud (Agrawal & Chadha, 2005; Bebbington, Larrinaga, & Moneva, 2008; Karpoff et al., 2008b). By the convention of the cited example, it also includes a negative capital markets reaction which happens to be legitimate (Fich & Shivdasani, 2007; Karpoff et al., 2008a, b), but in the corporate scandals world, fraud in financial statements distances to be the only type of accounting related issues.

Academic literature includes tax misbehaviors, fraud in financial statements, quality controls failures and international corruption practices as corporate scandals (Fombrun & Foss, 2004). Yet, these socially questionable events received similar halo that financial statements fraud under the capital markets lens: corporate scandals negatively affect the capital markets (Giannetti & Wang, 2016). However, there is a reasonable generalized doubt that justifies this research to challenge that preconception;

²³ Scholar.google.com. [consulted in 03/14/2018]

furthermore, and much more interesting, how corporate scandals influence capital markets.

To address these two concerns, first, this manuscript explores what factors differentiate financial statements fraud from other types of scandals—in this case, international corruption violations (FCPA)—to test whether the negative presumption of scandals is or not generalizable outside fraud. Then, a behavioral model is introduced to the capital markets literature to explain how investors perceived modern corporate scandals, in specific FCPA violations. In this case, the behavioral model includes environmental and personal characteristics to elucidate their final reaction.

This manuscript applies FCPA violations to illustrate the scandalous component of events transmitted by the media. For example, on September 28, 2016, the SEC revealed that Anheuser-Busch InBev would pay \$6 million as settlement of using a third-party company for improper payments to Indian government officials to increase sales and production.²⁴ The SEC started the investigation for anonymous whistleblowers. Likewise, on December 17, 2014, Avon Products Inc. agreed to settle with the SEC the payment of \$135 million as result of illegitimate gifts and payments to Chinese government officials through the usage of a subsidiary and consultants in exchange of regulatory favors.²⁵ Every time an SEC ends an investigation, they reveal the details in their official releases. Media reproduces the investigation details to attract audiences (Fenton, 2010). Noteworthy, because of the investigation process secrecy the general

²⁴ SEC Press Release 2016-196 available at <https://www.sec.gov/news/pressrelease/2016-196.html>. [Information consulted on February 8, 2018].

²⁵ SEC Press Release 2014-285 available at <https://www.sec.gov/news/pressrelease/2014-285.html> [Information consulted on February 8, 2018]

public becomes aware once the official press release appears. The purpose of this study is to analyze how stockholders' returns assimilate the authorities' press release.

In specific, FCPA investigations represent violations of Section 13 of the SEC Act and the FCPA. Authorities initiate prosecution based on confidential whistleblowers' claims. The legal actions are conducted under secrecy to the public as established on internal procedural protocols. Their inquiry focused on analyzing the involvement of organizational personnel in domestic or international bribery practices to obtain certain benefits in exchange for an economic compensation.

Examples of the acquired illegal benefits are unusual awarded contracts, special permits, or uncommon bargains to the organization outside the United States. Although vast could be the agents' motives for incurring in such illegitimate practices, the ultimate consequence benefits financially their firms. Authorities veto and prosecute these unlawful extra profits by sanctioning those involved and the companies too. Usually, the fine tends to be substantially higher to firms.

Although rarely the investigation process ends with a jury trial, the final press release informs the absolution of the criminal charges under an economic settlement. This is because regulators and firms tend to prefer the certainty of a settlement or 'resolution vehicle' rather than a noxious and subject to scrutiny jury trial (Koehler, 2010). The amount to be paid is fixed by authorities and firms' managers without disclosing to the public any details of the calculation basis.

Scarce is the academic literature concentrated in understanding the social consequences of FCPA violations. Most of the available materials emphasize the relevance of prevention to avoid unnecessary legal contingencies. For example, Huskins

(2008) emphasizes the potential legal liabilities that may affect firms' economic performance because of a weak control environment that could allow bribery practices if detected by authorities. Karpoff et al. (2014) documents that after the prosecution of an FCPA violation, firms net present value is negative contrasting with ex-ante values because of the associated costs such as the settlement. However, once these violations reached to the public domain and investors become aware of the investigation details revealed by the SEC or the DOJ their reaction and their motivators remain unexplored.

The primary objective of this investigation is to contrast and analyze the authorities' press releases details with firms' stock performance to understand the investors' reaction. The second objective is to test a behavioral model that combines behavioral, personal, and environmental aspects to understand the reactions to accounting scandals from the investor's lens. To achieve these objectives, this investigation conceptualizes a simple model that explores the capital markets reactions and its motivators using event-study and OLS methodologies. The event-study methodology deems conveniently because the precise date of the release and the details of the event are known (Fama & French, 1993). And, since authorities operate FCPA investigations under the principle of secrecy, only those involved in the process have the knowledge of the event. The OLS methodology also results applicable because once publicly open the investigation, it is to the capital markets to absorb and analyze more than one source of information in order to make a decision (Karpoff et al., 2008b; Kothari & Sloan, 1992; Liu & Thomas, 2000).

The analysis includes a comparison of the market responses from match-peer sample firms publicly free of such violation charges. The industry peer sample

comparison is commonly observed in accounting failures literature to address the selection bias issue while controlling with a non-treatment group (Agrawal & Chadha, 2005; Ogneva, Subramanyam, & Raghunandan, 2007).

Securities and Related Theoretical Frameworks

The academic definition of reputational scandals relies on the factors that contribute to such events to exist. Molotch and Lester (1974) explain the origins of scandals. It takes one person (or informant) that disagrees with an organizational outcome with enough willingness to communicate to the media the event details to create a scandal. Although the content provided by the informant is not yet explored in academic literature, it is possible to infer that the event details remain at the discretion of the source, whether they are faithful, inaccurate or fictitious. However, the released information itself should not be considered a scandal. Scandals should be considered as such because of the intensity of media attention.

Press editorial boards have a tendency to promote controversial and outrageous events in order to attract readers and therefore fund their ongoing operations (Blair, Stephenson, Hill, & Green, 2006). Blair et al. (2006) refer to the allusiveness of 'sex sells' to denote that news should have a scandalous component to catch readers' fascination. In this sense, after the Enron scandal seems that accounting events are in the preference of the editorial boards since then. Repetition of events with corporate-related issues occupied not only business press, but also front pages of daily journals. A prominent and recent example considering the repetition of media is the financial fraud

from Bernie Madoff; the event was repeated by media in different news over 309,000 times.²⁶

The role of media influencing individuals occupies top priority in the agenda of communication researchers. There are two main streams to understand the persuasiveness of mass media. The first notion of how individuals are influenced by media concentrates in understanding the right channel to efficiently send a message to a receiver (Daft & Lengel, 1983, 1986). The sender's objective is to transmit a message in the most accurate way. The media rich theoretical framework posits the effectiveness of the communication transmission in the shared meaning of the information (Daft & Lengel, 1983). A basic example of this explanation in the accounting setting is the argument that financial statements are effective informational tools because readers understand its meaning.

The second notion of how individuals perceived and respond to informational comes from the social cognitive realm. Under this theoretical framework, psychosocial factors motivate individuals' actions (Bandura, 2001). The reciprocal interaction between personal behaviors, beliefs, and environment promote individuals' actions. The classical example is the influence of television on viewers. Television shows construct a social reality that can interfere with individuals' behavior, but the final reaction depends on personal beliefs and environmental characteristics (Bandura, 2001, 2011).

The relevance of these two frameworks, media richness and social cognition, can help to understand investor response after reputational scandals. First, I explain the applicability of media richness in corporate scandals and the relationship with investors'

²⁶ The words Bernie Madoff have over 309,000 results in a traditional internet browse search. This character was accused of a Ponzi scheme and sentence by the DOJ for 150 years in prison for investment financial fraud. Google.com [consulted in March 7, 2018]

behavior. Then, the subsequent section concentrates on the psychosocial factors in explaining investors' response. Hypotheses are drawn accordingly.

Media Richness Framework

One of the most fundamental communication channels of firm performance is the financial statements. The relevance of this instrument relies on the information they provide to decisions makers as a formal source. The influence of formal sources on investors' decisions primordially helps securities' prices to adjust to new financial information. Investors exchange such titles in keeping with their expectations which are shaped as new information about the investment performance (good or bad) becomes available (Fama, 1991). Securities revalue because prices reflect new publicly available information (Fama, 1970, 1991). Financial outperformance enhances market value; underperformance decreases prices. Therefore, formal sources are relevant to investors because the content allows them to make investment decisions.

Although, so far, academic literature does not explicitly explore financial statement fraud under the media theory, it is possible to explain using this contextual framework the stock prices adjustments in a hypothetical sense. Financial statements represent the vehicle that contains the information. Investors characterize the receivers and users of that information. Violations of the instrument could be interpreted as an effectiveness flaw. Because the instrument that communicates contained unfaithful information, this casts its persuasiveness. Because the three elements—sender, instrument, and receiver—are present and their dynamics determine the effectiveness of the message, financial statements fraud can be explained under the effectiveness of the media richness framework.

However, financial statements frauds distance to be the only corporate scandal. Frauds in the financial statements have certain unique characteristics such as that the violation itself deceives decision makers by forging accounting information (Fich & Shivdasani, 2007). Public media also selects and repeats other business related wrongdoings to massively inform population (Miller, 2006). For example, tax scandals occur when media uncover tax aggressive strategies (Hanlon & Slemrod, 2009). This aggressive strategy refers to shifting or 'lodging' corporate earnings from one taxable regime to a lower corporate tax rate regime (Desai & Hines Jr, 2002b). Another type of scandal and matters of this research represents corruption acts. Also named, FCPA violations are internationally bribed acts where an individual engages in illegal practices to obtain dishonest benefits for their companies (Karpoff et al., 2008b). So, media produce and reproduce not only financial statements fraud but also other concerning corporate misconducts.

I argue that corporate related media events should not trigger a negatively automatic response from capital markets. This is because corporate scandals follow a process where information is transmitted by senders—in this case, the scandal itself—the transmitter represents the media, and receivers who process the information are the capital market participants. As evidenced by academic scholars, financial statements fraud provokes a negative response from investors because the message between senders and receivers is compromised (Fich & Shivdasani, 2007; Karpoff et al., 2008b; Palmrose et al., 2004). But corporate scandals do not necessarily present a transgression to the communication instrument. Therefore, corporate scandals may raise questions about the firms and its performance, but there should not be associated scandalous news about a

company with an automatic negative capital market response because there are individual and social characteristics that contribute to explaining investors' reactions. Therefore, the first hypothesis is as follows:

Hypothesis 1. Socially arguable scandalous events, such as FCPA violations, trigger a negative capital markets response.

