

Preventing or Concealing Organizational Misconduct? Corporate Boards in a Transitional Economy

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Abstract

This study seeks to understand the potential dark consequences of corporate boards on organizational misconduct in a transitional economy. Contrary to predictions from the agency theory, we find that outsider representation on the board is associated with an increased probability of misconduct in organizations that lack legitimacy in the early transitional period. Besides, the salience of board outsiders further enhances the positive relationship between outsider representation on the board and the likelihood of organizational illegality. We suggest that boards of directors may serve as window dressing for organizations lacking legitimacy in transitional economies. Such window dressing may create a circumstance that makes organizational misconduct possible in underdeveloped legal environments. This study suggests the importance of considering the potential dark side of adopting seemingly credible corporate governance structures in transitional economies.

Keywords: Organizational misconduct, corporate governance, transitional economies

Organizational misdeeds have shocked the economies in the U.S., Europe, and the rest of the world (Andreoli & Lefkowitz, 2009; Zhang et al., 2008), and transitional economies have been no exceptions (Cuming, Hou, & Lee, 2016; Hass, Tarsalewska, & Zhan, 2016; Jia, Ding, Li, & Wu, 2009). For instance, Kelon, a former state-owned enterprise that was a pillar of China's refrigerator industry, suffered a dramatic fall from grace due to a series of financial scandals (AFX-Asia, 2005). Gu Chujun, the former president of Kelon, had earlier been admired as China's "King of M&A", "the creator of the myth of profit" and "the hero of Kelon", until he was arrested for fabricating the firm's profits and revenues. The governments in many countries had issued regulations and policies about boards of directors as a response, aiming at enhancing the monitoring of corporate governance and management. The Sarbanes-Oxley Act of 2002 in the U.S. was well known, and China's Securities Regulatory Commission (CSRC) also issued guidelines calling for independent outside directors for publicly listed companies in 2001 (CSRC, 2001).

Yet, it remains inconclusive whether government attempts to deter illegal behavior through boards of directors have generated expected outcomes, especially in transitional economies (Berenson, 2003; Cuming et al., 2016). On the one side, governance activists advocate that having more outside directors on the board effectively monitor executives and prevent wrongdoing (Fama & Jensen, 1983; Jensen & Meckling, 1976). On the other side, outside directors may have weaker incentives to expend effort, and may have limited information to evaluate executives' decisions (Harris & Raviv, 2008; Kumar & Sivaramakrishnan, 2008). Outside directors are thus window dressing – they are ineffective monitors and they simply "decorate" the firm. Boards as window dressing may even have serious negative consequences by increasing the likelihood of misconduct, because firms face lower pressures from the institutional environments (Westphal & Zajac, 1998) and may have enhanced confidence to avoid detection.

This study promises to improve our understanding of the potential dark side of outside directors, by identifying boundary conditions when outsiders are more likely to be appointed as window dressing and are thus more likely to increase the probability of corporate fraud in a transitional economy. Specifically, we suggest that outsider representation on the board is positively associated with the likelihood of organizational misconduct 1) when organizations lack legitimacy which enhances the need for window dressing, and 2) when outside directors have

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higher levels of salience which increase the visibility of window dressing. This study thus responds to Davis (2005)'s call for more attention to the negative consequences of corporate governance structures beyond the original purpose, and Cuming et al. (2016)'s call for more nuanced research on the implications of corporate governance reforms in transitional economies.

To test our hypotheses, we investigate illegal transactions by all publicly-traded firms in the early period of transitional China. From a theoretical perspective, China has been undergoing institutional changes for the past three decades, and this may well present a good opportunity for developing a new perspective on corporate governance and illegal behavior based on the institutional influences (Tsui et al., 2004). China, where firms are strongly embedded in dynamic institutional environments, and where Western corporate governance structures have begun to spread rapidly despite the lack of evidence as to their effectiveness in China, offers an attractive context for such studies. Second, given the prevalence of corporate fraud and the rapid growth of investment in China, an improved understanding of the relationships between boards of directors and illegality in transitional economies can have significant practical implications. Indeed, the percentage of listed Chinese firms that had committed fraud was estimated to be much higher than seen in developed economies (Conyon & He, 2016; Jia et al., 2009).

Theory and Hypotheses

Outside Directors and Organizational Misconduct

Two logics may co-exist to account for the relationships between outside directors and organizational misconduct: the agency logic and the window dressing logic. Agency theory has been the theoretical framework for most previous work on corporate governance (Jensen & Meckling, 1976). From the agency logic, outside directors can deter corporate fraud by monitoring executives (Jensen & Meckling, 1976). A core means to increase the effectiveness of the monitoring function of boards is to decrease board dependence, i.e., the degree to which directors are dependent on the current executives or organization (Baysinger & Butler, 1985; Daily & Dalton, 1994; Dalton et al., 1998). Outside directors may be able to more effectively monitor executives than insiders owing to their presumed independence (Walsh & Seward, 1990). So boards consisting mainly of outside directors are the best monitoring mechanisms to prevent executive wrongdoing, because board members' interests are not aligned with those of the executives. Boards composed primarily of insiders are considered less effective in deterring misconduct because of the high possibility of collusion.

On the other side, outside directors may be appointed as window-dressing, which can lead to effects different from what is proposed by the agency logic. In transitional economies, organizations are entrenched in unstable institutional environments over which organizations have limited control. Changes in policies are usually difficult to forecast during the transition from a planned economy to a market-oriented one. In such unstable markets, the goal of organizational actions is often to maximize legitimacy (Meyer & Rowan, 1977), which can ensure the survival of the firm (Fligstein, 1996; Guthrie, 1997). Organizations strive for legitimacy by implementing any organizational practice that complies with the external institutional norm (DiMaggio & Powell, 1983). In this regard, outside directors may be adopted as window dressing or a token to convey compliance with the external institutional demands and thus to enhance organizational legitimacy.

