Board age and corporate financial fraud: An interactionist view

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Abstract
Unlike past studies which have focused on either executives or boards of directors, this study takes an interactionist view to investigate the determinants of corporate financial fraud. We propose that CEOs evaluate the opportunities for financial fraud according to both situational stimuli and their own personal characteristics. As older directors are often more experienced and have more to lose if they fail in their monitoring duties, we expect them to be more capable and to have stronger motivation for monitoring CEOs closely. As such, we propose that a CEO is less likely to engage in corporate financial fraud when the average age of the board of directors increases (i.e., board age). However, when the CEO is older than the board, the CEO may attach less importance to board age when deciding whether to commit fraud. Therefore, we further propose that the CEO–board directional age difference can weaken the effect of board age. Our empirical analyses provide strong support for these hypotheses. Our study contributes to the literature on corporate governance by highlighting the often neglected roles of board age and CEO–board directional age difference in deterring corporate financial fraud.

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Corporate financial fraud refers to the “intentional misrepresentation of amounts or disclosures in the financial statements” (Apostolou et al., 2000: p. 181). Interest in this type of organizational misconduct has grown substantially since the high-profile scandals at Enron, Tyco, and WorldCom (Wu, 2002). These and other similar scandals demonstrate that corporate financial fraud can result in negative and sometimes devastating corporate outcomes (Karpoff and Lott, 1993). Executives in key decision-making positions may be motivated to manipulate financial reports when opportunities arise, because financial reports that reflect their management ability can directly affect their personal wealth (Zhang et al., 2008). Board members are responsible for monitoring the decisions of executives and for preventing principal-agent problems such as corporate financial fraud (Eisenhardt, 1989; Hambrick et al., 2015). The frequent occurrence of financial fraud may to some extent indicate the ineffectiveness of the governance of directors (Mellahi, 2005).

Accordingly, given that executives play a critical role in corporate financial fraud and that boards of directors are charged with monitoring their decisions, it is imperative to understand what kinds of boards are effective in deterring corporate financial fraud. Past studies have usually approached the problem from an economic perspective, focusing on board independence, board size and board stock options (Beasley, 1996; Uzun and Varma, 2004). Except for a few studies on board gender diversity (e.g., Cumming et al., 2015), little attention has been given to the demographic characteristics of the board.

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Thus, our knowledge about the role of board characteristics in deterring corporate financial fraud is limited. This knowledge is however complemented by the literature on decision-making, which documents how the demographic characteristics of individuals can influence their own decisions and behavior and those of others as a result of psychological and social processes (Simons and Smith, 1999; Smith and Scully, 1994; Freeman and Giebink, 1979). As CEOs are involved in most cases of corporate financial fraud (Beasley et al., 1999), they are likely also responsible for the related decisions. As such, this study investigates how CEOs’ fraud decisions are shaped by the demographic characteristics of the board.

One important demographic characteristic affecting decision-making is age (Taylor, 1978). A number of studies have shown that age, which reflects individuals’ cognition, experience and motivation, influences a wide array of decisions and behavior, including risk-taking behavior (e.g., Serfling, 2014), effective decision-making (Ng and Feldman, 2008), ethical behavior (Deshpande, 1996), and even firm strategy (e.g., Wiersema and Bantel, 1992; Yim, 2013). Therefore, in this study, we focus on age as the focal demographic characteristic of boards and CEOs.

We develop our theoretical model by drawing on the literature on corporate governance and that on decision-making. In particular, the interactionist view in the decision-making literature, which captures the interaction among situational and personal variables (Endler and Magnusson, 1976; Trevino, 1986), can provide insight into executives’ decision-making concerning corporate financial fraud. This view emphasizes that personal and situational factors interact continuously to influence individuals’ decision-making (Chatterjee and Hambrick, 2011; Endler and Magnusson, 1976). Drawing on this logic, this study proposes that before deciding whether to commit financial fraud, CEOs may first gauge the opportunities for financial fraud and estimate the possibilities of success by drawing on situational stimuli of the demographic characteristics of the board of directors. Furthermore, CEOs’ perceptions of these situational stimuli are filtered through their own cognitions (Chatterjee and Hambrick, 2011; Trevino, 1986), which is often reflected in their own characteristics.

Specifically, we propose that CEOs assess the directors’ monitoring incentives and experience to gauge the strictness of board monitoring and to seek opportunities for financial fraud. We argue that the average age of the board of directors (hereafter “board age”) is one situational stimulus that reflects the directors’ monitoring incentives and experience. The reason is that older directors are likely to have more experience in effectively dealing with people and making accurate judgements (Baltes et al., 1995; Choo and Trotman, 1991; McDaniel et al., 1988), more directorial experience, and more incentives to protect their own financial security and career reputation (Carlsson and Karlsson, 1970; Hambrick and Mason, 1984; Taylor, 1978). All of these are important motivators for effective monitoring (Hambrick et al., 2015; Kelly and Gennard, 1996; Kor, 2006; Manning, 1984). As such, we propose that board age is negatively related to the likelihood of corporate financial fraud. In addition, situational stimuli and personal characteristics would both influence CEOs’ decision-making (Chatterjee and Hambrick, 2011; Trevino, 1986). When the CEO is older than the directors, the situational stimulus of board age would become less salient and the CEO would attach less importance to it. As such, we further propose that the effect of board age on corporate financial fraud may be weakened by the directional age difference between the CEO and the board.

We conducted a matched-sample study of 1324 observations of Chinese listed firms in the 4 years from 2010 to 2013. Our study makes several contributions to the corporate governance literature. First, previous studies have mainly taken an economic perspective when examining board monitoring (e.g., Beasley, 1996; Uzun and Varma, 2004) and have largely neglected age as an important factor. By demonstrating how the age of directors affects the likelihood of financial fraud, we advance the research on internal governance mechanisms and the micro-foundations of board monitoring. Second, notwithstanding several recent studies (e.g., Sauerwald et al., 2014; O’Connor et al., 2006), the prior literature has largely neglected CEO–board interactions. Our interactionist view highlights the importance of investigating the characteristics of CEOs and boards in tandem rather than separately, thus shedding new light on internal corporate governance. Finally, our study has practical implications for firms. Our finding of a deterrent effect of board age on corporate financial fraud underscores the importance of hiring older directors. We suggest that hiring older directors might be one way of improving board monitoring effectiveness.

Theory and hypotheses

Internal governance mechanisms and corporate financial fraud

Corporate financial fraud is a common type of organizational misconduct that is often instigated by executives, CEOs in particular (Beasley et al., 1999). Existing studies of corporate financial fraud mainly take a rational, economic perspective based on principal-agent logic (Jensen and Meckling, 1976). Specifically, they argue that agents (executives in this case) are self-interested and would choose actions that maximize their personal utility, usually at the expense of principals (shareholders in this study) (Jensen and Meckling, 1976; Ross, 1973).

Because financial reports reflect executives’ capability and can directly influence their personal wealth (Zhang et al., 2008), executives may be tempted to commit financial fraud. Among the top executives, CEOs are usually the mastermind of corporate financial fraud. There are two reasons. First, as the leader of the top management team, the CEO plays a significant role in firm decision making (Chin et al., 2013), and usually has the power to dismiss other executives (Zhang et al., 2011). CEO’s cognitions and actions can influence the firms’ capabilities and, ultimately, firm-level performance (Daft et al., 1988; Priem, 1994). As such, compared with the other executives, the CEO often receives more blame if the firm’s performance falls below expectation. Thus, the CEO has more incentive and more opportunity to engage in corporate financial fraud.
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