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CEOs Who Fudge Numbers Love Luxury and, Sometimes, Breaking the Law

By Francine McKenna

Another big CEO payday is in the news. Gaming company Zynga will pay lots of dollars to attract well-known Microsoft executive Don Mattrick to its flailing company. Zynga's stock is down almost 70 percent since the company's 2011 initial public offering, although it jumped up on the announcement founder Mark Pincus would step down. The company recently cut 520 jobs, about 18 percent of its workforce.

According to Zynga's SEC filings, Mattrick's package is worth almost $50 million over the next few years, including a $5.5 million signing bonus. Mattrick makes even more if he actually turns Zynga around.

Don Mattrick doesn't really need the money. A recent profile in Fast Company says Mattrick "lives like a Saudi prince," commuting to Microsoft headquarters from his home in Vancouver in his own jet. He is married to an heiress and admits a strong affinity for Ferraris, Lamborghinis and Lotuses.

Mattrick may be a classic "low frugality" CEO, based on a definition in a 2011 working paper by Abbie Smith of Chicago Booth and her colleagues Robert Davidson of Georgetown University and Aiyesha Dey of the University of Minnesota. "Executives' "Off-The-Job" Behavior, Corporate Culture, and Financial Reporting Risk" describes how two kinds of CEO and CFO behavior outside the workplace—prior legal trouble and ownership of luxury goods—are related to the likelihood of financial misstatements and fraud.

Prior legal trouble, according to Smith, includes driving under the influence, drug related charges, domestic violence, reckless behavior, disturbing the peace, and speeding tickets. The researchers interpret a CEO's prior legal troubles as a symptom of "a relatively high disregard for laws and lack of self-control and predict a direct, positive relation with his propensity to perpetrate fraud."

Consumer psychology research has defined frugality as "a distinct psychological trait characterized by the degree to which a consumer is restrained in acquiring and resourceful in using goods and services to achieve long-term goals." The researchers hypothesize that CEOs who own luxury goods, "unfrugal" CEOs, are less likely to "run a tight ship" than frugal CEOs. Favorite luxury assets for these CEOs are expensive cars and boats. One executive in both the fraud and non-fraud samples owned an aircraft.

The researchers found a significant increase during the tenure of "unfrugal" CEO in the probability of fraudulent corporate reporting, of other insiders being named in fraud, and of restatements caused by material reporting errors. Firms run by CEOs with legal troubles and by "unfrugal" CEOs are also significantly more likely to meet or barely beat analysts' forecasts, according to the research. Finally, "unfrugal" CEOs are also more likely to hire "unfrugal" CFOs. It's about social "fit."

Not everyone thinks CEOs or CFOs should be judged on their personal lives rather than solely on company performance. Some investors are willing to "dance with a devil" if it means consistent stock price increases and high dividends and other returns of shareholder capital. One example of this tradeoff is the case of retired General Electric CEO Jack Welch.

Jack Welch's 2002 divorce from his second wife became acrimonious after Jane Welch learned of Jack's affair with a much younger Harvard Business Review editor. (Welch divorced his first wife in 1987 after four kids and 28 years of marriage. He married Jane, seventeen years his junior, two years later.) The soon-to-be second former Mrs. Welch felt she should continue living in the style to which she had become accustomed, at the expense of GE shareholders. Court documents revealed that GE, the corporation, planned to subsidize Welch's luxurious lifestyle – a Manhattan apartment, use of company aircraft, cars, office, and financial planning services, four country-club memberships, satellite TV at his four homes, fresh flowers and courtside Knicks tickets – for the rest of his natural life.

Michael Craig argued for indulgence in The American Spectator in "Jane Welch's Sour Grapes." "Between the end of 1996 and when Welch stepped down at the end of August 2001," Craig rationalized that GE's stock price "rose from $16.35 to $40.98 (and had been as high as $60). Shareholders also received ever-increasing quarterly dividends."

Craig didn't mention the legacy of SEC investigations for fraudulent accounting manipulation, accounting restatements, regulatory enforcement actions and class action lawsuits against GE that emanated from the Jack Welch-inspired corporate culture.

In 2004 GE settled with the SEC for repeatedly misleading investors about Welch's retirement compensation package.

In July of 2010 GE was accused of bribing Iraqi officials in the so-called "oil for food" scandal. The list of GE's pre-2000 offenses, according to FAIR.org, includes overcharging the Army for battlefield systems in 1990 and a guilty plea on charges of fraud, money laundering and corrupt business practices while selling jet engines to Israel.

The Welch legacy continued after his retirement when successor Jeffrey Immelt settled in 2009 with the SEC for $50 million for "using improper accounting methods to increase its reported earnings or revenues and avoid reporting negative financial results." According to Robert Khuzami, the SEC Director of Enforcement at the time, "GE bent the accounting rules beyond the breaking point."

GE shares steadily declined after Immelt took over in 2001 to $23 by mid-2003, then rose back to near $40 in 2007 before heading to a low of $5.73 in March 2009. The share price has been floating in the $20 range since mid-2010.

Jonah Shacknai, who ran Medicis Pharmaceuticals, is an example of a CEO with both legal troubles and nonfrugal tendencies that led to criminal and civil charges for the company and its auditors. In 2007, Medicis agreed to pay $9.8 million to settle charges with the Department of Justice that it illegally marketed the topical skin preparation Loprox to children. The DOJ said Medicis also violated the False Claims Act by submitting off-label Loprox claims to Medicaid.

Shacknai used to own the Spreckels mansion, a historic home in Coronado, California that was the site in 2011 of the mysterious deaths of his girlfriend, ruled a suicide, and of his 6-year-old son from a fall, all within two days. Shacknai's girlfriend was found bound and hanging from the mansion's balcony after allegedly finding out the boy's injuries were fatal.

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She had been caring for him at the time of the accident. Prior police reports detailed years-old spousal abuse allegations between Shacknai and his second ex-wife. Shacknai has never been a suspect in his girlfriend's or his son's death.

Investors reached an $18 million class action settlement that same year with Shacknai, his CFO (a former PwC auditor), and company auditor EY for manipulation of revenue recognition, omitting a required reserve for returns, and concealing from investors that a material portion of sales were likely to be returned. Medicis continued to publish false and misleading financial statements and EY continued to approve them. EY paid $7 million of the settlement.

EY paid an additional $2 million penalty to the PCAOB, the audit regulator. The PCAOB sanctioned four current and former EY partners for failing "to fulfill their bedrock responsibility." Shacknai sold Medicis, a company that had a reputation for putting beautiful naked women on the covers of its annual reports, to Valeant Pharmaceuticals in September 2012 for $2.8 billion.

Zynga has had accounting issues already in its young life as a public company. CFO David Wehner left last August, less than a year after Zynga's IPO, to take a job at Facebook. Mattrick is a safe driver, as far as we know, but I can only imagine what may be in store for gaming company Zynga if Smith's theories about "nonfrugal" CEOs are predictive. I'd wager it's not a turnaround.

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