Forbes

July 23, 2013

Fast Cars and Speeding Tickets: How the Boss's Behavior in Private Life Predicts a Company's Wrongdoing

By Kathryn Dill

The make and model of a chief executive's car—and how fast he or she chooses to drive it—may provide clues to whether he or she will commit fraud, according to a new study of how executives' off-the-job behavior reflects and even affects corporate culture.

Researchers looked at the legal histories of the executives of 218 businesses, half of them showing evidence of fraud and half not. They focused on DUIs, drug arrests, domestic incidents, charges of disturbing the peace, and traffic violations, all of which, the study's authors said, are "symptoms of a relatively high disregard for laws and lack of self-control," and also looked at a CEO's ownership of homes, cars, boats, and other luxury items, categorizing the ownership of big-ticket assets as evidence of "low frugality."

We speak of companies' wrongdoing, said Robert Davidson, professor at Georgetown University and lead author of the report, "but a firm doesn't *do* anything—the people that are running the firm make decisions. Somebody in the firm decided they were going to commit fraud. Is that random or is there something systematic about it?"

What researchers found was a discernible relationship between a CEO's prior legal infractions and his liklihood to personally commit accounting fraud. They also found that "unfrugal" CEOs are also more likely to preside over businesses where executives commit fraud.

> ***"The argument is that if you have poor systems, controls, and monitoring in place, you're more likely to make mistakes. In firms run by unfrugal CEOs, these unintentional errors were far more likely."***
>
> Robert Davidson
> Georgetown University's
> McDonough School of Business

The "unfrugal CEO" is more likely to build a fraud-friendly company environment by hiring a likewise unfrugal CFO and allowing the company culture to relax in a way that makes errors—both intentional and accidental—more common.

Such an executive is "more likely to appoint people to the board of directors that he had prior social connections with," said Davidson. "They were members of the same clubs, had worked in the same firm in the past, had sat on the same boards in the past—they had some form of relationship that was verifiable prior to appointment to the board."

After naming connections to the company board, the CEO of a fraudulent company may decrease board members' stock-based compensation.

"There's a lot of theory that suggests this reduces the board's incentive to monitor, because their wealth isn't tied to monitoring the firm well," said Davidson.

Beyond evidence of deliberate fraud, the study showed that unintentional reporting errors also occur more regularly at companies with nonfrugal CEOs.

"The argument is that if you have poor systems, controls, and monitoring in place, you're more likely to make mistakes," said Davidson. "In firms run by unfrugal CEOs, these unintentional errors were far more likely. We interpret that as evidence that the culture of that firm is such that these errors are more likely to occur and that there is a reduced emphasis on accuracy, monitoring, etc."

The research also showed that businesses in the public eye had more instances of fraud than those receiving less attention. That might seem unlikely, but Davidson explained that publicity can actually up the ante to commit a crime. Citing Enron and WorldCom as examples he said, "A lot of the fraud firms were highly successful and highly profitable before the fraud started, which could raise their profile in the media. If a firm is doing well and then goes bad, there's pressure to compensate for the drop in value. There's an incentive to cook the books."

Though Davidson's research points to particular warning signs, the takeaway for those involved in the executive search process is hardly clear-cut. There is no simple profile for an executive who is more likely to commit fraud: the executives of fraudulent and non-fraudulent companies shared numerous common characteristics, including similar tenure and employment histories.

Davidson recommends that anyone hiring a new chief executive pay close attention to the details of the mandatory criminal background check to which all potential candidates are subject, including the kind of minor infractions, like speeding tickets, that usually don't raise eyebrows.

"You should at least be aware of [any small legal infraction in a CEO's past] and consider it—there is information in these small infractions," said Davidson. "Legal infractions of one sort are a strong predictor of legal infractions of another sort."

FORBES
Georgetown University's McDonough School of Business
July 23, 2013

(http://www.forbes.com/sites/kathryndill/2013/07/23/fast-cars-and-speeding-tickets-how-the-bosss-behavior-in-private-life-predicts-a-companys-wrongdoing/)