In order to explain what factors contribute to understanding the market's response, we argue that because the reaction to informational messages is a reciprocal combination between beliefs, behavior, and environment (Bandura, 2001), the final outcome of scandals should not be taken lightly. This material focuses on exploring the market's final response to publicly negative events, by framing the social cognitive components in the capital market dynamics to analyze the environmental and beliefs factors that influence individual's behavior. This section elaborates this argument.

Social Cognitive Framework

Social cognitive theory states that individuals' actions are explained by reciprocity between personal beliefs, behavior, and environment. These psychosocial factors have a mutual "reciprocal determinism" (Bandura, 1986). For example, individuals' behavior is influenced by their environment and those behaviors, by reciprocity, help to shape their environment as well. Similarly, beliefs shape individuals' behavior and vice versa, the behavior contributes to explain individual' beliefs.

This modeled behavior is observable in the capital markets dynamics. Investors make portfolio decisions using not only financial but also non-financial rationale. Investors have a tendency to calibrate investment portfolio decisions based on measures such as ethics, trust or beliefs (Anderson & Frankle, 1980; Black et al., 2000; Fombrun & Shanley, 1990; Grinblatt & Keloharju, 2001; Harris & Raviv, 1993; Ho, 2005; Pfarrer,

Pollock, & Rindova, 2010). Anderson and Frankle (1980) found evidence of abnormal positive market returns for firms that voluntarily disclose social endeavors. Furthermore, the abnormal market value depends on how well the name of firms stands to society (Black et al., 2000). Mostly, this value-added occurs because investors create emotional attachments associated with firms' behaviors (Fombrun & Shanley, 1990) And, there are also rewards to stock performance based on corporate reputation (Fombrun & Shanley, 1990; Pfarrer et al., 2010). So, individuals consider in their investing decisions firms' social actions. In that logic, social actions attract new investors that improve stocks' performance, and financial performance develops because of individuals' and society's beliefs. Consequently, it is possible to observe the reciprocity interaction in the financial markets.

My argument centers the capital market response surrounded by the environmental and beliefs elements of the social cognitive framework. The environment component in the analysis is represented by market analysts. Legal penalties paid by firms represent individuals' beliefs. The next hypotheses follow that order, first environmental responses, then the role of beliefs, and concludes with the interaction of both elements over the capital market response.

In the capital market environment, there are some characters dedicated to analyzing current firms' and securities' performance versus a potential future performance. From their analysis, they issue forecasting opinions representing plausible predictions (Brennan, Jegadeesh, & Swaminathan, 1993). These market participants use their experience and private access to information about firms and their professional skills to increase the accuracy of their opinion (Ivković & Jegadeesh, 2004). The

consequence of their opinions not only contributes to faster stock prices adjustments (Brennan et al., 1993) but also reduces transaction costs (Brennan & Subrahmanyam, 1995). Their predictions discrepancies surrounding firms' news are moderately low (Ivković & Jegadeesh, 2004). Therefore, investors have a tendency to rely on these analysts' predictions as an environmental source to make financial decisions.

However, investors have a tendency to listen to the guidance of analysts' recommendation and how they revise them constantly. Stickel (1995) finds that stock prices are greatly influenced not only by analysts' recommendations to buy or sell but also by the change of such recommendations over time. Clement and Tse (2003) argue that these changes of analysts' opinions represent revised expectations of their original predictions for future organizational financial performance. The relevance of these revisions represents the most consulted reference from investors in a trading-day basis (Bradley, Clarke, Lee, & Ornathanalai, 2014). This reinforces the role of these characters as environmental influences to capital markets responses.

In terms of corporate scandals, we theorize that analysts' influence is a factor to understand how markets respond to corporate scandals. If investor reaction is fed by environmental factors such as analysts' opinions, therefore, investors will condemn scandals partly because analysts also condemn scandals. And, because stock prices are influenced by analysts' opinions (Clement & Tse, 2003), if they revised their expectations about the firm to negative, prices consequently will drop. Instead, if analysts' reconsiderations do not exhibit lowered but positive expectations, investors and therefore stock prices will unlikely fall. So, the next hypothesis is:

Hypothesis 2. Capital market's reactions after controversial events are influenced by how analysts change their firms' perception.

In many cases, corporate scandals have associated a penalty imposed by regulators. When such penalties exist, the penalty itself may be significant to firms' economic performance. These economic penalties can be analyzed in two dimensions depending on the context: as a component of market efficiency dynamics where stock prices reflect expected profits and losses (Fama, 1991; Fama et al., 1969; Kothari & Sloan, 1992). Or the penalty could be also observed as the managerial efforts to seize potential legal implications.

As a component of the market efficiency elements, (Karpoff et al., 2008a, b) argues that in financial statements fraud with associated penalties represent a substantial component in the stocks' prices adjustments because of the anticipating financial underperformance. However, in the financial statements fraud context, investors can exercise discretionary measures to initiate a litigation process followed by the misbehavior (Bonner, Palmrose, & Young, 1998; Griffin, Grundfest, & Perino, 2004). Therefore, under this perspective the litigation risk is undissolved.

My argument is that the penalty can also be analyzed in the context of the settlement as a fixed amount by firms' managers to end the investigation. Under such consideration, penalties represent instead of expenditures, the managerial effort to solve promptly a potential further legal issue. By not observing the penalty as an expense, investors can judge the fine based on their beliefs rather than an economic value. In this case, a dual interpretation of the legal expense would imply that penalties are less consequential when they represent the mitigation of potentially higher economic losses by ending, without accepting or denying, any legal responsibility.

In academic literature, lower levels of uncertainty are associated with more stable securities' values (Bloom, 2014). The justification is largely because lower levels of litigation risk reduce investors' uncertainty (Hughes & Thakor, 1992; Lowry & Shu, 2002). Investor beliefs are influenced by the scandal fine but not because of the economic value, but because of lower levels of perceived uncertainty. And, consistent with the psychosocial factors, investors' beliefs are directly related to their behavior. Therefore, when scandals are resolved with a legal resolution vehicle such as a settlement, firm market value should not decrease because investors will not undervalue the securities. Consequently, the next hypothesis states the following:

Hypothesis 3. Paid settlements to end FCPA investigations increase firms' market value.

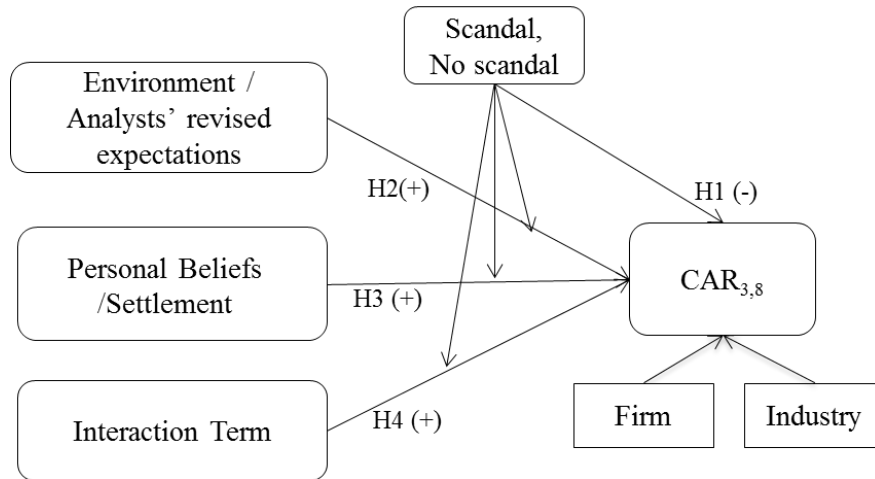
Consistent with the psychosocial factors, the reality construction is a function of many sources (Bandura, 2001). Environmental effects interacting with individuals' beliefs after scandals operate to decrease investors' preoccupations to make doubtful financial decisions. Therefore, the fear of making, impulsive or rush decisions in light of the public event decreases by attending to those sources: the revised expectations from analysts who have the most professional experience and lower levels of litigation risk as consequence of the economic settlement. Therefore, I predict the interaction of both the analysts' recommendation and the penalty over the final market response to explain the scandal phenomenon.

Hypothesis 4. Analysts' judgment of scandalous events and legal settlements paid by firms help to dissipate stockholders' fears of firms' prosperity.

To address the preceding hypotheses, the summary of the theoretical model is presented in Figure 1. The structure of the remaining sections of the study flows in the

next order. The afterward section details the collected data and its sources, methodology, empirical model. Analysis and results are reported subsequently. The study concludes with the discussion section.

Figure 1. Theoretical Model



Collected Data, Methodology and Model

To operationalized corporate related scandals, this study analyzes and explores FCPA violations. FCPA violations have a socially arguable component that attracts the media attention. Besides the ethical component of the wrongdoing, an argument in the overall debate of these events tends to challenge that international corruption violations should be prosecuted in the jurisdiction where the misbehavior was conducted rather than by the United States authorities (Huskins, 2008). Another inconformity explains that the execution of the regulation has not reduced FCPA cases overtime (Koehler, 2010). Because of the scandalous component of these violations, social claims had intensified the media coverage onto the authorities' press communications (Miller, 2006). We collected from the public archives the official documents released by the SEC and DOJ.

To sample my investigation, only completed investigations between 2007 and 2016, where the firm was directly liable, are included as valid cases. In this time frame, authorities documented 126 violations. However, not all the cases fit for the purpose of this inquiry. The selection criteria for valid cases part of this sample was as follows:

- (1) Only publicly listed firms in the U.S. securities markets (NYSE and NASDAQ) were cited;
- (2) A period of one fiscal year had to have elapsed since before and after the event;
- (3) Firms disclosing any information prior the event were excluded;
- (4) At least one analyst had to have been covering the company at the time of the event;
- (5) Every event must have been covered by the media or be reproduced on the internet.

From the hand-collected documents, the clustered data includes firms' names, public release dates, and any associated penalties. The valid number of collected cases for the study was 94 firms.

Model Variables

This study explores capital market response to the FCPA press releases as corporate scandals. The market response is measured using stock cumulative abnormal returns (CAR) applying the Fama-French three-factor model based on the known incident date (Fama & French, 1993). This includes the three- and eight-day horizons with zero missing values, forecasted with data from 100 observations before the event. Such operationalization deems adequate because this methodology is recommended for analyzing outcomes of stockholders' returns as a sign of investors' perception to certain

events (Karpoff et al., 2014). CAR values are available in the WRDS Event Study Data Analysis.

