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Executives' "off-the-job" behavior, corporate culture, and financial reporting risk[☆]

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ABSTRACT

We examine how executives' behavior outside the workplace, as measured by their ownership of luxury goods (low "frugality") and prior legal infractions, is related to financial reporting risk. We predict and find that chief executive officers (CEOs) and chief financial officers (CFOs) with a legal record are more likely to perpetrate fraud. In contrast, we do not find a relation between executives' frugality and the propensity to perpetrate fraud. However, as predicted, we find that unfrugal CEOs oversee a relatively loose control environment characterized by relatively high and increasing probabilities of other insiders perpetrating fraud and unintentional material reporting errors during their tenure. Further, cultural changes associated with an increase in fraud risk are more likely during unfrugal (vs. frugal) CEOs' reigns, including the appointment of an unfrugal CFO, an increase in executives' equity-based incentives to misreport, and a decline in measures of board monitoring intensity.

1. Introduction

We examine how and why two aspects of top executives' behavior outside the workplace, as measured by their legal infractions and ownership of luxury goods, are related to the likelihood of future misstated financial statements, including fraud and unintentional material reporting errors.[1] We investigate two potential channels through which executives' outside behavior is linked to the probability of future misstatements: (1) the executive's propensity to misreport (hereafter "propensity channel"); and (2) changes in corporate culture (hereafter "culture channel").[2]

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[1] We consider an executive's legal infractions and luxury asset ownership over the period up to and including the year before the reporting error or initiation of fraud. We refer to these as "prior" legal infractions and luxury asset ownership.

[2] We use "culture" to refer to a firm's multifaceted control environment with likely effects on the risk of misreporting (e.g., internal control

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Motivated by the criminology literature, we interpret an executive's prior legal infractions, including driving under the influence of alcohol, other drug-related charges, domestic violence, reckless behavior, disturbing the peace, and traffic violations, as symptoms of a relatively high disregard for laws and lack of self-control. We predict and find a direct, positive relation between CEOs' and CFOs' prior records and their propensity to perpetrate fraud (propensity channel), as reflected in the executive being named for fraudulent corporate reporting in a Securities and Exchange Commission (SEC) Accounting and Auditing Enforcement Release (AAER). We find no relation between CEOs' prior legal infractions and *other* insiders being named in an AAER, unintentional reporting errors, or other symptoms of a relatively weak control environment (culture channel).

We interpret an executive's ownership of luxury goods, including expensive cars, boats, and houses, as a symptom of relatively low "frugality." Motivated by the psychology and managerial accounting literatures, we predict that CEOs who refrain from acquiring luxury goods (hereafter "frugal CEOs") are likely to run a "tight ship" relative to unfrugal CEOs (culture channel). Consistent with the culture channel, we find that the probabilities of both fraudulent reporting by other insiders and erroneous reporting are higher in firms run by an unfrugal (vs. frugal) CEO, and these differences become more pronounced over the CEO's tenure. Further, we find some evidence that the increasing probability of fraud over the tenure of unfrugal CEOs is associated with the appointment of an unfrugal CFO, as well as an increase in more "traditional" fraud risk factors, i.e., an increase in executives' equity-based incentives and weakened board monitoring. In contrast to executives with records, we find no evidence that unfrugal executives have a higher propensity to perpetrate fraud.

The interpretation of our results is subject to several caveats. First, due to the high cost of the background checks used for data on legal records and asset ownership, our fraud and error samples are small, and have a high proportion of fraud and error firms relative to the underlying population of firms.[3] Second, our fraud and error samples include only firms whose misreporting is *detected* and *enforced,* raising the possibility that our results are confounded by factors associated with the SEC's detection and enforcement procedures. And third, endogenous sorting of executives to firms may bias our results. Our results are robust to a variety of identification strategies for addressing the latter two issues, mitigating these concerns.

Subject to these caveats, our paper makes three main contributions. First, we provide new evidence on the risk of materially misstated financial statements. Second, we introduce novel measures of executive "type" based on prior legal infractions and luxury asset ownership. We document evidence that these measures of executives' "off-the-job" behavior capture meaningful differences in managerial style in a financial reporting context, raising the possibility that these measures are useful in exploring other aspects of corporate behavior and performance. And third, we provide the first evidence of which we are aware of how changes in corporate culture over the tenure of CEOs differ in an intuitive and intriguing way by CEO type.

The remainder of this paper is organized as follows. Section 2 reviews the relevant literature and develops our hypotheses. Section 3 describes the sample and data and provides some descriptive statistics. Section 4 presents our analysis of the relation between fraud and executive type, and our analysis of the propensity channel. Section 5 presents our analysis of the culture channel. Section 6 presents sensitivity analyses and Section 7 provides concluding remarks and future research opportunities.

2. Hypotheses development

2.1. Overview of the literature

Our research builds on several literatures. Hambrick and Mason's (1984) "Upper Echelons Theory" argues that managers' experiences, values, and cognitive styles, such as honesty, affect their choices and consequent corporate decisions. Consistent with this theory, Bertrand and Schoar (2003) document significant manager fixed effects with respect to corporate investment behavior, financing policy, organizational strategy, and performance. Similarly, Bamber, Jiang, and Wang (2010) and Dyreng, Hanlon, and Maydew (2010) document significant management fixed effects with respect to firms' voluntary accounting disclosures and corporate tax avoidance, respectively.

Our reliance on off-the-job behavior to measure executive type offers two advantages over the use of manager fixed effects to measure managerial "style." First, executives' "off-the-job" behavior is less likely to be affected than on-the-job behavior by characteristics of the firm such as the incentive plans and the control environment, facilitating the identification of executive type. Second, manager fixed effects do not identify specific characteristics of executives, but rather capture all relevant managerial time-invariant characteristics such as preferences, ability, and backgrounds.

Some prior studies focus on identifying specific managerial characteristics associated with corporate decisions and/or performance. For example, Kaplan, Klebanov, and Sorensen (2012) find that subsequent corporate performance is positively associated with CEOs' general abilities and execution skills, and Malmendier and Tate (2009) document that award-winning "superstar" CEOs subsequently underperform, manage earnings more, and extract more compensation.

Personal characteristics that have received considerable attention are overconfidence and narcissism. Roll (1986) argues that management overconfidence is associated with unsuccessful corporate takeovers. Malmendier and Tate (2008, 2005) find that overconfident CEOs are more likely to engage in value-destroying mergers and acquisitions (M&A) and link overconfidence to corporate investment

(*footnote continued*)
systems, director monitoring, equity-based incentive plans, reliability of CFO). Hereafter, we use "culture" and "control environment" interchangeably.

[3] The sample for our main analysis of fraudulent reporting includes 109 fraud firms and 109 matched non-fraud firms. The sample for our analysis of reporting errors includes 94 error firms and 179 control firms.