Moreover, increased outsider representation as window dressing could have potential negative consequences. First, compliance with external demands often takes the form of cynical adoption of token structures decoupled from actual practice (Meyer & Rowan, 1977). A firm may decouple these outside directors, who are configured to meet the institutional demands, from the actual operation of the firm. These outside directors tend to be less informed about a firm's resources, strategies, and other critical aspects of a firm; therefore, they are less able to effectively monitor the firm's operation. A firm may further protect this token structure from evaluations on the basis of technical performance (Meyer & Rowan, 1977): inspection and evaluation of whether this structure functions, i.e., whether these outside directors effectively monitor managers, are minimized. Second, the window dressing structure may further substitute for other substantive corporate governance reforms and negatively affect the functioning of other monitoring mechanisms. By formally adopting "institutionally 'correct' procedures" (Walsh & Seward, 1990: 431) which indicate board effectiveness and reduce social pressure about the agency problem, top managers may effectively deter other substantive corporate governance reforms. For example, Westphal and Zajac (1998) found that adopting a symbolic long-term incentive plan lessened shareholder pressure and was negatively related to the subsequent separation of the CEO and board chair positions. Third, with outside directors on the board as window dressing which signals a firm's legitimacy, a firm may feel enhanced confidence to avoid detections when they break laws.

Regulatory agencies may pay limited attention to firms appearing “legitimate” and are less likely to detect their violations. All these mechanisms – the decoupling of outside directors from actual practices, the deterrence of other substantive corporate governance reforms, and the low likelihood of being detected by regulatory agencies – create a favorable circumstance that makes corporate illegality possible. Outside directors as window dressing may be likely to increase the probability of committing corporate illegality in a transitional economy with underdeveloped legal environments. Combining the two logics, we have two baseline competing hypotheses.

Hypothesis 1a (agency logic): *Outsider representation on the board is negatively associated with the probability of organizational misconduct in a transitional economy.*

Hypothesis 1b (window dressing logic): *Outsider representation on the board is positively associated with the probability of organizational misconduct in a transitional economy.*

Organizational Legitimacy as Boundary Condition

The window dressing logic and the conventional agency theory make contrasting predictions regarding the relationship between outside directors and the likelihood of corporate illegality. We set out to identify the boundary conditions where one logic works better than the other. Emphasizing organizational heterogeneities, we argue that the extent to which organizations are legitimized in the institutional environment largely determines whether the window dressing or the agency logic will have more predictive power. If organizations lack legitimacy, outside directors are likely to be appointed as window dressing to convey compliance with the external institutional demands and thus to gain legitimacy. The window dressing logic should have greater explanatory power for organizations with lower levels of legitimacy. On the contrary, if organizations are already legitimized and thus have less need to further enhance legitimacy, outside directors are less likely to be appointed as merely window dressing in an attempt to obtain legitimacy. Therefore the window dressing logic should have lower explanatory power for organizations with higher levels of legitimacy. Following Suchman (1995), we differentiate between two forms of legitimacy: pragmatic legitimacy and cultural-cognitive legitimacy. The two forms of legitimacy rest on somewhat different perceptions that organizational activities are desirable, proper, or appropriate within socially constructed systems of norms, values, and beliefs (Suchman, 1995). Hence, we develop separate hypotheses related to the two forms of legitimacy.

Pragmatic legitimacy. Pragmatic legitimacy rests on “the self-interest calculations of an organization’s most immediate audience” (Suchman, 1995: 578). Often, immediate audiences include shareholders. Shareholders are likely to become constituencies, scrutinizing organizations to determine the practical value of any given organizations. Pragmatic legitimacy may thus boil down to support for an organization based on the organization’s expected materialistic value to shareholders (Dowling & Pfeffer, 1975). For example, organizational stock market performance can be a good proxy of pragmatic legitimacy. Organizations are evaluated by shareholders based on what organizations accomplish financially (Meyer and Rowan, 1977). Organizations with low stock market performance are generally perceived by shareholders as financially unsuccessful, indicating low levels of pragmatic legitimacy (Westphal & Zajac, 1998). Adopting a corporate governance structure that conforms to institutional demands may be able to help such firms regain legitimacy by demonstrating that their activities are proper and appropriate within the institutional environment. As a result, organizations that lack pragmatic legitimacy are more likely to appoint outside directors as window dressing to convey their compliance to institutional demands. Yet a board with a high percentage of outside directors appointed mainly as window dressing may have negative consequences in a transitional economy with underdeveloped legal environments, as argued in Hypothesis 1b. Therefore we hypothesize that:

Hypothesis 2: *Outsider representation on the board is positively associated with the likelihood of organizational misconduct in firms that lack pragmatic legitimacy in a transitional economy.*

Cultural-cognitive legitimacy. Different from pragmatic legitimacy that rests on judgments about whether a given organization benefits the evaluator practically or materialistically, cultural-cognitive legitimacy may involve “mere acceptance of the organization as necessary or inevitable based on some taken-for-granted cultural account” (Suchman, 1995: 582). Such taken-for-grantedness differs from evaluating the organization based on self-interest or practical value (Jepperson, 1991). Zucker (1983:25) identified this form of legitimacy with cognitive “exteriority and objectivity”, so that “for things to be otherwise is literally unthinkable.”

For example, in the early period of transitional China, ownership (state-owned enterprises versus private enterprises) could be a good proxy of cultural-cognitive legitimacy. State-owned enterprises (SOEs) in China can be perceived as having a high level of cultural-cognitive legitimacy, as they attain taken-for-granted status in society.

The private firm, as a new organizational form representing capitalism in a socialist state with longstanding anti-capitalistic sentiments, lacks cultural-cognitive legitimacy. Because of the pariah-like status of capitalists and merchants in the socialist state, private firms remain quite vulnerable to the enforcement of government regulations and discriminations from stakeholders (Nee, 1992). It is difficult for private enterprises to obtain financial support from banks, which continue to favor state-owned firms (Boisot & Child, 1996). Private firms must generally be quite self-reliant, or depend on private sources of credit, which are limited or available only at a very high interest rate. Organizations that lack cultural-cognitive legitimacy often seek to acquire legitimacy by adopting a socially legitimate corporate governance structure. Indeed, organizations may enhance their taken-for-grantedness by rebuilding their images through conforming to institutional demands or window dressing (DiMaggio & Powell, 1983; Zucker, 1988). If appointing more outside directors is an act done mainly as window dressing, it may hinder the board's ability to prevent illegal behaviors in transitional economies with immature markets, as argued in Hypothesis 1b. Therefore, we hypothesize that:

Hypothesis 3: *Outsider representation on the board is positively associated with the likelihood of organizational misconduct in firms that lack cultural-cognitive legitimacy in a transitional economy.*

Board Outsider Salience as Boundary Condition

To directly test the window dressing mechanism, we build on the concept of outsider salience to assess the degree to which an outside director can “decorate” a firm. While the previous moderator, organizational legitimacy, shapes the need for window dressing, board salience affects the visibility of window dressing. Salience refers to characteristics that are noticeable and judged to be relevant (Taylor & Fiske, 1978). The existing literature on the salience effects generally finds that people who are more salient tend to be perceived as more visible and influential (e.g., Briggs & Lassiter, 1994; Hillman, Cannella, & Harris, 2002). Organizational audience may require visible and credible evidence of accountability and transparency in corporate governance. A board with salient outside directors is likely to be perceived as highly visible and credible, thereby increasing the window dressing effect.