Once completed the final sample of events, analysts' recommendations that represent the environmental factor of each valid case were collected and merged into a single database with the rest of the studied variables. Such information is accessible in the I/B/E/S database. The combination of both data sources associates monthly recommendations (selling, buying, or holding) before and after events. Given the selection criteria, analysts' forecasts do not contain missing values. The previously mentioned computational information is available in the COMPUSTAT database.

Financial analysts cover and evaluate organizations' financial performance. Analysts issue periodic recommendations about securities, and these recommendations are based on their financial knowledge, professional experience, and ability to understand and forecast expected performance. Their suggestions express sell, buy, or hold positions. Academic literature grounds the basis under what circumstances analysts tend to incline to each one of those opinions (Doukas, Kim, & Pantzalis, 2002; Harris & Raviv, 1993; Hong & Stein, 1999; Liu & Thomas, 2000; Stickel, 1992). For example, when they recommend "Sell," it implies the right timing to take profits or accept losses because the firm is about to begin underperforming or is already starting to do so. For them, securities' overvalue is not justified by organizational performance. "Buy," in contrast, suggests that it is a good time to invest in specific firms; analysts expect that undervalued securities' prices will increase allowing potential profits. "Hold" signifies the need to wait until further events occur as the security performs according to the value of the firm.

The I/B/E/S database aggregates and classifies analysts' suggestions, assigning scales as to who recommended what positions.

This database, however, has an important limitation. Opinions measurement represent an average monthly scale from 1 to 5 of the analysts covering the company where “5” represents highly recommended to invest and “1” represents highly recommended to sell. The limitation is that press releases may occur on any day of the month. For example, it is possible that the official release occurs nearby the end of the month with certain average values that can be related to the event effect, but also the event can happen in the middle with lower values towards the end. This limitation is bearable because the measurement of the recommendations variables does not consider magnitude, only a decrease or increase from one point in time to another (Figure 2 exhibits closer details).

To understand how analysts change or revise their perception after the public release, rather than using the scale as presented in the database, the variables “Buy” and “Sell” were transformed into categorical values. The revised opinion Buy (*ChgeBuy*) and Sell (*ChgeSell*) take the value of “1” if analysts changed their recommendation from one position to another once the event occurred, and zero otherwise. For example, if as a consequence of a public release, analysts in average inclined to “Buy” from an original perception of selling, the final values of *ChgeBuy* and *ChgeSell* are “1” and zero respectively. Only the variables *ChgeBuy* and *ChgeSell* are used because the position of “Hold,” represents the default variable.

As previously stated, two exogenous inducements seek to explain the capital market reactions: the environmental factor of using the revised analysts' opinions as

consequence of the event, and the change in personal beliefs using the investigation settlement. The change in the personal beliefs represents the settlement penalty or fine that firms agreed to pay to end the legal issue (Koehler, 2010). Governmental agencies judge under what circumstances organizations merits a punishment fine. In many cases, firms and authorities negotiate the amount to settle the investigation. The measurement of the settlement as a variable is the final amount attributable only to the violation (*Penalty*) with zero used to indicate the absence of any economic reprimand. To account for outliers, the data was transformed using the Windsorized methodology (Tukey, 1977).

Study Controls

To account for non-theorized effects over the variables of study, in this case, the stocks' abnormal returns, the empirical model controls for firm-specific attributes and industry performance that are traditionally observable in capital markets response literature (Dechow, Hutton, Kim, & Sloan, 2012; Karpoff et al., 2014; Wang, 2011). Firm attributes include size, using annual data of *total assets* (*Assets*), and market capitalization (*MktCap*), changes in the size (*ChgeTA*) and in profits (*ChgeNI*), profitability measures such as Return on Assets, Return on Equity (*ROA* and *ROE*), and Tobin's Q (*TobinsQ*). Industry performance indicators control for a systemic environment during the event period. Industry controls encompass changes in profits (*ChgeNISPInd*) and industry Return on Equity (*SPIndRoe*).

Controls are measured on annual basis. Capital markets response to annual financial information has stronger effect than quarterly release information (Beaver, 1968). Stockholders expect that earnings variation from one year to another be consistent to as predicted. Quarterly releases inform partial achievements of the yearly forecasts. As

time passes, the cumulative effect of the partial earnings is gradually contrasted by market participants with their original expectations up to the final annual information (Dechow, 1994). Then, the overall effect due to a full financial period can be studied along with the capital market short-term response, analysts' revised opinions, and penalties. For example, between two financial periods there is a market expectation of X% growth (decrease). As consequence of partial events in the timeframe, participants revised their expectations of firms achieving the X% goal. Therefore, the annual financial indicators that benchmark an overall expectation can be analyzed with short term data such as the market response, and the studied variables. By selecting the aforementioned control variables, this design maximizes the likelihood of abstracting that the post-scandal market response could be also because of the original financial expectations.

To address potential selection bias, the research design also controls for a group of firms free of FCPA accusations. This group represents an equal industrial comparable set of firms (Bhojraj & Lee, 2002). The selection criteria for a firm to be considered as a peer follows the six-digit Standard Industry Classification code (SIC). This classification finds equivalent competitors in the market. The peer company is, at the time of the event, the closest firm in their industry in size (in terms of total assets). The overall intention of assembling this set is to follow, given similar circumstances, the variables of study behavior as compared to the control group that lacks a specific quality, in this case, the observed event.

The peer selection process follows the industrial classification with the closer size of total assets and book-to-market ratios (Bhojraj & Lee, 2002). By selecting industrial peers, the design controls not only for similar firms' characteristics but also for potential

systemic or spill-over effects in comparable contexts and. Comparable systemic effects controls accounts for specific industry-market response. For example, under economic downturns certain industries outperform while others follow recessions. Consequently, market participants have a better understand industrial relative performance allowing the research design to compare firms' information and reactions to such information.

Methodology

Once supplied with the capital markets returns and exogenous information, the study explores the market reactions given the information releases using an event analysis (Fama & French, 1993; Karpoff et al., 2014). From this process, abnormal returns were obtained. The analysis includes computing the event dates with the company name using, three- and eight-day windows. This process applies to the full sample, to the focus group and to the control peer group. Findings from the event analysis serve to address hypothesis H₁ and represent the baseline assumptions for each group and as described earlier, the dependent variables for addressing the remaining hypotheses (CAR₃ and CAR₈).

Then, the empirical model using a multivariate analysis estimates with ordinary-least-squares (OLS) the regression coefficients. The multivariable regression first focuses on the full sample; study and control group assessments complement the analysis. Then, an interaction results between the explanatory variables to the sample is presented.

To address validity issues, a nonparametric comparison between groups reveals differences in abnormal stock returns and the explanatory variables. Also, supplemental analysis tests potential endogeneity issues and robustness of the model by changing the predicting variables in order to support the stability of the model.

Empirical Baseline Model

To address the research question, the empirical model should be capable of explaining the shocks in the response variables (CAR_j) given the exogenous variations. The model includes the theorized hypotheses and the control variables. Table 7 details the variables description and its measurement. The following equation represents the empirical model:

$$CAR_j = \beta_j + \lambda_1 Corruption + \lambda_2 Penalty_j + \lambda_3 ChgeRecom_{j,k} + \lambda_4 Assets_j + \lambda_5 MktValue_j + \lambda_6 ChgeTA_j + \lambda_7 ChgeNI_j + \lambda_8 ROE_j + \lambda_9 ROA_j + \lambda_{10} TobinsQ_j + \lambda_{11} ChgeNISPInd_j + \lambda_{12} SPIndROE_j + \varepsilon_j \dots (1)$$

Table 7. Description of the Model Variables

Variable	Description	Measurement
CAR_3	Cumulative Abnormal Returns in +/- 3 days before the event	Event Study
CAR_8	Cumulative Abnormal Returns in +/- 8 days before the event	Event Study
<i>Corruption</i>	Binary grouping variable [1 = FCPA violations, 0=no FCPA violations]	Binary
<i>Penalty</i>	Amount agreed by firms to settle the investigation	USD million
<i>ChgeBuy</i>	Change in the Buy recommendation [1 when analyst increase the buying recommendation, 0 otherwise]	Binary
<i>ChgeSell</i>	Change in the Sell recommendation [1 when analyst increase the selling recommendation, 0 otherwise]	Binary
<i>Assets</i>	Total Assets before the FCPA event	USD millions
<i>MktValue</i>	Market Value before the FCPA event	USD millions
<i>ChgeTA</i>	Change in total assets from before and after the event	USD millions
<i>ChgeNI</i>	Change in total income from before and after the event	USD millions
<i>ROE</i>	Annual Return on Equity before the event	Percentage
<i>ROA</i>	Return on Assets before the event	Percentage
<i>TobinsQ</i>	Firms' value estimation of the sum of total assets plus the market value minus the book value divided by total assets	Ratio
<i>ChgeNISPInd</i>	Change in total income of the SP Industrial index before and after the event	USD million
<i>SPIndROE</i>	Industrial index Return on Equity before the event	Percentage

Analysis and Findings

Key Statistical Findings

Table 1 displays the analyzed data from 2007 to 2016. The final sample revealed a total governmental collection from settlements of \$15.6 Billion as consequence of the 94 FCPA violations. On average, organizations paid \$83.5 million to finish the investigation. Panels A and B in Table 6 below illustrate the key financial statistics.

Pearson's correlation coefficient references across variables are displayed in Table 8. Noteworthy to say is the statistical significance of the explanatory power from the predictors *ChgeBuy* over the study variable CAR_8 ($p\text{-value} < .05$); also as relevant, the low statistical correlations between the control variables over the cumulative abnormal returns, the predictors, and other control variables ($p\text{-values} > .1$). The control variable *ROA* resulted with significant correlations over the abnormal response ($p\text{-value} < .05$). This information indicates a statistical tendency from the revised analyst expectations to explain overall abnormal market response.

Table 8. Key Statistics

Key Statistics			
Panel A. Number of Accounting Scandals by Case, Penalties and Year			
Year	# of Corruption Cases	Settlement U.S. dollars (millions)	
2007	8	139.60	
2008	7	1,655.53	
2009	5	42.79	
2010	16	1,327.25	
2011	12	286.35	
2012	8	152.30	
2013	8	747.85	
2014	5	138.60	
2015	6	585.30	
2016	19	2,771.34	
Total	94	7,846.91	
Mean		83.48	
SD		2,289.40	
Panel B. Key Statistics			
	Mean	SD	N
CAR3	0.004	0.046	94
CAR8	0.010	0.072	94
ChgeRecomBuy	0.213	0.411	94
ChgeRecomSell	0.138	0.347	94
Assets (millions)	77,834	270,705	94
ChgeTA (millions)	3,982	20,617	94
ChgeNI (millions)	-244	2,612	94
ROE	0.103	0.231	94
ROA	0.051	0.073	94
TobinsQ	1.094	0.508	94
ChgeNetIncomeSPInd	8.936	17.898	94
SPIndROE	0.162	0.017	94

Event Study Test

To begin the hypothesis testing, the first observation is the event study information. The examination consists in using the Fama-French three-factor-model to estimate the dependent variables CAR_3 and CAR_8 (Fama & French, 1993), as well as the

Patell Z²⁷ Event Test statistic to reveal the event date when the market truly responded (Binder, 1998). Panels A and B in Table 10 report the mean and cumulated total abnormal returns with statistical values surrounding the event window and results from the Patell Z statistic.

