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In search of responsible CEOs: The case of CEOs with non-profit experience ☆

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ABSTRACT

We advance, and test, two competing hypotheses that relate prior non-profit experience to mismanagement and/or negligence against the null of no relationship. The evidence supports the hypothesis that the bureaucratic and chaotic culture of many non-profits often attracts and/or molds individuals with subpar managerial habits. We find that firms headed by CEOs with non-profit experience are more likely to restate financial statements than other firms, even after controlling for variables that have been shown to affect restatements, and that the returns around announcements of class action securities litigation are more negative for firms with "non-profit" CEOs.

1. Introduction

In recent years, market participants and the general public have grown increasingly concerned about corporate integrity and accountability. With the infamous corporate debacles that occurred shortly after the turn of the millennium still reverberating throughout the economy, investors are searching for ways to ensure that their wealth remains in good hands. Since much of the wealth in the United States exists in the form of corporate equity and debt (Wolff (1998)), the leaders of corporations – the chief executives – deserve particular attention. The goal of this paper is to contribute to the existing literature on corporate governance by investigating a small but influential subset of CEOs to determine whether certain past career decisions can shed light on the level of one's propensity for mismanagement. Specifically, we examine whether prior non-profit experience signals a lower/higher tendency for mismanagement at the CEO level. We advance, and test, two competing hypotheses that relate non-profit experience to questionable conduct. We find that much of the evidence is consistent with the hypothesis that predicts a positive relationship between prior non-profit experience and mismanagement.

To the extent that propensity for fraud is related to one's ambition to attain wealth, non-profit experience signals a lower predisposition for fraud, as wages are notoriously low in this sector. For example, Monster.com, an employment search website, offers the following warning to those considering non-profits:

> *Low pay*: Constrained by limited financial resources, many nonprofit organizations offer below average to low salaries. Comparable jobs paying $40,000 a year in government or business may only pay $25,000 to $30,000 with a nonprofit organization. A 25% salary differential is quite common. Consequently, don't expect to make as much money working for a nonprofit organization as you might with other types of organizations. The rewards are elsewhere, and primarily non-monetary, with nonprofits.

Academic research on wage differential echoes this characterization. Weisbrod (1983) finds that non-profit and government lawyers earn 15% less than similar individuals in the for-profit sector. Preston (1989) reports that the salaries of white-collar workers are generally 5–20% lower for nonprofit employees. Roomkin and Weisbrod (1999) find that CEOs and COOs in non-profit hospitals earn 25% less than their counterparts in for-profit hospitals. Finally, Cragg and Dyck (2000) document that senior managers in U.K.'s state-owned businesses received half the compensation of their publicly traded counterparts prior to privatization.

To the extent that individuals maintain a roughly stable attitude toward wealth over time, both academic studies and anecdotal evidence suggest that we should expect someone who made a conscious decision to take up a non-profit job to be less likely to commit white-collar crime. According to this reasoning, CEOs with non-profit experience should be less likely to be linked to fraudulent or potentially fraudulent activities. This constitutes our Compensation Hypothesis.

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Our second hypothesis, the Accountability Hypothesis, posits that the bureaucratic and chaotic culture of non-profits attracts and/or molds individuals with poor managerial skills, and therefore non-profit experience should be positively related to the probability of fraud and/or mismanagement. To quote Monster.com once more,

> Many nonprofits are stressful places to work because of the chaotic nature of their organizations and decision-making. Some are highly political and bureaucratic. Boards of directors often work against their best interests. Some nonprofits have notorious reputations for administrative incompetence and disorganization; lack quality personnel and staff development; operate with antiquated equipment and from cramped quarters; and have attitude problems. Relationships between the CEO, board members, staff and volunteers can become a nightmare. If you prize strong leadership, clear decision points, high levels of efficiency and the latest in office technology, many nonprofit organizations will disappoint, frustrate, and discourage you. If you can tolerate ambiguity, inefficiency and chaos and function well in makeshift work environments, you may do well in such work environments.

The managerial economics literature supports this view. Fizel and Nunnikhoven (1992) find that for-profit nursing homes are more efficient than their non-profit counterparts, while Kessler and McClellan (2002) and Duggan (2002) report similar results for hospitals. Pfeffer (1981) argues that the generally higher level of bureaucracy and inefficiency in non-profit organizations is a direct result of the tension inherent in trying to please multiple stakeholders. In the case of for-profits, on the other hand, the goal of profit maximization prevails above all others.