What type of window dressing is perceived as salient is a matter of rhetoric (McCloskey, 1998). In this light, we evaluate the education level of outside directors as a proxy of the salience effect. Human capital theory predicts that high educational credentials are associated with “functionally important” jobs that are closely related to salience and prestige (Treiman, 1977). A director with a higher education level may send a more visible signal about the corporate governance quality of the firm in which the person serves. The higher the education levels of outside directors, the greater the window dressing effect. When outsider representation on a board is increased and outside directors have high levels of education, the window dressing effect is the greatest, resulting in the highest likelihood of corporate fraud in transitional economies with underdeveloped formal institutions. Therefore, we hypothesize that:

Hypothesis 4: *Outsider representation on the board is positively associated with the likelihood of organizational misconduct for firms with high levels of outsider salience in a transitional economy.*

Methods

Sample and Data Sources

We test our hypotheses using data covering illegal financial transactions by all publicly-traded firms in the early transitional period of China. Our sample is limited to publicly-traded firms because information on governance structures is only available in financial statements of listed firms. The year of 1998 is chosen as the first observation year because information disclosure requirements in China remained very loose until 1998, when the first version of the Securities Law and a series of regulations were enacted. We end our observation in 2005, because the Chinese government has greatly improved its regulations on outside directors in publicly listed firms since 2006. The new Securities Law and Company Law came into effect on January 1, 2006, which introduce strict measures to enhance managerial accountability, including detailed regulations on the scrutiny and duties of outside directors.²

²The directors' duty regime has been significantly reinforced by the introduction of a whole new chapter on the qualifications and duties of directors in the Company law. Article 147 sets out the grounds on which a person may be disqualified from being an outside director, and Art 148 regulates that directors and senior managers are subject to duties of loyalty and duties of care and diligence. Besides, based on the Sarbanes-Oxley Act of the United States, Article 68 in the new Securities Law regulates that directors and senior managers of listed companies must provide their opinions in the periodic reports of their companies and guarantee the authenticity, accuracy and integrity of the information as disclosed in these reports.

The new Securities Law and Company Law substantially reduce the possibilities that outside directors are appointed as simply window dressing. We thus focus on the early period of China's economic transition when the window dressing logic is more feasible and prevalent, a research context appropriate for testing the theoretical relationships proposed in this study.

The most casual perusal of the business press confirms that financial scandals remain widespread among Chinese listed firms. Such incidents are identified from the press releases by the CSRC, the Shanghai Stock Exchange (SHSE), and the Shenzhen Stock Exchange (SZSE) announcing enforcement actions. These organizations serve as the three main monitors of the two Chinese stock markets, supervising listed companies, auditors, securities brokers, and so on. Enforcement actions are announced when violations of securities regulations such as the Temporary Rules and Regulations on the Management of Share Issues and Trade are detected. The incidents typically involve fabricated profits, made-up assets, false statements, intentional omissions of critical information, or an illegal pledge for a loan. During the study period from 1998 to 2005, 237 of the 1,352 firms listed on Shanghai and Shenzhen stock exchanges for at least part of the period were identified in connection with some financial scandal publicly reported by the CSRC, SHSE, or SZSE.

We collect data from four sources. The China Stock Market & Accounting Research Database (CSMAR) compiled by the University of Hong Kong and GTA Information Technology Company Limited collects corporate governance and financial information for all listed companies on both the Shanghai and Shenzhen Stock Exchanges. The Sinofin database compiled by the Center for China Economic Research Services and Sinofin Information Services Company also contains information about corporate governance and financial reports for all firms listed on China's stock markets. GTIone is used as an additional data source to help resolve any inconsistencies between the specific information provided by CSMAR and that provided by Sinofin. GTIone is a database compiled by GTI Information Services Company in Shenzhen. *China Securities Journal*, *Shanghai Securities Journal*, and other bulletins issued by the CSRC, SHSE, and SZSE constitutes a fourth data source. Moreover, corporate websites help to resolve situations where the information from the above four sources is missing, inconsistent, or irregular.

Variables and Measures

The dependent variable, *Fraud*, is a dummy variable coded as "1" if a firm is publicly penalized by CSRC, SHSE, or SZSE in a particular year, and as "0" otherwise.

All independent variables, moderators and control variables, if time-varying, are lagged one year (t-1) for predicting illegal behavior in the following year. *% outside director* is the ratio of the number of directors who are not members of the management team to the board size in the prior year. As stated above, pragmatic legitimacy can be represented by a firm's stock market performance. We calculate a firm's yearly Cumulative Abnormal Return (CAR), adjusted for splits and dividend payouts.

$$CAR_{i(t-1)} = \sum_d R_{id} - R_{md}$$

where R_{id} is the return on security i for day d in the prior year (t-1), R_{md} is the return of the value-weighted market portfolio for the day. CAR is then multiplied by (-1) to measure *lack of pragmatic legitimacy* (e.g., Agrawal, Jaffe, & Mandelker, 1992; Rau & Vermaelen, 1998). As discussed earlier, in the early period of transitional China, ownership (state-owned enterprises versus private enterprises) could be a good proxy of cultural-cognitive legitimacy. *Lack of cultural-cognitive legitimacy* is a dummy variable, coded as "1" if the final controller of the firm is a private entity and as "0" if the final controller is a government entity. *Board outsider salience* is captured by outsider education, which is measured as the percentage of outside directors with university degrees beyond bachelor degrees.