Table 9. Pearson's Correlations

Pearson's Correlations													
	1	2	3	4	5	6	7	8	9	10	11	12	13
CAR3	1												
CAR8	.624**	1											
Penalty	.110	.158	1										
ChgeBuy	.158	.319**	-.069	1									
ChgeSell	.171	.107	-.043	.093	1								
Assets	-.014	.074	.214*	.027	.202	1							
ChgeTA	-.026	.089	.118	-.042	.161	.662**	1						
ChgeNI	.088	.083	-.037	.021	.082	.014	-.092	1					
ROE	.169	.068	-.022	-.010	-.074	.020	-.025	.092	1				
ROA	.286**	.256*	-.213*	-.026	-.071	-.077	-.063	.140	.596**	1			
TobinsQ	.101	.052	-.347**	.111	.016	-.194	-.098	.004	.052	.385**	1		
ChgeNISPInd	.118	.131	.086	.109	.167	.079	.134	.062	.045	-.170	-.147	1	
SPIndROE	-.002	.035	-.077	.046	-.012	-.017	-.027	.142	.204*	.048	.079	.596**	1

**, Correlation is significant at the .01 level (2-tailed).

*, Correlation is significant at the .05 level (2-tailed).

²⁷ Patell Z tests the null hypothesis that each day's reaction is the event date. Rejecting the null hypothesis reveals the actual reaction day using a Z-statistic for each day with a two-tailed test with 95% confidence.

Table 10. Event Study Results of Capital Market Responses

Event Study Results of Capital Market Responses

Panel A. Three-day Event Window

Event-window	Corruption Mean Abnormal Return	Corruption CAR	Corruption Patell-Z for Abnormal Return	Control Mean Abnormal Return	Control CAR	Control Patell-Z for Abnormal Return
-3	-.116%	-.116%	.010	-.279%	-.279%	-1.396
-2	.044%	-.072%	1.609	-.487%	-.766%	-2.210
-1	.535%	.463%	2.043	-.008%	-.774%	-.593
0	.078%	.542%	.863	-.168%	-.941%	-1.102
1	.099%	.641%	-.311	.227%	-.714%	1.103
2	.020%	.662%	-.436	-.192%	-.907%	-.606
3	-.268%	.387%	-2.061	-.076%	-.983%	-.667

Panel B. Eight-day Event Window

Event window	Corruption Mean Abnormal Return	Corruption CAR	Corruption Patell-Z for Abnormal Return	Control Mean Abnormal Return	Control CAR	Control Patell-Z for Abnormal Return
-8	-.205%	-.205%	-.472	.313%	.313%	1.680
-7	.125%	-.080%	.465	-.171%	.142%	-.290
-6	.132%	.053%	-.505	.338%	.481%	.757
-5	-.168%	-.116%	-.185	-.211%	.269%	-.632
-4	.070%	-.045%	1.349	-.376%	-.107%	-1.482
-3	-.105%	-.150%	.029	-.282%	-.389%	-1.441
-2	.051%	-.099%	1.700	-.505%	-.894%	-2.295
-1	.531%	.431%	1.947	-.003%	-.897%	-.535
0	.058%	.490%	.716	-.150%	-1.047%	-.986
1	.093%	.582%	-.212	.240%	-.806%	1.126
2	.049%	.632%	-.211	-.208%	-1.015%	-.522
3	-.263%	.369%	-1.827	-.104%	-1.119%	-.744
4	.421%	.790%	1.455	.073%	-1.046%	.406
5	.197%	.987%	1.421	-.337%	-1.383%	-.690
6	.148%	1.135%	1.111	-.368%	-1.751%	-1.390
7	-.001%	1.134%	.443	-.769%	-2.520%	-3.231
8	.070%	1.204%	1.369	-.471%	-2.990%	-2.569

Bold numbers represent statistical significance higher than 90% confidence (2-tailed) using a Patell-Z statistic as an approximation of a t-statistic.

Hypothesis H₁ frames that corporate scandals do not necessarily implicate negative stockholders returns as consequence of socially questionable events. Findings indicate that the market reaction has positive average cumulative abnormal values due to the FCPA public release (Mean CAR₃= .387% and Mean CAR₈=1.204%). Also, statistical

results in both three- and eight-day window indicate an abnormal significant response one day before the public release (two-tailed Z-statistic > 1.94). In this test, statistically significant values in dates prior the official release suggest a rumors response (Binder, 1998; Van Bommel, 2003). Additionally, test results indicate a dual-abnormal response. The second abnormal reaction occurs three days after the announcement (two-tailed Z-statistic < -1.94). In general, responding few dates after indicates a gradual awareness about the event. As observable in Table 10, these results provide sufficient arguments to **reject H₁**.

The control group, in contrast, yielded negative average abnormal values in this test. In both time horizons, returns are close to -1% in the three-day and -3% in the eight-day windows. Figures 2 and 3 add a visual perspective about the average CARs of both the study and the control group.

Figure 2. Average Cumulative Abnormal Returns Three-Day Window

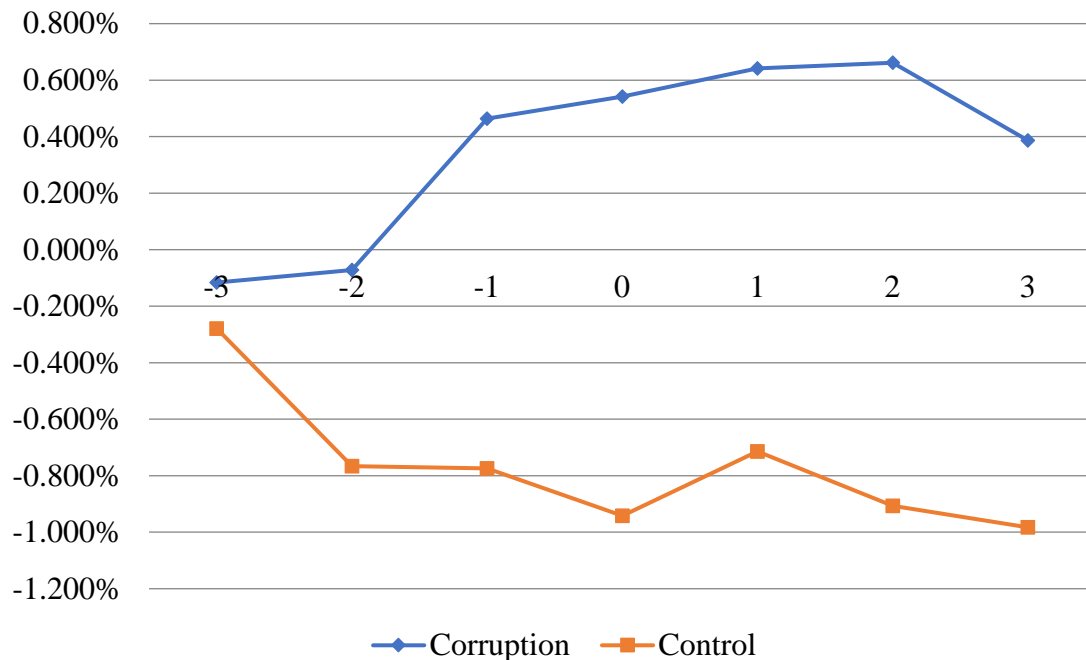
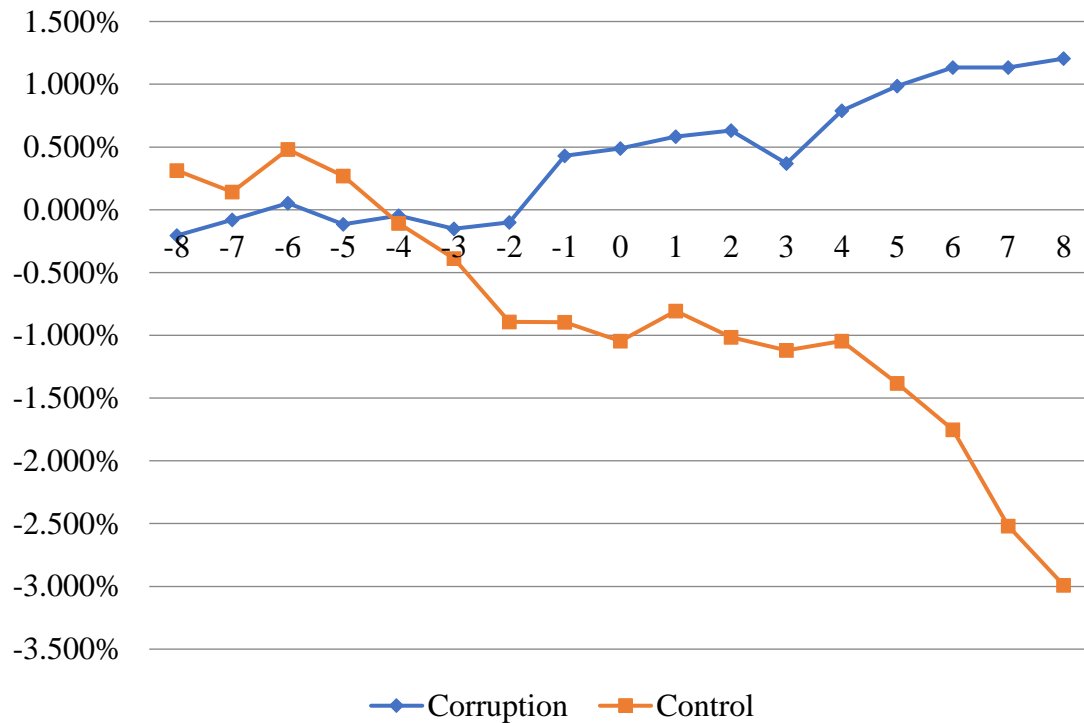


Figure 3. Average Cumulative Abnormal Returns Eight-Day Window



Multivariable Tests

To test the remaining hypotheses, the conceptual theorized design applies an OLS regression methodology of the empirical model. This is because individuals who make decisions are exposed simultaneously to more than one source of information (Bandura 2001). The model tests the relationships between the explanatory variables, environmental factors, and beliefs, along with the control variables with the final market responses. To do so, first, the analysis explores the full sample study and control group, followed by the individual assessments, then the interaction term. Table 11 represents the research sequence.