If non-profit organizations are indeed largely “disorganized” and “chaotic”, as Monster.com claims, individuals with subpar managerial habits may be attracted to these businesses. In addition, even if there are no ex-ante differences in the characteristics of individuals who choose to work for non-profits, certain modes of conduct that are acceptable in the former may be intolerable in the latter. Hence, the experience of working in a non-profit environment may itself lead to corruption when the *modus operandi* is carried over to the private sector. We do not attempt to empirically distinguish between these nature-versus-nurture arguments; we simply note that both are consistent with non-profit CEOs engaging in more reckless behavior and/or mismanagement than CEOs without prior non-profit employment.

Finally, a number of theories can be proposed in favor of not finding any relationship between non-profit experience and negligence and/or fraud. First, “non-profit” CEOs might be no different than other CEOs as far as their predisposition to questionable conduct. Second, “non-profit” CEOs might indeed have lower/greater predisposition to questionable conduct, but internal and external corporate governance adjusts in such a way that *realized* negligence and/or fraud is independent of CEO experience and personal characteristics in equilibrium. Third, given the relatively small number of firms headed by CEOs with non-profit experience, we might simply not have enough statistical power to prove anything conclusively.

To distinguish among these hypotheses, we employ two proxies for corporate fraud and/or mismanagement: incidence of financial statement restatements and incidence of class action lawsuits. We admit that both proxies are at best imperfect surrogates for true fraud, and may be closer related to negligence and inattentiveness than to premeditated fraud and racket. However, as we discuss below, both have been used extensively in prior studies of corporate governance.

It should be noted that throughout this paper, we refer to non-profit organizations and government entities collectively as “non-profits”. The individuals whose firms underlie the core of our analysis were CEOs of publicly traded for-profit corporations during the base year of 1999, with one or more stints at non-profits prior to the base year. We refer to them as non-profit CEOs merely as shorthand notation for “chief executives of for-profit corporations with non-profit experience at some point in the past.”

Our results are generally consistent with the Accountability Hypothesis. During the 1996–2005 sample period, financial statement restatements were significantly more prevalent for test firms, that is, firms headed by non-profit CEOs, than for control firms. Furthermore, abnormal returns around restatement announcements were more negative for test firms than for control firms, although the difference is not statistically significant. When it comes to class action securities litigation, we cannot reject the null that non-profit experience plays no role in determining the frequency of lawsuit filings, but the abnormal returns around announcements of filings were significantly worse for the test group than for the control group.

The rest of the paper proceeds as follows. In Section 2, we present an overview of related literature. In Section 3, we describe the selection criteria for our test and control firms, and discuss CEO demographics, firm and CEO characteristics, and data sources. In Section 4, we examine whether non-profit experience is related to the probability and consequences of financial restatements. Section 5 complements the preceding analysis, as we explore the relationship between prior non-profit employment and the probability and consequences of class action litigation. Finally, we summarize our research and offer concluding remarks in Section 6.

2. Related literature

As far as the author knows, this is the first paper to explore the relationship between prior non-profit experience and the propensity for fraud or negligence in a corporate setting. There are two related streams of research. One of these examines the link between CEO characteristics, such as gender, education, and experience and firm-level variables. For example, Palia (2000) finds that CEOs in regulated industries have a lower level of education than CEOs in unregulated industries, arguing that the market for CEOs matches better-educated executives with firms that have more to gain from human capital. Magnusson and Boggs (2006) report that executives with international experience are more likely to be selected as CEOs of large U.S. corporations. Benmelech and Frydman (2010) document that CEOs with a military background prefer lower levels of corporate investment and are less likely to commit fraud.

Another related area of research examines the differences between for-profit and non-profit entities as they relate to work environment, employee compensation, and incentives. Although there is general agreement that salaries are lower in non-profits (Weisbrod, 1983; Preston, 1989; Roomkin & Weisbrod, 1999; Cragg & Dyck, 2000), other differences are not as clear-cut (Emanuele & Higgins, 2000). In industries where non-profit and for-profit businesses operate side by side, non-profits are generally less efficient (Fizel & Nunnikhoven, 1992; Kessler & McClellan, 2002; Duggan, 2002).

We contribute to both of these areas of research, and perhaps commence a new strand that explores the association between non-profit experience and for-profit success.

3. Data and sample selection

Our sample consists of all firms covered by CRSP and ExecuComp that, according to information gathered from Bloomberg, were headed by CEOs with prior non-profit experience as of 1999. One reason behind our decision to select 1999 as the base year is that ExecuComp has more data for 1999 than for any other year. Another reason is that much of the fraud at large U.S. corporations such as Enron and WorldCom occurred during the surrounding period. Since 1999 was part of