We include several control variables. A dummy variable, *Exchange market*, is included in the models to check for any relationship with the market where the firm is listed. It is coded as "1" if the firm is listed on the Shanghai stock exchange and "0" for Shenzhen.

Organizational slack is controlled, as illegal behavior may occur as managers attempt to cope with limited options due to a lack of organizational slack (Baucus & Near, 1991). It is measured as the amount of surplus reserve appropriated out of earned surplus for future planned or unforeseen expenditure. *Return on assets* is included to control for the impact of financial strain on corporate fraud. Poor or declining financial performance is regarded as one of the most frequently posited antecedents of corporate illegality (Baucus, 1994; Baucus & Near, 1991; McKendall &

Wagner, 1997). It is noted that while *Return on assets* measures accounting-based performance, pragmatic legitimacy (stock market performance) measures market-based performance. Researchers have long emphasized the differences between these two measures (e.g., Verweire & Berghé, 2004), so we include these two in the same models.

Two sets of control variables on corporate governance are also included. The first set consists of variables related to the firm's ownership and board of directors. *Top 5 ownership* is the percentage of shares held by the five largest shareholders. Concentrated equity ownership may provide the largest shareholders greater power to monitor the managers (Bai et al., 2004). However, large shareholders may also be tempted to misuse the organization's resources without regard for the interests of small investors. *Market for corporate control* is calculated by dividing the shareholding of the largest shareholder by the total shareholdings of the second to the fifth largest shareholders. When this ratio is small, the other large shareholders have more discretionary power and greater incentive to discourage any rapacity of the largest shareholder, thus increasing the firm's value (Bai et al., 2004). We also control for *Board size*, the number of members in the board of directors, though the literature on board size provides no consensus about the effect of board size on organizational performance. Resource dependence theory predicts that a larger board is associated with a firm's greater ability to extract critical resources from the environment (Pfeffer, 1972), thus reducing the firm's motive to engage in illegality. However, agency theory proposes that larger boards may be less likely to function effectively because board members could be less participative, less cohesive, and less able to reach consensus (Jensen, 1993; Firstenberg & Malkiel, 1994).

The second set of control variables on corporate governance is related to managerial incentives and the demographics of the CEO and other top managers. A general premise of agency theory is that stock options and shareholdings may help align the interests of managers and shareholders (Beatty & Zajac, 1994; Himmelberg, Hubbard, & Palia, 1999; Kerr & Kren, 1992). Since stock options were rare in China, *managerial shareholding* is used, calculated as the percentage of shares held by the top management team (TMT), including the CEO, CFO, and other executives whose holdings are listed in the annual report. Also, prior literature suggests that managerial demographic traits may affect the incidence of corporate fraud (Hambrick & Mason, 1984; Zahra, Priem, & Rasheed, 2005). Therefore, we include several demographic variables in the models. *CEO age* and *gender* are controlled to investigate the impact of CEO demography on corporate fraud. *TMT age* is the average age of the members of the top management team other than the CEO. *TMT gender* is the number of males in the top management team other than the CEO. *TMT tenure* is the average tenure of the members of the top management team other than the CEO. *TMT education* is the percentage of top managers with university degrees beyond the bachelor's degree.

Analysis

The event history analysis is used to model the relationship between the time-varying explanatory variables and the likelihood of a firm's committing illegal behavior. Event history analysis is suitable when the data is longitudinal and the dependent variable is dichotomous. The data in this study are right-censored, so a hazard rate model would be appropriate because it would incorporate information on both uncensored and censored cases.

The Cox proportional hazards model (Cox, 1972) is particularly suitable for this analysis (compared with, for example, an exponential, Weibull, or other parametric hazard models) because it does not make parametric assumptions about the relationship between the duration and the hazard rate. Indeed, incorrect parametric assumptions may cause biased estimates of the impacts of covariates on the hazard rate (Blossfeld & Rohwer, 1995). The study makes no *a priori* theoretical prediction about how the likelihood of illegal acts should be related to the time elapsed. Therefore, a Cox model is preferred. The Cox model is limited in that it uses information only about the relative order of events, rather than information about their specific timing. The loss of efficiency in parameter estimates is increased for small samples (Yamaguchi, 1991). This study focuses on all Chinese listed firms in the period from 1998 to 2005, so the sample is relatively large, minimizing the seriousness of this issue.

Another potential source of bias in parameter estimates may exist if a large fraction of the events happened before the beginning of the study period. The observations started in 1998, before which only a small number of cases of illegal behavior were reported by the *CSRC*, *SHSE*, and *SZSE*. Hence any bias in parameter estimates arising from left censoring should be negligible.

The data are structured by firm-year, with each year each firm treated as a unit of analysis, creating a set of 6,982 firm-years. Because only first events are examined, firms are removed from the risk set upon conducting an illegal act. Also, 15 cases are right-truncated due to the termination of their listing during the study period. All independent variables are lagged by one year, so the hazard rate for illegal behavior in each year is conditional on the corporate governance

characteristics in the prior year. In addition, we use robust standard errors clustering at the industry level to allow for any interdependence of observations pertaining to the same industry.

Results

Table 1 presents descriptive statistics and correlation coefficients for the 6,982 observations. Table 2 reports the coefficients for the Cox regression models predicting illegal corporate behaviors. Model 1 includes only control variables. In Model 2, % outside directors is not significant. Both Hypothesis 1a and Hypothesis 1b are rejected. The window dressing logic could not account for the relationship between board composition and corporate misconduct for all firms in China. This finding also does not support the conventional agency theory. It is likely that both logics could co-exist in China’s transitional economy; therefore, we may need to identify the moderating conditions where one logic works better than the other. Models 3-6 examine the moderating effects of lack of pragmatic legitimacy, lack of cultural-cognitive legitimacy, and board salience on the relationship between outside directors and illegal corporate actions. In Model 3, outsider representation on the board is associated with an increased likelihood of corporate fraud in firms that lack pragmatic legitimacy. In Model 4, outsider representation on the board is related to an enhanced probability of illegal behavior in firms that lack cultural-cognitive legitimacy. In Model 5, % of outside directors on the board is related to an enhanced probability of corporate fraud when outsiders are salient. Taken together, outside directors are likely to be appointed as window dressing when firms lack legitimacy, and the window dressing effect is greater when outside directors are more salient. Such window dressing effects may produce negative consequences.