The methodological sequence first considers the comprehensive baseline model results presented in Table 11 columns 1 and 2 with an idea of the initial approach for the

two horizons. Columns 3 and 4 of the cited table report the studied group model simultaneously testing H_2 and H_3 . Also, the model approach that includes the interaction term between predictors of H_4 in the same horizons is observable in columns 5 and 6. A control group model analysis enriches the presentation in columns 7 and 8.

Baseline results displayed in columns 1 and 2 in Table 11 reveal that the comprehensive model estimation values. The predictor *Corruption*, as a grouping variable (1 equals study group, 0 otherwise) lacks statistical significance of in the three-day horizon ($p\text{-value} > .1$) but it is significant in the eight-day ($p\text{-value} < .05$). The estimate of the grouping term *Corruption* provides evidence that predictors over the abnormal returns for both the studied and the control groups differ ($b = .216$). This reinforces the estimation differences of the market response in the eight-day horizon.

Table 11. Multivariate Results of the Empirical Model

Multivariate Results of the Empirical Model

Panel A. FCPA Events

	(1)			(2)					(3)			(4)				
	CAR ₃	SE	P-value	CAR ₈	SE	P-value	Tol	VIF	CAR ₃	SE	P-value	CAR ₈	SE	P-value	Tol	VIF
Corruption	.117	.010	.288	.216	.018	.045	.324	3.085	-	-	-	-	-	-	-	-
Penalty	.092	.000	.242	.122	.000	.073	.879	1.138	.206	.000	.060	.249	.000	.017	.824	1.213
ChgeBuy	.073	.007	.322	.137	.012	.037	.943	1.060	.142	.011	.162	.335	.017	.001	.946	1.057
ChgeSell	.059	.010	.434	.016	.016	.812	.900	1.111	.166	.014	.114	.072	.021	.471	.887	1.127
PenaltyXChgeBuy	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
PenaltyXChgeSell	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Assets	-.011	.000	.903	-.008	.000	.922	.647	1.545	-.054	.000	.698	-.049	.000	.708	.507	1.974
ChgeTA	-.027	.000	.756	.049	.000	.531	.659	1.517	-.040	.000	.770	.097	.000	.451	.528	1.894
ChgeNI	.241	.000	.001	.402	.000	.000	.991	1.009	.034	.000	.741	.036	.000	.713	.930	1.076
ROE	.095	.004	.219	.083	.007	.227	.858	1.166	-.023	.026	.862	-.209	.039	.095	.564	1.772
ROA	.051	.033	.532	.139	.053	.056	.768	1.303	.377	.089	.009	.494	.134	.000	.480	2.085
TobinsQ	-.028	.005	.722	-.177	.008	.011	.839	1.192	.041	.011	.728	-.053	.016	.639	.689	1.451
ChgeNISPIInd	.007	.000	.939	.059	.000	.536	.447	2.236	.223	.000	.101	.155	.001	.228	.533	1.875
SPIndROE	-.045	.203	.700	-.118	.394	.354	.248	4.034	-.147	.346	.266	-.034	.518	.788	.554	1.806
N	188			188					94			94				
R ²	.110			.292					.212			.195				
F	1.799		.050	6.231		.000			2.006		.038	3.044		.002		

Table 11. Multivariate Results of the Empirical Model (Continued)

Multivariate Results of the Empirical Model (Continued)

	(5)			(6)					(7)			(8)				
	CAR ₃	SE	P-value	CAR ₈	SE	P-value	Tol	VIF	CAR ₃	SE	P-value	CAR ₈	SE	P-value	Tol	VIF
Penalty	.145	.000	.192	.156	.000	.116	.763	1.310	-	-	-	-	-	-	-	-
ChgeBuy	-.014	.014	.910	.060	.020	.597	.574	1.742	.021	.010	.841	0.001	.016	.994	.915	1.093
ChgeSell	.166	.015	.155	.101	.021	.332	.695	1.439	-.076	.015	.475	-0.056	.024	.538	.872	1.146
PenaltyXChgeBuy	.329	.000	.073	.591	.000	.000	.285	3.508	-	-	-	-	-	-	-	-
PenaltyXChgeSell	-.120	.000	.549	-.300	.000	.094	.234	4.272	-	-	-	-	-	-	-	-
Assets	.017	.000	.916	.112	.000	.440	.353	2.836	.013	.000	.896	0.008	.000	.927	.937	1.067
ChgeTA	-.023	.000	.862	.132	.000	.270	.519	1.928	.086	.000	.427	0.066	.000	.478	.838	1.193
ChgeNI	.043	.000	.670	.054	.000	.548	.924	1.082	.350	.000	.001	0.547	.000	.000	.982	1.018
ROE	-.011	.025	.932	-.189	.036	.102	.563	1.775	.117	.004	.297	0.138	.007	.153	.784	1.275
ROA	.351	.088	.014	.452	.124	.000	.476	2.100	-.107	.037	.365	0.090	.062	.372	.709	1.410
TobinsQ	.077	.011	.518	.012	.015	.910	.668	1.497	-.084	.005	.434	-0.277	.009	.003	.858	1.166
ChgeNISPIInd	.216	.000	.107	.141	.000	.236	.532	1.879	-.158	.000	.175	-0.066	.000	.508	.730	1.370
SPIndROE	-.172	.341	.190	-.072	.480	.535	.549	1.820	.084	.246	.485	-0.037	.412	.720	.681	1.468
N	94			94					94			94				
R ²	.135			.314					.187			.405				
F	2.116		.022	4.275		.000			1.912		.055	5.645		.000		

Bold numbers represent p-values<0.05.

Findings from only FCPA scandals in Table 11 (columns 3 and 4) reveal the relevance of the revised analysts' expectations on investors' decision theorized in hypothesis H₂. Test results cited columns in Table 11 suggest that the change in analysts' recommendations to *Buy* positively influence the market reaction with statistically significant values in the eight-day horizon ($b=.335$, $p\text{-value}<.05$). The change to *Sell* recommendation from analysts resulted without significance ($p\text{-value}>.1$) to explain the cumulative returns in neither one of the time horizons. Given the positive influence of these experts to explain the stock returns once known the FCPA scandal, there is sufficient statistical evidence **to fully support the hypothesis H₂**, inferring a positive market response to the change of analysts' opinion towards investing.

Hypothesis H₃ analyzes the influence on uncertainty beliefs over the market response using the settlement as ending indicator. Settle penalties in the three-day window do not statistically help to predict the cumulative abnormal response ($p\text{-value}>.1$). In the eight-day horizon, however, the influence is positive and significant over such cumulative values ($b=.245$, $p\text{-value}<.05$). This information argues that the **hypothesis H₃ is also fully supported**. Implying that payments done by firms to prevent higher litigation risks (jury trial) help to dissipate higher levels of uncertainty in the investors' beliefs.

To conclude with the hypothesis testing, the hypothesis H₄ focuses on understanding the interaction effect of the two explanatory variables over the stocks' abnormal returns. Results are shown in Table 11 columns 5 and 6. They indicate the influence of the interaction effect between the economic penalty and how analysts' opinion changed as consequence of the event. Results are both positive and statistically

significant in the change to *Buy* recommendation for the two analyzed time periods (CAR₃: $b=.329$, $p\text{-value}<.1$ and CAR₈: $b=.591$, $p\text{-value}<.001$). The interaction referred to the revised *Sell* recommendation does not have sufficient explanatory power over the market reaction. Therefore, there is statistical evidence to argue **full support** of **H₄** because the interaction term between the settlement and analysts' opinions results to infer positive abnormal returns have positive statistical influence.

Validity and Robustness Tests

In order to analyze the accuracy and consistency of the findings, the data was subject to supplemental validity tests. The analysis first tests the variance distributions to address the homogeneity assumptions between groups. The second examination tests any potential endogeneity issues between the independent variables and the capital market responses. Last, a model's stability test supports the consistency of the findings.

The first validity test analyzes the homogeneity assumptions across groups. The analysis focus on whether the capital market responds differently between the study and the control groups. One-way ANOVA test allows the examination of the variances distributions (Brown & Forsythe, 1974). Test results presented in Table 12 Panel A do not indicate a violation of the homogeneity assumption of unequal variability across both of time horizons between the observed and control groups ($p\text{-value}>.1$). However, the percentage of variability explanation is less than 10% given the two groups ($\eta^2<.1$). This information suggests that capital markets responses variability distribution is similar between the observed and control group, but not because of facing or not a FCPA scandal. These results indicate that seems logical the pursuance of a deeper explanation about the behavior of the capital market responses after the international bribery scandals.

Analysts' revised opinions were subject to the same variances test to evaluate whether the opinions' variability distributions differ or not because of the scandal. Results from constraining the grouping variable by the study and the control groups indicate uneven variability in *Buy* and *Hold* (p-value<.05), but indistinct variability in *Sell* (p-value>.1) as presented in Table 12 (Panel A). Also, in both group cases, the explanatory power of their variability has no statistical significance (p-value>.1) with less than 2%. This information argues that the variances distribution of analysts' recommendations to *Buy* and *Hold* differs across groups, which is consistent with the OLS results with respect to the little explanatory power of the analyst recommendation to *Sell* between groups and strong in *Buy*. Therefore, analysts change their expectations differently because firms faced a scandal, and they change stronger towards *Buy* compared to the distribution of analysts' covering the non-scandal firms. In other words, analysts in their revised expectations perceived scandal firms differently than the non-scandal firms, and they tended to increase their recommendation to *Buy*.

Table 12. Homogeneity and Between-Subjects Results

Homogeneity and Between-Subjects Results						
Panel A. by Study and Control Groups						
	Levene's df (1,186)	P-value	R ²	F (1,186)	P-value	η ²
<i>CAR₃</i>	.003	.956	.021	3.973	.048	.021
<i>CAR₈</i>	.241	.624	.051	9.935	.002	.051
<i>ChgeRecomBuy</i>	7.157	.008	.019	3.558	.061	.019
<i>ChgeRecomSell</i>	.018	.895	.017	3.311	.070	.017
<i>ChgeRecomHold</i>	4.614	.033	.006	1.189	.277	.006

Bold numbers represent p-values<.05.

