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Intersection of Fraud and Traffic Violations

By Floyd Norris

If the chief executive likes to drive too fast, watch out. He may be more likely to commit fraud.

If he lives too high on the hog, worry about whether he is paying enough attention to work to catch fraud being committed by his subordinates. And there may be a greater chance that the company is making mistakes in its accounting, though not fraudulently.

Determining whether fraud was committed at a company is hard enough, but trying to figure out why is much harder. Presumably some chief executives do it to get rich from rising stock prices, but others in similar situations do not give in to such temptations.

Three academics set out to see whether there were any clear differences between chief executives of companies where fraud was committed and chiefs of similar companies where fraud did not take place — or at least where it was never detected. And they found evidence that those who are willing to violate other rules are also more willing to violate securities laws.

Their results are reported in a paper, “Executives’ ‘Off-the-Job’ Behavior, Corporate Culture and Financial Reporting Risk,” which is to appear in the Journal of Financial Economics. It was written by Robert Davidson, who teaches accounting at Georgetown University, along with Aiyesha Dey of the University of Minnesota and Abbie Smith of the University of Chicago.

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Georgetown University’s
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Examining fraud cases that the Securities and Exchange Commission filed over the years — covering frauds that began between 1992 and 2004 — the researchers looked for other companies that were as similar as possible to the companies that were caught. Those companies were of similar size, had similar balance sheets and similar prefraud stock market performance as the fraudulent companies and were in the same industries.

That gave them 109 companies where fraud was detected and 109 similar ones where it was not.

The academics then hired private investigators to check out the bosses. They looked for past criminal records, including traffic violations, and they searched public records to see which cars, homes and boats the chief executives owned.

The criminal records were the most interesting.

You might think that anyone who rises to the top of a public company would have a clean criminal record. That does not turn out to be the case.

Of the 109 chief executives of companies found to have committed fraud, 12 had previous encounters with the law that were more serious than a speeding ticket. The academics counted eight felony drug charges, four cases of domestic violence and four traffic violations so serious that they were lumped under the heading of reckless endangerment. (Some of the bosses had more than one item on their record.)

Of the other 109 — the ones whose companies had not been accused of committing fraud — there was nothing more serious than an ordinary traffic violation.

The idea that companies might want to avoid hiring chief executives with a history of felony drug charges is hardly a surprising one. But it is not as obvious that even simple traffic tickets seem to correlate with fraud.

Of the 109 chief executives from nonfraudulent companies, just five had traffic tickets. Sixteen of the fraud company chief executives had such tickets. Some of them also had more serious violations. Altogether, 22 of the 109 had some previous violation.

"We still have pretty strong results if we use only speeding tickets," Mr. Davidson said. "The implication is you would at least want to consider the things that are often considered relatively minor."

The statistics are far from conclusive — 109 is not a large number — but they may take on a little more weight from the decision of the researchers to investigate an additional 164 chief executives.

They came from 94 companies that were forced to restate their financial statements but were not accused of fraud by the S.E.C., and from 70 others chosen at random from the universe of companies that did not have fraud or accounting errors. None of the 164 had serious offenses, and the proportion with minor traffic violations was much lower than it was among the fraudulent companies.

What this could indicate is that people who are willing to violate one set of social norms are more likely to be willing to violate far more serious ones.

The identities of the chief executives with records were not disclosed by the researchers, so we do not know which executive was charged with each crime, or if he or she was convicted. Given the absolute power some chief executives have within their companies, it might be interesting to look at how bosses previously accused of domestic violence treated their subordinates in the office. The researchers also set out to see if what they call unfrugal chief executives run companies that are fundamentally different from those run by bosses who spend less on themselves.

To determine that required decisions on just what constituted unfrugal behavior. They settled on a definition involving ownership of homes, boats and cars, which is available from public records. Chief executives were deemed to be unfrugal if they owned a car that listed for more than $75,000, a boat that was more than 25 feet long or a house worth more than twice the average cost of a home near the company's headquarters.

And what did they find? Unfrugal chief executives are no more likely to commit fraud than their colleagues, but they are more likely to run companies where others commit fraud, and they are more likely to run companies that are forced to restate their financial statements.

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They are also more likely to change the pay structure for directors by reducing stock-based composition. There is some evidence from other studies that boards with significant equity stakes may be more vigilant in monitoring management.

Those limits on frugality struck me as perhaps a little low, given the ample income of many chief executives. Mr. Davidson said they also used an alternative definition — requiring a $110,000 car, or a 40-foot-long boat or a home worth five times the area average — and the trends were generally similar.

I don’t think any of this proves that a traffic ticket should disqualify someone from running a public company. And it appears that most fraud is committed by chief executives who have no previous record of criminal behavior, so that is hardly the only thing a board should monitor.

But the evidence may indicate that boards should routinely run background checks on top officers and on those being considered for such positions. If someone does have a bunch of traffic tickets, or worse, that could be an indication that deeper consideration is needed before that person is given control of a public company.

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