TABLE 1: Descriptive Statistics and Correlations *

	Mean	S.D	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21
1 Fraud	0.03	0.18																					
2 Exchange market	0.58	0.49	-0.04																				
3 Organizational slack	1.26	5.27	-0.02	0.05																			
4 Return on assets	0.03	0.10	-0.14	0.05	0.03																		
5 TMT age	43.83	4.32	-0.04	0.06	0.07	0.01																	
6 TMT gender	5.25	2.17	0.00	0.01	0.07	0.01	0.12																
7 TMT education	0.72	0.15	0.00	0.00	0.06	-0.01	-0.09	0.02															
8 TMT tenure	1.87	0.81	-0.04	0.01	0.02	0.06	0.15	0.03	-0.01														
9 Managerial shareholding	2.19	2.37	-0.03	0.00	0.00	0.07	0.25	0.37	-0.06	0.12													
10 Top 5 ownership	58.27	13.88	-0.07	0.04	0.07	0.11	0.04	0.05	0.04	0.03	-0.04												
11 Market for corporate control	0.22	0.18	0.01	0.01	0.05	0.01	-0.05	0.01	0.03	-0.03	-0.07	0.31											
12 Board size	9.70	2.54	-0.02	0.03	0.10	0.01	0.11	0.18	0.03	0.08	0.06	-0.01	0.06										
13 Outsider salience	0.11	0.24	-0.01	0.01	0.10	-0.02	-0.03	0.04	0.15	-0.03	-0.09	-0.10	-0.05	0.05									
14 CEO age	45.71	6.79	-0.04	0.00	0.08	0.04	0.54	0.08	-0.05	0.08	0.17	0.04	-0.03	0.07	-0.02								
15 CEO gender	0.96	0.19	0.01	-0.03	0.01	-0.01	0.05	0.13	0.03	0.00	-0.01	0.03	0.00	0.04	0.02	-0.01							
16 CEO duality	0.13	0.33	0.01	-0.03	0.00	0.00	0.06	0.07	0.00	-0.01	0.12	-0.06	0.03	0.00	-0.02	0.14	0.00						
17 CEO tenure relative to board	1.15	5.02	-0.01	-0.03	0.00	0.00	-0.02	-0.01	0.00	-0.03	-0.01	0.00	0.00	-0.02	-0.01	0.00	0.00	-0.01					
18 Outsider shareholding	0.01	0.02	-0.01	0.01	-0.02	0.03	-0.07	-0.01	0.00	-0.01	0.01	0.01	0.09	0.00	0.06	-0.06	0.01	0.00	0.00				
19 CEO compensation	0.60	0.28	0.00	0.01	0.04	0.01	0.00	0.03	0.01	0.01	-0.02	0.01	0.05	-0.01	0.04	-0.01	0.01	0.01	0.00	0.00			
20 %outside directors	0.75	0.16	-0.01	0.04	0.00	-0.02	-0.13	-0.32	0.05	-0.06	-0.34	-0.01	0.08	0.11	0.09	-0.08	0.03	-0.28	0.03	0.01	0.03		
Lack of cultural-cognitive legitimacy	0.20	0.39	0.07	0.00	-0.04	-0.02	-0.22	-0.12	-0.01	-0.08	-0.12	-0.17	0.16	-0.07	0.06	-0.13	-0.02	0.08	0.01	0.08	0.02	0.02	
22 Lack of pragmatic legitimacy	-0.01	0.27	0.03	0.00	-0.06	-0.18	-0.06	-0.01	-0.03	-0.02	-0.07	-0.09	-0.05	-0.01	0.12	-0.04	0.00	0.00	0.00	0.01	0.00	0.04	0.04

* N = 6,982. All correlations above |0.024| are significant at the 5 percent level.

TABLE 2: Cox Proportional Hazards Models of Corporate Fraud in Transitional China ^a

Variable	Model				
	1	2	3	4	5
Controls:					
Exchange market	-0.29*	-0.30*	-0.31**	-0.30*	-0.31**
	(0.12)	(0.12)	(0.12)	(0.12)	(0.12)
Organizational slack _(t-1)	-0.17**	-0.17**	-0.15**	-0.16**	-0.01**
	(0.05)	(0.05)	(0.05)	(0.05)	(0.01)
Return on assets _(t-1)	-0.98**	-1.00**	-0.96**	-0.97**	-0.96**
	(0.12)	(0.11)	(0.10)	(0.10)	(0.10)
Lack of pragmatic legitimacy _(t-1)	0.25*	0.24*	0.28**	0.23*	0.36**
	(0.11)	(0.11)	(0.10)	(0.11)	(0.10)
Lack of cultural-cognitive legitimacy _(t-1)	0.47**	0.46**	0.45**	0.45**	0.44*
	(0.17)	(0.17)	(0.16)	(0.16)	(0.20)
Ownership structure					
Top 5 ownership _(t-1)	-0.03**	-0.02**	-0.02**	-0.02**	-0.03**
	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)
Market for corporate control _(t-1)	0.95	0.66	0.67	0.68	0.75
	(0.59)	(0.50)	(0.50)	(0.50)	(0.47)
Board of directors					
Board size _(t-1)	-0.03*	-0.02	-0.02	-0.02	-0.02
	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)
Outsider salience _(t-1)	-0.40*	-0.43*	-0.47*	-0.43+	-0.46*
	(0.20)	(0.21)	(0.22)	(0.23)	(0.22)
CEO and top management team					
TMT age _(t-1)	-0.02	-0.01	-0.01	-0.01	-0.01
	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)
TMT gender _(t-1)	0.05*	0.05+	0.04	0.05	0.04
	(0.02)	(0.03)	(0.03)	(0.03)	(0.03)
TMT education _(t-1)	0.08	0.12	0.08	0.10	0.08
	(0.38)	(0.39)	(0.41)	(0.39)	(0.41)
TMT tenure _(t-1)	-0.18**	-0.18**	-0.18**	-0.18**	-0.20**
	(0.07)	(0.07)	(0.07)	(0.07)	(0.07)
Managerial shareholding _(t-1)	-0.04	-0.04	-0.04	-0.04	-0.04
	(0.02)	(0.03)	(0.03)	(0.03)	(0.03)
CEO age _(t-1)	-0.01**	-0.01**	-0.01**	-0.01**	-0.01**
	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)
CEO gender _(t-1)	0.10	0.11	0.12	0.12	0.14
	(0.57)	(0.53)	(0.54)	(0.53)	(0.51)
CEO-board independence					
CEO duality _(t-1)	0.22**	0.13*	0.15*	0.15**	0.13*
	(0.07)	(0.06)	(0.06)	(0.05)	(0.06)
CEO tenure relative to board _(t-1)	-0.25	-0.26	-0.27	-0.27	-0.26
	(0.42)	(0.44)	(0.44)	(0.44)	(0.41)
Outsider shareholding _(t-1)	-9.94*	-11.19*	-10.43*	-10.73*	-0.01
	(3.88)	(5.25)	(4.09)	(4.40)	(0.01)
CEO compensation _(t-1)	-0.27	-0.25	-0.20	-0.22	-0.01
	(0.26)	(0.20)	(0.19)	(0.19)	(0.01)
Main effects					
% outside directors _(t-1)		-0.36	-0.52*	-0.53*	-0.57+
		(0.28)	(0.24)	(0.24)	(0.31)
Interactions					
% Outside directors _(t-1) x Lack of pragmatic legitimacy _(t-1)			2.61**		
			(1.01)		
% Outside directors _(t-1) x Lack of cultural-cognitive legitimacy _(t-1)				1.46**	
				(0.54)	
% Outside directors _(t-1) x Board outsider salience _(t-1)					2.10+
					(1.31)