Hypothesis testing results indicate the statistical influence of analysts helping the capital markets to invest after the studied event; however, a plausible argument could

suggest that analysts' recommendations may be triggered by observing the stock returns instead of by analyzing the expected firms' financial performance. To address this potential endogeneity issue, a logistic regression analysis focuses on understanding if there could be a potential influence that not only stock returns but also economic penalties may exercise over analysts' recommendations. This analysis is performed by replacing as the dependent variable the already dichotomist variable *ChgeBuy* and as Pseudo-independent variables *CAR₃*, *CAR₈*, and *EconomicPenalties*. Statistical results in Table 13 dissipate this potential issue. As expected, the model contains limited explanatory power (Pseudo- $R^2=.030$) and the pseudo-independent variables have no statistical significance to explain the behavior of analysts (p-values>.1). Therefore, the originally designed empirical model hardly suggests endogeneity issues with the variables dynamics. This analyst

Table 13. Logistics Endogeneity Test

Logistics Endogeneity Test			
	Unstandardized Beta	SE	P-value
Penalty	-.003	.002	.217
<i>CAR₃</i>	.055	5.002	.991
<i>CAR₈</i>	4.850	3.027	.109
Random percentage of prediction of ChgeBuy	74.5		
Specified percentage of prediction of ChgeBuy	74.5		
Pseudo- R^2	.030		

Lastly, a supplemental analysis tests the robustness of the empirical model's stability by changing the abnormal returns variables with a random alternative (Moulton, 1986). The unrelated variable 'change in assets in the S&P500 index' replaces the dependent variables (*CAR₃* and *CAR₈*). Results in Table 14, columns 1 and 2, indicate that the influence of the independent and control variables to explain the random variable

is absent (p-values>.1). The significant result (p-value<.05) occurs only within the control variable the industrial S&P ROE (*SPIndROE*). This information suggests the model's statistical stability.

Table 14. Robustness Test Results

Robustness Test Results										
	(1)					(2)				
	Δ AssetsSP500	SE	P-value	Tol	VIF	Δ AssetsSP500	SE	P-value	Tol	VIF
Corruption	.092	39.898	.415	.403	2.480	-	-	-	-	-
Penalty	-.004	.124	.958	.820	1.220	.068	.162	.513	.828	1.208
ChgeBuy	.044	29.753	.556	.946	1.057	.096	51.766	.325	.946	1.057
ChgeSell	-.011	41.936	.887	.872	1.147	-.028	63.396	.778	.887	1.128
Assets	.025	.000	.802	.530	1.886	.044	.000	.737	.507	1.970
ChgeTA	.068	.001	.483	.549	1.822	.068	.001	.603	.528	1.894
ChgeNI	-.003	.000	.963	.988	1.012	-.089	.008	.364	.930	1.075
ROE	.003	15.853	.974	.850	1.176	-.086	119.342	.493	.565	1.771
ROA	-.013	141.886	.867	.801	1.248	.126	412.222	.356	.480	2.085
TobinsQ	.090	20.492	.253	.840	1.191	.164	49.137	.152	.690	1.449
ChgeNISPInd	.105	.879	.239	.654	1.530	.125	1.585	.333	.533	1.875
SPIndROE	.339	880.112	.005	.362	2.764	.388	1598.694	.003	.553	1.808
N	188					94				
R ²	0.212					0.274				
F	33.350		.000			7.210		.000		

Bold numbers represent p-values<.05.

Discussion and Conclusions

To infer that corporate scandals with socially questionable acts, such as FCPA violations, will have a negative response from capital markets appears unwarranted and somewhat hasty. Instead, counterintuitive findings suggest that market behavior is a function of the environment and uncertainty. Investors do not immediately judge events as negative. In fact, because corporate scandals do not necessarily involve financial information, investors' decisions are aided by professional analysts that help to dissipate potential doubts about the firms' stability. This sentiment is supported by the presence of

a settlement symbolizing the end of the investigation and possibly lower levels of uncertainty. This behavior positions firm managers in the middle of a hard rock and a soft place because authorities will still prosecute illegitimate acts that investors may not necessarily condemn.

In the specification of the conceptual model, the theorization of the settlement instead of analyzing it as legal expenses, the fine is studied as an asset paid to end investigations. Although Karpoff et al.'s (2014) findings narrate the downturn in firms' value after these events, the market value increases. Apparently, investors expect that somewhere in between the investigations and the final settlement, the stocks' values were suppressed. Now that the investigation ended, the expectation is that stock prices regain or readjust to non-investigation value levels.

The alternative explanation for the positive returns refers to unexpected uncertainty and financial anomalies. Under the unexpected uncertainty added by the authorities' release, investors' concerns about information asymmetry are mitigated by turning to experts' advice. This group also represents the most reliable, and readily available, informal source regarding financial organizational performance. The predictive prophetic power of analysts serves as guidance to investors in the absence of formal information sources such as financial statements or annual reports. The information asymmetry of the official release noise is replaced by others' opinions.

This study contributes to the academic literature in explaining the market consequences of a regulatory process that could be seen as an ambiguous and socially questionable event. The ambiguity is because of a negative economic impact due to the sanction mechanism and the positive perception of successfully ending a legal issue. This

study marginally adds to the literature that the behavior of investors under ambiguous events refers to a primary source to forecasters to make decisions rather than any other rational source such as economics, financials, or ethics.

CHAPTER 7: FINDINGS INTEGRATION, CONCLUSIONS, AND LIMITATIONS

Findings Integration

In this chapter, we integrate and present the dissertation findings. The integration process consisted in comparing the overview of the findings from the qualitative study with both the reality simulation quantitative experiment and the archival quantitative research.

The qualitative findings suggest that organizational values drive the risk assessment to deal with potential problems and reputation is the number one priority. The risk assessment focuses in maintaining the organizational reputation, but when we tested this in simulations for a better understanding of the real-life behavior, for some individuals making risk decisions this did not sustain because of personal losses. For some other individuals such as internal auditors, maintaining companies' reputation was actually the top priority align with the values of the organization.

Context of Scandals – Qualitative Inquiry

The qualitative study was the first step to capture what are the organization values and how those values are prioritized in the risk assessment; maintaining their reputation was the primary concern and their number one priority in the risk assessment. The contextualization of scandals relies on a qualitative grounded theory research. Open-ended interviews with 27 professionals document the findings. The research question explores the experience of managerial officers attending to and mitigating reputational threats attributable to themselves or to external parties, whether or not affiliated with the organization.

The interviewed professionals in the reputation caring process provided valuable insights of their experiences dealing with real reputational problems. The applied methodology was grounded theory based on semi-structured interviews. As a theory, emerging technique, the central findings explain that not all reputational threats faced by organizations become an actual scandal, and when scandals occur, organizations design and implement a damage-restore management plan.

Organizations prevent scandals on daily basis operations. They do so by developing a corporate governance intelligence that enhances their ability to identify reputational threats before any outsider. The improvement of such intelligence is done by channeling internal governance structures for reputational threats identification. Once the threat is identified organizations better able to contain and attend to mitigating the probability of suffering a scandal.

Three main organizational structures served this purpose. The sophistication of the detection and monitoring mechanisms, the inclusiveness of the ethical environment, and the adherence to compliance regulations are determinants in identifying reputational threats. Scandals occur when at least one of these elements is vulnerable in identifying a reputational threat.

When those structures are not able to contain reputational threats, organizations then have to respond to reverse the negative associated effects. This managerial plan design mitigates four major damages: financial, operational, public trust, and stakeholder's perception.

Financial damages mitigation process translates into conservative accounting transparency through voluntary disclosures and accounting accruals adjustments.

Operational damages restoration occurs by re-allocating organizational resources. The public trust is regained by focusing on organizational reliability regarding products' or services' quality. The last identified damage targets stakeholders' perception. Their perception repairmen follow with a strategic information communication plan that aims operational transparency. Organizations' ability to develop and implement a restore plan is a key determinant to efficiently manage the reputational damage.

Facing Reputational Threats – Quantitative Research

From the experiment, we could reveal that executives are willing to perform in the best interest of the organization as long as their personal finances are not at risk. When executives analyze decisions with their own personal wealth, they will deviate from the organizational values because the executives' mindset to place the organizational reputation as second. Expected personal losses influence executives who take the key decisions to jeopardize organizational values and priorities to avoid personal wealth.

To understand if such a mindset is referred only to executives or to the rest of the organizational members, I controlled for role in the experimental design. In the experiment results, however, internal auditors when they have to respond to a reputational threat with certain associated personal costs, they did not deviate from the organizational values. This group would maintain the integrity of the organization's value and be willing to accept personal financial losses just as expected from any other organizational personnel.

Digging into specifics, this second piece explores the role of managerial incentives and monitoring activities facing reputational threats (prior the occurrence of scandals). Executives, as reputational threat organizational main respondents, represent

those whose efforts should be oriented in adequately addressing reputational threats, and compensated by ownership. They have the responsibility of caring diligently the organizations' reputation. Yet, scandals still occur for mistreating a reputational threat. Then, "Do agency theory predictions—align incentives and monitoring—adequately address ways of effectively attending to reputational threats facing high and low reputational scandal probabilities?"

We explored this concern applying a quantitative experimental methodology. The sample consisted of 180 professionals, half executives and the rest professional and experienced internal auditors. The sampling process obeys to the two components of agency theory: executives and their ownership-compensations, and internal auditors as oversight part of the governance environment.

From their responses, findings suggest that the likelihood of corporate scandals increases when reputational threats are poorly attended. After scandals occurrence, investors represent ones of the victims when share prices decrease as consequence of the scandal. In traditional business environments, executives are compensated by ownership in the organizations. If a scandal is not prevented, and share prices decline, both executives and investors are affected.

In terms of managerial incentives, from participant responses, I found that the likelihood of facing a scandal increases when expected executives' personal compensations may be compromised. Executives' willingness or devotion for threat containment stands low if the cost of containment affects their potential personal gains. As a consequence, higher risk bearing scenarios increase the likelihood of scandals.

Executives behave conservatively bearing reputational threats when the containment costs do not interfere with expected personal gains.

In the role of internal auditors, the overall behavior tends to conservatism especially when organizations engage in unethical practices. This behavior successfully contains reputational threats before becomes real scandals. The side effect of such behavior may compromise organizational performance under low-risk scenarios. Even while facing minimal reputational threats, their extreme ethical judgment may blind organizational performance (or profitability), and conversely affect investors.

The most effective reputational threat containment behavior occurs when executives and internal auditors balance their influence and cooperate between them. When these figures do not reach legitimate consensus, potential negative consequences may arise whether engaging in a higher likelihood of suffering a reputational scandal or compromising economic performance and investors' wealth.

