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Strong external governance makes top managers more prone to cheat

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When top-level managers find governance mechanisms too coercive, they're more likely to commit fraud, according to a new paper by strategic management experts at Rice University's Jones Graduate School of Business, Auburn University's Harbert College of Business and Indiana University's Kelley School of Business.

This goes against the conventional wisdom that external corporate governance measures, such as a threatened takeover, naturally curb financial fraud by company leaders, said Robert Hoskisson, the George R. Brown Professor of Management at Rice. He co-authored "External Corporate Governance and Financial Fraud: Cognitive Evaluation Theory Insights on Agency Theory Prescriptions" with Brian Connelly, a professor of management at Auburn, and Wei Shi, a former doctoral candidate in strategic management at the Rice, who joined the faculty at Indiana University this summer. The paper will be published in the *Strategic Management Journal*.

"Many of us are familiar with stories about top managers 'cooking the books' in one way or another," the authors wrote. "As a result, companies and regulatory bodies often implement strict controls to try to prevent financial fraud. However, cognitive evaluation theory describes how those external controls could actually have the opposite of their intended effect because they rob managers of their intrinsic motivation for behaving appropriately. We find this to be the case. When top managers face more stringent external control mechanisms, in the form of activist shareholders, the threat of a takeover or zealous securities analysts, they

are actually more likely to engage in financial misbehavior."

According to cognitive evaluation theory, humans need to feel a certain level of self-determination. The theory asserts that external monitoring and controls "crowd out" an individual's motivation to behave in ways the controls are designed to ensure. It stands in contrast to agency theory, which argues that people are driven by self-interest. According to this line of thought, the presence of external governance mechanisms should make managers less likely to enrich themselves via financial fraud. The added scrutiny boosts the chance of getting caught.

To test if cognitive evaluation theory applies to top managers, the scholars studied institutional and regulatory data from 1999 to 2012 of companies in the S&P 1500 index. They focused on three kinds of external governance mechanisms: dedicated institutional investors, the threat of corporate takeover and ratings agencies.

In the first mechanism, dedicated institutional investors have access to key data because they hold stock over longer-than-average periods of time and closely watch the senior management's actions. Traditional agency theory suggests that under that kind of spotlight, financial fraud by managers should shrink. But the data showed the opposite. Higher levels of dedicated institutional ownership were linked to higher levels of fraud. The authors found that the likelihood of financial fraud commission increases 36 percent when dedicated institutional ownership increases from 4.5 percent (mean) to 11.2 percent (mean plus one standard deviation).

A looming corporate takeover also pressures firms. Lackluster management quickly gets ousted; poorly performing firms get acquired. To study the effects of this external pressure, the researchers analyzed how financial fraud differed if managers were shielded from this pressure by takeover defense provisions—for example, staggered board

appointments, "golden parachutes" and "poison pills," a tactic public companies use to thwart hostile takeovers by making the target's stock prohibitively expensive or otherwise unattractive to an unwanted acquirer.

Traditional agency theory predicts that fraud should increase when more of these shields are in place. But according to the data, when takeover defenses increased, financial fraud dwindled. The researchers found that the likelihood of financial fraud commission decreased 37 percent when the number of takeover defense provisions increase from zero to one.

Finally, ratings agencies also exert pressure. Securities analysts are privy to troves of information and thus serve as a second pair of eyes on a firm and its performance. Their reviews can send a stock price plummeting or soaring. According to traditional agency theory, more analyst scrutiny should equal less financial fraud. However, according to the scholars' findings, higher analyst pressure correlated to higher levels of fraud. The researchers found that the likelihood of financial fraud commission increased 82 percent when the average percent of analysts issuing buy and sell recommendations increases from 56 percent (mean) to 78.5 percent (mean plus one standard deviation).

"In sum, our findings suggest that policymakers may face a paradox in regulating corporate governance," the authors said. "Imposing strict external monitoring and control can decrease top managers' intrinsic motivation and reduce their focus on internal values, potentially leading them to commit financial fraud. However, granting top managers too much freedom from external performance pressure could result in some managers extracting personal gains at the expense of shareholders. Perhaps managers can 'earn the right' to autonomy over time as they demonstrate that they consistently act in the best interest of shareholders, despite who may or may not be looking over their shoulders."

More information: *Strategic Management Journal*, onlinelibrary.wiley.com/doi/10 … 02/smj.2560/abstract

Provided by Rice University

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