^a Values in parentheses are robust standard errors. The results are adjusted by clustering at the industry level. + significant at 10%; * significant at 5%; ** significant at 1%.

We illustrate the interaction effects in Figures 1, 2, and 3 in which “high” and “low” are defined as one standard deviation above and below the mean, respectively. Figure 1 shows that the association between % outside directors and corporate fraud is positive for firms that lack pragmatic legitimacy. It supports Hypothesis 2. Figure 2 illustrates that the relationship between outsider representation on the board and corporate fraud is positive for firms that lack cultural-cognitive legitimacy, supporting Hypothesis 3. Figure 3 demonstrates that outsider representation on the board is positively related to the probability of corporate illegality for firms with high levels of board outsider salience, whereas the relationship becomes negative for firms with low levels of outsider salience, corroborating Hypothesis 4.

FIGURE 1: Moderating Impact of Lack of Pragmatic Legitimacy

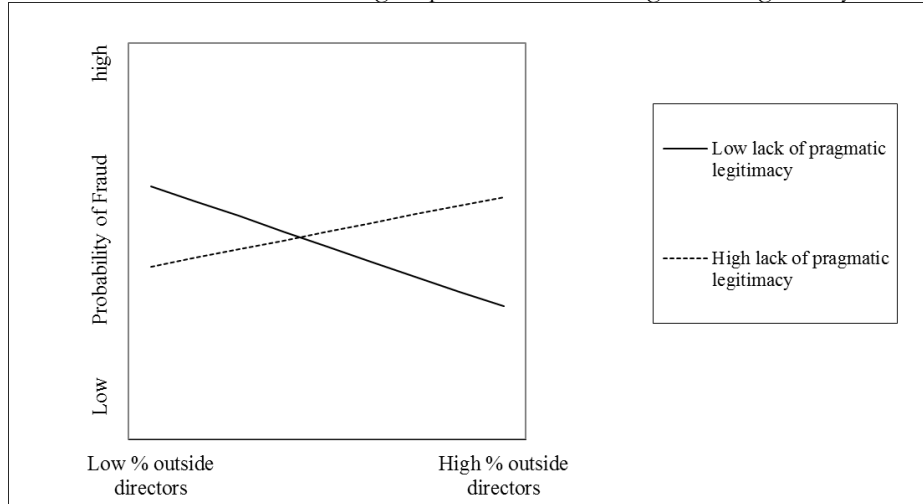


FIGURE 2: Moderating Impact of Lack of Cultural-cognitive Legitimacy

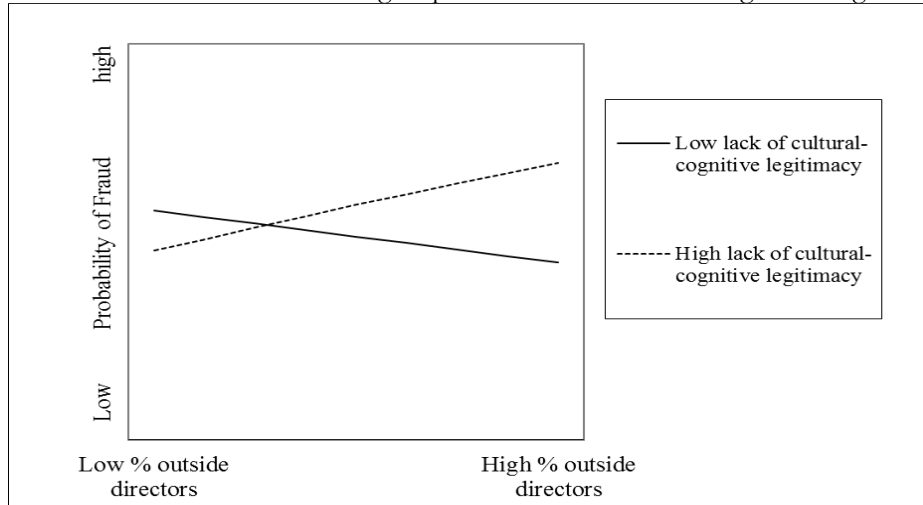
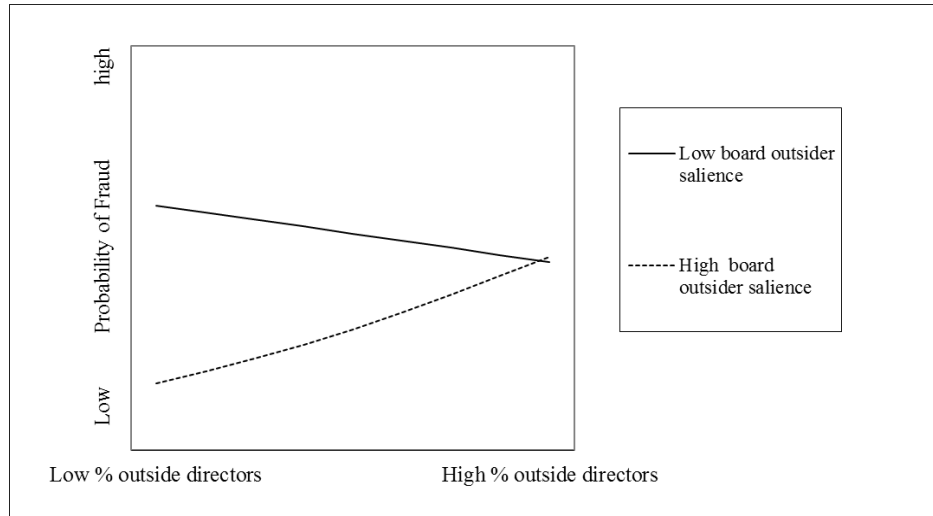