Capital Markets Scandals – Quantitative Research

The third piece is a match sample archival study that analyzes 96 corporate scandals and an equal number of peer industry firms. Because the goal is to understand the behavior of capital markets to a specific situation, the research methodology combines an event study (Fama & French, 1993) with a cross-sectional multivariate analysis.

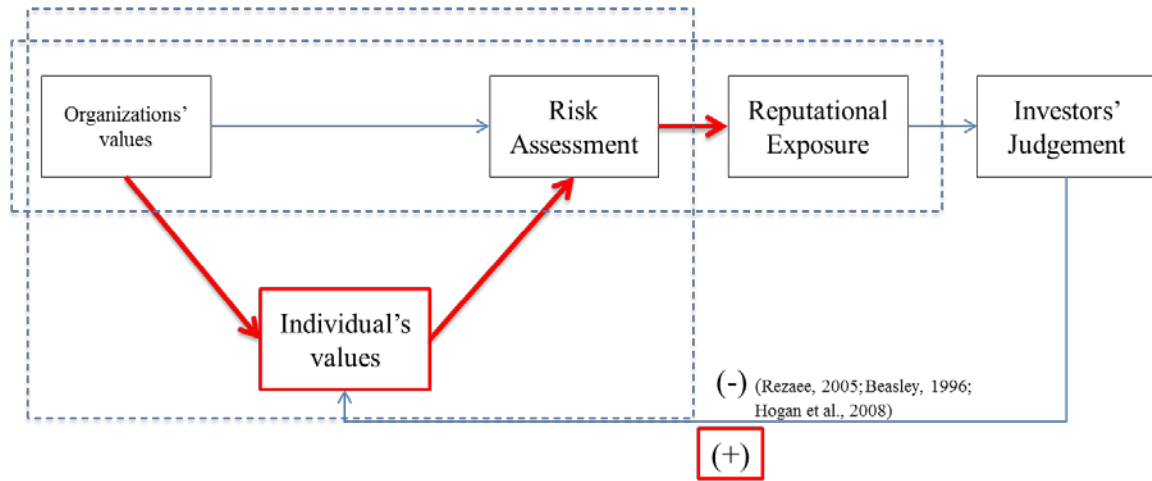
I theorized that, in light of the commonality of corporate scandals, investors may not perceive them equally. Some events may have a negative reaction such as financial statements fraud. But, different events may not have similar components in the mindset of investors who make the final decisions.

I also theorized that personal and environmental elements influence investors' behavior. Environmental elements such as analysts provide periodic recommendations about firms' financial performance. After events, investors must evaluate every available source of information. Therefore, there should be a strong inclination from investors to internalize how analysts evaluate firms' future performance. The personal elements are the investors' perception of uncertainty. Because the event also could be the end of a legal process, there is a reduction of the uncertainty levels that investors reward as positive.

Findings indicate that not every corporate scandal is negatively judged by capital markets. Also, that under unexpected events, investors positively attend to the environmental sources to dissipate potential doubts about the event. Similarly, investors perceived positively lower levels of uncertainty. Therefore, both environmental and personal characteristics positively influence the abnormal market response.

Combining the qualitative, and the two quantitative pieces, we find that organizations have values. To protect these values, they develop risk assessments mechanisms. They determined their risk exposure. Executives mediate the effectiveness between the organizational values and the risk assessment. Once an event occurs, investors judge whether the behavior of the firm aided by analyst and the implications of the event. But, this judgment could influence executives' behavior when they have stock-based compensations. Therefore, there is a cycle of reputational risk exposure between organizations, executives, and capital markets participants. Figure 4 represents this cycle.

Figure 4. Organizations' Reputational Risk Cycle



Discussion and Conclusions

This material integrates findings from three different sources and methodological approaches. From those materials, evidence suggests that reputational risk exposure increased when organizations' and executives' values are unaligned. Managers' values mediate the implementation of organizational values towards risk assessment. And, because analysts and investors' beliefs do not negatively react to scandalous news, the market value of the firm may not decrease. As consequence, executives may not find investors' disapproval that encourages them to focus on the reputational preventive efforts. Therefore, organizations and executives must align their ethical values to protect proactively their organizations' reputation. Firms' financial performance indicators do not influence investors' behavior after scandals.

From integrating individual findings, I argue that the likelihood of scandals is explained by the dissonance in the order of the values between organizations and executives. Once scandals occur, investors judge whether the dissonance of the values could affect the future organizational performance. If not, this last group will intensify

their trust in organizations increasing firms' market value. But evidence suggests that equity compensations may lead companies to positive abnormal returns. Therefore, the intention of aligning incentives will maximize value completely ignores the reputational value of organizations in both cases, short-term returns.

In the first qualitative research, where the addressed question is, what is the experience of organizations attending to and mitigating reputational threats attributable to themselves or to external parties, whether or not they are affiliated with the organization? Their responses document that not all reputational threats become scandals. In fact, they mitigate their reputational exposure by channeling resources to their governance risk assessment strategies based on the organizations' values to promptly detect the reputational threat before anyone else outside the organization does. The governance structures, in turn, rely on solid detection and monitoring control systems, the inclusiveness of the ethical control environment, and strong regulatory adherence. A scandal occurs when at least one of those elements fails and, once it does, the organization must invest additional resources in the design and implementation of a damage-controlling management plan to minimize the associated negative effects.

Also, this qualitative research, our evidence suggests that organizations have a set of values such as firms' reputation, long-term stability, short-term performance, and stakeholders' satisfaction. These set of values represents the driver of their risk management strategic efforts oriented in assuring the long-term organizational reputation. Also, I found that scandals occur because one of these elements was vulnerable and someone who does not share such values perpetrated at least one of those values.

The reality simulation experimental setting inquires on whether executives adequately attend to reputational threats. In order to address such concern, the hypothesis that executives will proactively react to reputational threats based on the severity of the threat. Also, the theorized hypothesis states that when the executives are mainly driven by economic incentives they will react negligent when their personal economic expectations are compromised. The theorization process concludes with an interaction term between the severity of the threat and the economic incentives in the quest for an optimal response.

Findings indicate that the severity of the reputational threat does not influence with the executive's decision and executives prefer not to deal with reputational threats when their expected personal-gains are likely to be jeopardized. But, the interaction term indicates that the severity will influence the final response when executives' personal finance is not endangered. This suggests that managers who execute the risk assessment will do so when their personal values are aligned with those of the organization and the economic incentives are less relevant than firm' reputation.

In the experimental findings, we found that individuals have also a set of values that served as a reference to calibrate how they respond to mitigate risks. Executives are willing to deal effectively with risk managerial decisions as long as those decisions do not affect their personal financial gains. Internal auditors as members of the corporate governance responsible for organizations' stability followed the order of the organizational values that lead to long-term permanence.

The third study inquires in how the capital markets respond when these events occur. To understand investors' reaction, the central hypothesis argues that accounting

scandals do not necessarily result in negative abnormal returns. Then, the following hypotheses center in explaining environmental and personality factors that could induce the market response under the reputational events. The environmental factor is represented by the role of analysts in the investor decision-making process. The settlement payment to end the investigation represents investors' beliefs. Both elements the environmental and the personal, are theorized interacting with the final investor response to acknowledge the combined effect.

The last capital markets study findings indicate that investors' responses to scandals could also be positive. Also, evidence suggests, as theorized, that analysts revised recommendation towards buying positively influence the final response. In terms of the settlement, this component also is positively associated with the market's reaction. The interaction term also suggests a positive association. These counterintuitive findings suggest that securities value is not automatically depressed after scandalous events. Instead, shareholders dissipate potential doubts about firms' stability guided by analysts' revised expectations rather than judging the event ethical implications.

Limitations

My study has some limitations. In terms of the sample, the study analyzes only major publicly traded corporations. Any possible application to non-traded companies may not have the similar applicability. This is a natural limitation because of the research design that combines executive's compensations, capital markets dynamics, and SEC-regulated companies. Similarly, stakeholders are not part of the sample. This group is not included within the sample, and therefore, is not considered. Therefore, models, findings,

and implications should be restricted only to that group and to the specific type of mentioned scandals.

Also, I found another limitation in not including the non-economic aspects in the executives' behavior. The research only accounts for their risk perception and economic incentives. Other factors such as ethics, personal self-efficacy, or individual beliefs are not included. Therefore, there is a literature gap to include these components for a subsequent analysis in the reputational maintenance process.

As mentioned earlier, analysts' opinions are measured on a monthly basis. Analysts follow firms' performances. They offered periodic recommendations about firms. Analysts scale their recommendations from 1 to 5. However, events can happen at any moment during the month. An event at the beginning or the end may have a little or may intensify on the monthly average measures. We mitigate this limitation by using a dichotomist variable on whether analysts reduced or increase their recommendations.

Summary

The commonality of corporate scandals and the quest of who should be accountable for motivates this investigation. Organizations, over time, develop as one of their most important assets, the value of their name. Companies' names can exceed three or more times their assets value (Fombrun & Shanley, 1990). Scandals, however, only take a day to compromise what years of effort have created: a bond / trust between firms and its shareholders and stakeholders.

After these events occur, society's most important claim is who has accountability for the event. In other words, under whose shoulders the burden of the scandals should rely. This is, therefore, the research essential question. In order to address this central

concern, three main questions arise. Is the organization the one who should be accountable? Is it something in the firms' machinery or a structure that expose them to reputational events scandals? But, perhaps it is not the organizations that have the responsibility, maybe the obligation relies on the individuals who are in charge of running the organizations. Or possibly, investors as owners have the real responsibility in designing the mechanisms that promote executives' diligent behavior.

To address such theoretical concerns, current theoretical frameworks present some flaws in the explanation scandals. However, they establish the foundations to deeper investigations about the phenomena. I work with a definition of scandals where these events are promoted by outsiders about an intentionally organizational behavior (Molotch & Lester, 1974).

Institutional theory argues that internal structures should be designed to accomplish goals (DiMaggio & Powell, 2000). Imitation of structures in the legitimacy quest instead of pursuing their own goals balks its achievement (Oliver, 1991). Yet, because the origin that triggers the scandals is unclear, it is not possible to assume that institutional flaws triggered the event.

The second component in the exploring the accountability issue represents the role of executives. To explain their behavior, the agent-principal literature argues that owners and executives are separate entities and their incentives differ without an aligning mechanism (Eisenhardt, 1989; Fama & Jensen, 1983b; Jensen & Meckling, 1976; Ross, 1973). However, the alignment process assumes individuals' actions are only because of economic reasons ignoring that there are other non-economic motivators that may induce executive behavior.