FIGURE 3: Moderating Impact of Board Outsider Salience



Some of the control variables display the expected effects. For instance, firms with greater accounting performance and more slack resources are less likely to be engaged in illegal acts. The observed relationship between illegality and top 5 ownership concentration, CEO duality, and outsider shareholding are all consistent with the predictions of previous research on corporate governance (Bai et al., 2004; Cannella & Lubatkin, 1993; Rechner & Dalton, 1991). Additionally, younger CEOs are found to be more inclined to commit fraud than older CEOs, because youth is usually associated with greater risk-taking (Gottfredson & Hirschi, 1990). More mobile, short-tenured executives are observed to be more likely to engage in illegal acts, as they are more prone to change (Clinard, 1983).

Robustness tests

An alternative explanation of dysfunctional outsiders in firms with low levels of legitimacy and high levels of salience may be related to an overly powerful CEO. That is, the moderating effects of organizational legitimacy and board salience may be confounded by the CEO-to-board power relationship. To account for this alternative explanation, we assess four aspects of the CEO-to-board relationship in accordance with the suggestions of Zajac and Westphal (1996) and Westphal and Zajac (1996). First, we investigate CEO tenure relative to that of the board members. New directors have been found to be more likely to submit to others in board meetings (Alderfer 1986), while CEOs with a high relative tenure may often discourage the questioning of their authority using their personal mystique or patriarchy (Finkelstein & Hambrick, 1989). Second, we assess CEO duality, which is defined as the joint possession of the CEO and board chairperson positions. A CEO holding both positions is seen to have greater formal authority, often hampering board independence (Cannella & Lubatkin, 1993; Rechner & Dalton, 1991). Third, we measure the total compensation package for the CEO, as the literature on corporate governance has long attributed high levels of CEO compensation to CEO entrenchment and board dependence (Westphal & Zajac, 1995). Fourth, and finally, outside stock ownership is included in this study because a director's power tends to increase in line with the proportion of total shares (Zald, 1969). Outside directors with equity investments in their firm are more likely to be vigilant monitors of the CEO (Beatty & Zajac, 1994). *CEO tenure relative to board* is calculated as CEO's tenure divided by the average tenure of the firm's directors. *CEO duality* is coded as "1" if a single person was both the chairman of the board of directors and CEO; and as "0" otherwise. *CEO compensation* is measured as CEO's total direct compensation, which includes salary, short-term bonus, and the value of long-term incentive grants made in the prior year. *Outsider shareholding* is calculated as the total percentage of shares held by outsider directors. Table 3 presents regression results accounting for the alternative explanation. We include the interactions between the percentage of outside directors, lack of pragmatic legitimacy, lack of cultural-cognitive legitimacy, and board salience. We then enter the interaction between the percentage of outside directors and the four proxies of CEO-to-board power relationship. The interactions between the percentage of outside directors, lack of pragmatic legitimacy, lack of cultural-cognitive legitimacy, and board salience are found to be consistently significant before and after adding the four interactions. These results further confirm our abovementioned findings.

Besides, to check the reliability of the results obtained from the Cox proportional hazards model, we also employ the discrete-time logit regression analyses. We find nearly identical results as those reported above.

TABLE 3: Robustness Tests: Cox Proportional Hazards Models of Corporate Fraud after Accounting for Alternative Explanations ^a

Variable	Model				
	1	2	3	4	5
Controls:					
Exchange market	-0.30*	-0.31**	-0.31**	-0.31**	-0.30*
	(0.12)	(0.12)	(0.12)	(0.12)	(0.12)
Organizational slack _(t-1)	-0.15**	-0.15**	-0.15**	-0.15**	-0.15**
	(0.05)	(0.05)	(0.05)	(0.05)	(0.05)
Return on assets _(t-1)	-0.96**	-0.96**	-0.96**	-0.96**	-0.96**
	(0.10)	(0.10)	(0.10)	(0.10)	(0.10)
Lack of cultural-cognitive legitimacy _(t-1)	0.45**	0.45**	0.45**	0.45**	0.45**
	(0.16)	(0.16)	(0.16)	(0.16)	(0.16)
Lack of pragmatic legitimacy _(t-1)	0.28**	0.27**	0.27**	0.28**	0.27**
	(0.10)	(0.10)	(0.10)	(0.10)	(0.10)
Ownership structure					
Top 5 ownership _(t-1)	-0.02**	-0.02**	-0.02**	-0.02**	-0.02**
	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)
Market for corporate control _(t-1)	0.67	0.67	0.67	0.68	0.67
	(0.50)	(0.50)	(0.50)	(0.50)	(0.50)
Board of directors					
Board size _(t-1)	-0.02	-0.02	-0.02	-0.02	-0.02
	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)
Outsider education _(t-1)	-0.46*	-0.47*	-0.47*	-0.46*	-0.47*
	(0.22)	(0.21)	(0.21)	(0.22)	(0.21)
CEO and top management team					
TMT age _(t-1)	-0.01	-0.01	-0.01	-0.01	-0.01
	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)
TMT gender _(t-1)	0.04	0.05+	0.04	0.04	0.04
	(0.03)	(0.03)	(0.03)	(0.03)	(0.03)
TMT education _(t-1)	0.07	0.07	0.08	0.08	0.08
	(0.42)	(0.41)	(0.41)	(0.41)	(0.41)
TMT tenure _(t-1)	-0.18**	-0.18**	-0.18**	-0.18**	-0.18**
	(0.07)	(0.07)	(0.07)	(0.07)	(0.07)
Managerial shareholding _(t-1)	-0.04	-0.04	-0.04	-0.04	-0.04
	(0.03)	(0.03)	(0.03)	(0.03)	(0.03)
CEO age _(t-1)	-0.01**	-0.01**	-0.01**	-0.01**	-0.01**
	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)
CEO gender _(t-1)	0.13	0.12	0.12	0.12	0.13
	(0.55)	(0.54)	(0.54)	(0.54)	(0.55)
CEO-board independence					
CEO duality _(t-1)	0.18*	0.15**	0.15**	0.15*	0.18*
	(0.09)	(0.06)	(0.06)	(0.06)	(0.09)
CEO tenure relative to board _(t-1)	-0.27	-0.31	-0.27	-0.26	-0.31
	(0.44)	(0.45)	(0.44)	(0.44)	(0.45)
Outsider shareholding _(t-1)	-10.45*	-10.34*	-11.97**	-10.45*	-11.80**
	(4.11)	(4.11)	(2.41)	(4.11)	(2.47)
CEO compensation _(t-1)	-0.20	-0.20	-0.20	-0.19	-0.20
	(0.20)	(0.19)	(0.19)	(0.19)	(0.19)
Main effects					
% outside directors _(t-1)	-0.54*	-0.38	-0.58*	-0.50*	-0.46
	(0.22)	(0.26)	(0.25)	(0.24)	(0.28)
Interactions					
% Outside directors _(t-1) x Lack of pragmatic legitimacy _(t-1)	2.66*	2.62*	2.62**	2.57*	2.64*
	(1.09)	(1.02)	(1.01)	(1.05)	(1.10)
% Outside directors _(t-1) x Lack of cultural-cognitive legitimacy _(t-1)	1.38**	1.37**	1.39**	1.35**	1.36**
	(0.50)	(0.48)	(0.48)	(0.49)	(0.49)
% Outside directors _(t-1) x Board outsider salience _(t-1)	2.11+	2.10+	2.11+	2.10+	2.09+
	(1.31)	(1.31)	(1.31)	(1.31)	(1.31)
% Outside directors _(t-1) x CEO duality _(t-1)	0.32				0.31
	(0.64)				(0.62)
% Outside directors _(t-1) x CEO tenure relative to board _(t-1)		0.88			0.83
		(0.66)			(0.66)
% Outside directors _(t-1) x Outsider shareholding _(t-1)			-33.20		-31.08
			(34.54)		(35.93)
% Outside directors _(t-1) x CEO compensation _(t-1)				0.56	0.54
				(0.68)	(0.69)

^a Values in parentheses are robust standard errors. The results are adjusted by clustering at the industry level. + significant at 10%; * significant at 5%; ** significant at 1%.

Discussion and Conclusions

This study appears to paint a mixed picture of China. Overall, the extent of outsider representation on a board is not significantly associated with the incidence of corporate fraud. After delving closely into the relationship, we observe noticeably divergent patterns for firms with different levels of legitimacy. In firms that lack organizational legitimacy (pragmatic and cultural-cognitive legitimacy), the high percentage of outside directors is likely to be associated with an increased probability of corporate fraud.

In response to Davis's call for more attention on the spread of corporate governance structures beyond the original purpose (Davis, 2005), this study finds some evidence of the dark side of ritualistic adoptions of seemingly credible corporate governance practices. It echoes Edelman's (1992) study of companies setting up offices for equal employment opportunities, which can be viewed as merely a firm's compliance with federal anti-discrimination laws. It also coincides with a series of research by Zajac and Westphal on the symbolic adoption of CEO long-term incentive plans (Westphal & Zajac 1996, 1998; Zajac & Westphal, 1995). Extending these studies, the current paper suggests that corporate governance is adopted to respond to institutional changes in an unstable market. The need to gain legitimacy for less legitimized firms in a changing institutional environment is found to be an important factor in triggering a ritualistic adoption of corporate governance structures.

In addition, this study finds that such ritualistic adoption could have a detrimental effect. Compliance with external demands may produce negative consequences as the real issue is not addressed. The Chinese government's demand for transparency through a high ratio of outsider representation on the board may not be effective in helping to deter illegal behavior, contrary to the government's intention. As Tetlock (2002) suggests, increasing the accountability of decision-makers by no means leads to an assurance of superior decision quality, as decision-makers often become intuitive politicians. In a similar vein, the demands for greater transparency stemming from the Sarbanes-Oxley Act of 2002 may also be met with ritualistic adoption that is intended to convey obedience, which may lead to even worse consequences.

Because this study examines all Chinese firms listed on its stock exchanges, including those poorly performing, this study also has some insights to offer for distressed firms. A criticism of the prior research in this area is that the majority focuses on large and successful firms (Daily & Dalton, 1993), with less attention to those in decline. Thus, the exploration of underperforming organizations included in this study may contribute to our understanding of the effectiveness of corporate governance in such situations. Interestingly, the results show that in poorly performing organizations, the increasing outside director representation on the board may not help deter organizational misconduct. This finding further explains the downward spiral of organizational failure that is suggested by Hambrick and D'Aveni (1992). Future research could delve further in this area, seeking ways to stop this downward spiral.

Limitations. Following previous studies of illegal corporate behavior (e.g., McKendall & Wagner 1997), this study also uses violations that are detected and publicly penalized by the regulatory agencies. These misconduct counts are likely to underestimate the actual situation, including those not detected. However, as suggested by Clinard and Yeager (1980), there is no reason to assume that organizations that escape detections differ from organizations detected by the government as to their organizational composition. Hence, such underestimation may not be a serious problem. Second, we focus on the early transitional period when China's capital market is still new and the legal environments are underdeveloped. So it is possible that owing to the immature market, agency theory appears to be invalid.

Future research should address this important issue, e.g., through cross-country studies with variations in the development of market institutions. Third, we do not study non-listed Chinese firms in this paper, and non-listed firms may well have different governance dynamics (Peng, Justin, & Tong, 2004). Future research certainly should examine the generalizability of the results found in this paper.

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