The last theoretical element to address the accountability concern is the capital markets participants group. The behavior in the securities affairs is explained by the efficiency in the capital markets. Investors and other related participants adjust securities prices based on expectations about firms' performance (Fama, 1970, 1991). Positive returns follow positive financial news and the opposite with negative news ones. In this sense, the assumption does not consider non-financial information released outside firms' control which is the scandals case.

For inquiry to these broad concerns, this research framework applies a mixed method design that combines two experiential components, a theoretical-emerge qualitative piece and an experimental quantitative inquire, with a quantitative archival piece with.

In the qualitative component, I follow a comparative inductive process for understanding the overall experiences of organizations dealing with reputational scandals. The methodological approach used is grounded theory based on semi-structured interviews with managers of 27 major publicly traded organizations.

The second experiential piece focuses on analyzing specific factors that enhance the likelihood of suffering a reputational scandal. I conducted an experiment research where 90 executives and 90 internal auditors had to execute a BOD recommendation facing an organizational reputational threat. The research methodology applies one-way ANOVA test where the dependent variable is the executives' response and the independent variable are the severity of the threat and expected personal losses.

The third piece is a match sample archival study that collected 96 corporate scandals and an equal number of peer industry firms. Because the goal is to understand

the behavior of capital markets to a specific situation, the research methodology combines an event study (Fama & French, 1993) with a cross-sectional multivariate analysis.

Findings from the qualitative research served as a framework in the experimental setting. Then, I validate executive responses with the qualitative research findings. Also, by selecting a specific type of scandal, I validate the qualitative findings with the archival findings. Then, I integrate the three studies' findings and triangulated them to obtain a single overall finding.

In the first qualitative research, where I address the question, what is the experience of organizations attending to and mitigating reputational threats attributable to themselves or to external parties, whether or not they are affiliated with the organization? Their responses document that not all reputational threats become scandals. In fact, they mitigate their reputational exposure by channeling resources to their governance risk assessment strategies based on the organizations' values to promptly detect the reputational threat before anyone else outside the organization does. The governance structures, in turn, rely on solid detection and monitoring control systems, the inclusiveness of the ethical control environment, and strong regulatory adherence. A scandal occurs when at least one of those elements fails and, once it does, the organization must invest additional resources in the design and implementation of a damage-controlling management plan to minimize the associated negative effects.

The reality simulation experimental setting inquires on whether executives adequately attend to reputational threats. In order to address such concern, I hypothesize that executives will proactively react to reputational threats based on the severity of the

threat. I also theorized that when the executives are mainly driven by economic incentives they will react negligent when their personal economic expectations are compromised. The theorization process concludes with an interaction term between the severity of the threat and the economic incentives in the quest for an optimal response.

Findings indicate that the severity of the reputational threat does not influence the executives' decisions and executives prefer not to deal with reputational threats when their expected personal-gains are likely to be jeopardized. But, the interaction term indicates that the severity will influence the final response when executives' personal finance is not endangered. This suggests that managers who execute the risk assessment will do so when their personal values are aligned with those of the organization and the economic incentives are less relevant than firm' reputation.

The third study inquires in how the capital markets respond when these events occur. To understand investors' reaction, the central hypothesis argues that accounting scandals do not necessarily result in negative abnormal returns. Then, the following hypotheses center in explaining environmental and personality factors that could induce the market response under the reputational events. The environmental factor is represented by the role of analysts in the investors' decision-making process. The settlement payment to end the investigation represents investors' beliefs. Both elements the environmental and the personal, are theorized interacting with the final investors' response to acknowledge the combined effect.

The last capital markets study findings indicate that investors' responses to scandals could also be positive. Also, evidence suggests, as theorized, that analysts revised recommendation towards buying positively influence the final response. In terms

of the settlement, this component also is positively associated with the market's reaction. The interaction term also suggests a positive association. These counterintuitive findings suggest that securities value is not automatically depressed after scandalous events. Instead, shareholders dissipate potential doubts about firms' stability guided by analysts' revised expectations rather than judging the event ethical implications.

This material concludes by integrative findings of the three studies. From them, evidence suggests that reputational risk exposure increased when organizations' and executives' values are unaligned. Managers' values mediate the implementation of organizational values towards risk assessment. And, because analysts and investors' beliefs do not negatively react to scandalous news, the market value of the firm may not decrease. As consequence, executives may not find investors' disapproval that encourages them to focus on the reputational preventive efforts. Therefore, organizations and executives must align their ethical values to protect proactively their organizations' reputation. Firms' financial performance indicators do not influence investors' behavior after scandals.

APPENDIX A: INTERVIEW PROTOCOL

Interview Questions

Introduction (interviewer): *“Hello (name _____). Thank you so much for taking the time to meet with me today. I really appreciate it. Before getting started, there are a couple of things I would like to cover.”*

Purpose and Format for the Interview (Interviewer): *“As part of an investigation, I am interested in developing a greater understanding reputational risk attributable to affiliated and non-affiliated entities to your organization. I will ask you a series of open-ended questions on this topic, and I will also ask one or more follow-up questions as you respond. The interview will last for approximately 60 minutes.”*

Confidentiality (Interviewer): *“Everything you share in this interview will be kept in strictest confidence, and your comments will be transcribed anonymously – omitting hour name, anyone else you refer to in this interview, as well as the name of your current organization and/or past organizations. Your interview responses will be included with all the other interviews I conduct.”*

Audio Taping (Interviewer): *“To help me capture your responses accurately and without being overly distracting by taking notes, I would like to record our conversation with your permission. Again, your responses will be kept confidential. If at any time, you are uncomfortable with this interview, please let me know and I will turn the recorder off.”*

“Any questions before we begin?”

Part 1 – Opening Ice-breaker & Background Questions:

Opening Question: *Please tell me about yourself, both personally and professionally.*

Sample probing questions:

- *Can you tell me about your experience background?*
- *How long have you been part of in this organization?*
- *How did you obtain this position?*

Part 2 - Core Questions - Experiences

Question 1: *Please tell me about the time that you have perceived a potential risk to your reputation triggered by an affiliated entity.*

Sample probing questions:

- *Tell me about how did you organization handle such event?*
- *What types of procedures does your organization have before and after?*
- *What was your overall experience?*

- *What change inside the organizations after?*
- *Tell me about who was the most affected?*
- *Did it lead to a change in management process, procedure, etc.?*

Question 2: *Please tell me about the time that you have perceived a potential risk to your reputation triggered by a non-affiliated entity?*

Sample probing questions:

- *Tell me about how did you organization handle such event?*
- *What types of procedures does your organization have before and after?*
- *What was your overall experience?*
- *What change inside the organizations after?*
- *Tell me about who was the most affected?*
- *Did it lead to a change in management process, procedure, etc.?*

Sample of others probing questions:

- *How do you understand reputation risk?*
- *Do you have a common definition for reputation risk?*
- *Please give me some examples reputation.*

Part 3 – Closing

Lastly, when you think about reputation risk and what it means to your work, are there any questions you were expecting me to ask that we have not covered, or do you have anything more to add?

Concluding Statement (Interviewer): *That concludes our interview. Thank you very much for all the time and sharing your insight. I really appreciate your time. If I need to clarify anything we've discussed, would it be okay for me to follow up with a brief phone call or email?*

Thank you again (name_____).

APPENDIX B: COMPONENTS AND PRINCIPLES OF COSO 2013 INTEGRATED FRAMEWORK

Components	Principles
Control environment	<ol style="list-style-type: none"> 1. The organization demonstrates a commitment to integrity and ethical values 2. The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control. 3. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives. 4. The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives 5. The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives
Risk assessment	<ol style="list-style-type: none"> 6. The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives. 7. The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed. 8. The organization considers the potential for fraud in assessing risks to the achievement of objectives. 9. The organization identifies and assesses changes that could significantly impact the system of internal control.
Control activities	<ol style="list-style-type: none"> 10. The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels. 11. The organization selects and develops general control activities over technology to support the achievement of objectives. 12. The organization deploys control activities through policies that establish what is expected and procedures that put policies into place.
Information and communication	<ol style="list-style-type: none"> 13. The organization obtains or generates and uses relevant, quality information to support the functioning of internal control. 14. The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control. 15. The organization communicates with external parties regarding matters affecting the functioning of internal control.
Monitoring activities	<ol style="list-style-type: none"> 16. The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning. 17. The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.

APPENDIX C: EXPERIMENTAL INSTRUMENT

The pharmaceutical company PharmaWorld Inc. (PHA), #9 in the world about the same size as Bristol-Myers, is one of the oldest and largest organizations in the world. PHA's latest development is a male hair-growing drug without any negative side effects. The drug tests passed the initial clinical trials and is ready for distribution. The drug requires a special permit to be launched in the US market. The US Surgeon General has not yet granted approval. In the past, 95% of the times drugs were approved, occasionally further testing was required.

In order to generate early revenue to partially offset the large R&D investment costs while waiting for the last approval, the drug was pre-launched six months ago in South America, the third largest company's market region, where such approval is not required. Product sales and purchase orders are exponentially growing.

Your ROLE in this exercise is (CEO/Chief Executive Auditor) of the organization. Your compensation, like other PHA's employees, includes salary, stock options and other employee benefits. Since last year, your stock options have increased 20%.

During a recent quality control test of the product, the regional operations manager has reported that a product run did not meet appropriate quality specifications. A key chemical component from one of the main Asian suppliers proved defective. The manager estimated that two-thirds of the shipment to South America, and now on the market, is defective.

On a pre-examination, the health-risk department concluded that the defective batch may (SEVERITY OF THE REPUTATIONAL THREAT: result in decreased sexual performance, nausea, headaches and somnolence / reduce the drug effectiveness) for one out of (SEVERITY OF REPUTATIONAL THREAT: six/twenty) patients.

Coincidentally, at the time of this discovery and subsequent analysis of effects, the board of directors was holding a meeting. Out of the problem-solving available options between a total regional product recall, only a defective shipment batch recall, and no product recall until further examinations, they suggested to contemplate the (STRATEGIC RESPONSE: total /defective batch / no) recall option. The market risk division estimated that such suggestion may cause a (EXPECTED ECONOMIC LOSS: 22.5% / 7.9% / 0.0%) decrease in PHA's stock prices.

To each statement select from 1 to 5

(where 1. Strongly disagree, 2. Disagree, 3. Neither agree nor disagree, 4. Agree and 5. Strongly agree).

- *As (CEO/CEA) of the organization, I agree with the Board of Directors' suggestion.*
- *Hair loss represents a major concern among males.*
- *Side effects of drugs are determinant for consumers' preferences.*
- *Variations in stock prices reflect companies' economic performance.*

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