Financial Misreporting in the C-Suite: A Case of Hubris?

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TWO CASES OF FINANCIAL MISREPORTING STARS
How might we describe an entrepreneur who, in rapid succession, received the following public honours?

• Entrepreneur of the year
• Outstanding Achievement Award winner from Hollywood
• Honorary university doctorate
• One of the top 50 most powerful persons in an industry
• Appointment as director of one of the country’s largest publicly held entities

We likely assume this person is neither shy nor interested in hiding from the limelight! Micheline Charest, the recipient of these honours, was founder, controlling shareholder and co-CEO of CINAR, a firm that became the target of endless allegations based on its use of tax credits, its financial reporting, its use of investment tax havens, and copyright infringement. Ms. Charest died in 2004 but some court cases from her days as Co-CEO (pre-2001) still linger. Financial improprieties, including earnings overstatements and improperly handled related party transactions, led to the firm restructuring and eventually it was sold at a significant loss to shareholders. Until accused of financial and business misconduct, Ms. Charest had a very public profile. Further, instead of undermining her rise to fame, the financial press, business circles and financial analysts, painted glowing profiles of her firm’s operations, allowing the firm to raise significant amounts of new capital.

Is Ms. Charest’s story unusual when we consider the list of executives charged with financial reporting frauds or improprieties? Consider another Canadian entrepreneur whose “products” achieved world-class status and whose achievements earned him the Order of Canada, who won several industry awards and who lived a very public life, highlighted in newspapers’ society pages? The rise to fame of Garth Drabinsky and of Livent Inc. was also followed by a precipitous fall. Mr. Drabinsky avoided prison for many years through a trial that lasted an eternity but he is now a convicted felon. Livent itself went bankrupt soon after allegations of financial reporting fraud surfaced, some 14 years ago. As with Ms. Charest, it appears that Mr. Drabinsky’s magic mesmerized bankers, investment bankers, accountants, journalists, analysts and investors enabling him to raise significant amounts of
money despite a business model that was devouring cash at a fast pace.

What do Ms. Charest and Mr. Drabinsky have in common? On the basis of analyses performed with my coauthors Denis Cormier (UQAM) and Pascale Lapointe-Antunes (Brock), we argue that these two successful individuals were driven by hubris to engage in financial misreporting and to deepen their involvement when economic or market forces started to work against them. Perhaps more importantly, their hubris was fed by the response of external actors. I now elaborate further on our study and its findings.

MANAGERIAL HUBRIS AS THE DRIVER OF FINANCIAL FRAUD OR MANIPULATIONS

Managerial hubris can be defined as exaggerated pride or self-confidence often resulting in retribution (Merriam-Webster Online Dictionary; Hayward and Hambrick, 1997). Hubris derives from Greek mythology in which it was deemed to be man’s fatal flaw. “Those excessively confident, presumptuous, blindly ambitious or otherwise lacking humility were relentlessly struck down by the gods” (Grimal, 1986, as reported in Hayward and Hambrick, 1997, p. 106).

In our study, we looked at sixteen (16) Canadian firms whose senior executives were accused of financial reporting or disclosure fraud and for which there were formal accusations of financial reporting fraud filed by securities regulators. For each at least an administrative fine or penalty was levied. The alleged improprieties took place between 1995 and 2009 and our sample included failed firms such as Cinar and Livent, as well as, Hollinger, Atlas Cold Storage, Mount Real, Semi-Tech, Bre-X and YBM Magnex. We matched these troubled firms with comparable counterparts that have not been subjected to allegations of misreporting or fraud and compared them in terms of financial results, governance and, most importantly, managerial hubris. Since we cannot observe or measure directly a CEO’s or a senior executive’s hubris, we relied on an indirect measure that comprises the following elements: awards, distinctions or prizes obtained by the CEO or other senior executives, favourable media coverage, favourable analyst coverage (market darling phenomenon) and the fact that the CEO is also the founder of the firm.

We argue that, fed by fawning praise from external parties, CEOs and executives at the failed firms developed an exaggerated self-worth and became immune to (or intolerant of) criticism, thus reinforcing their over-confidence. First, such expressions of praise or adulation by external observers raises an individual’s conviction that he/she is right: if media coverage (or analysts) endorse with my views, I must be right. Second, the standing of an individual within his/her organization is also enhanced by such external praise: it becomes difficult to argue against someone who is on the front page of all financial newspapers and is the CEO, CFO, CIO etc. of the year. Finally, assuming that the executive has already started to engage in financial reporting manipulations or fraud, such expressions of praise or adulation by external observers, accompanied by his/her elevated sense of self-worth or arrogance, can translate into a challenge: if no one has noticed anything improper, this is an invitation to continue, especially if there are direct personal benefits to be derived from such actions.

FINDINGS

Our findings show that firms that have been the object of financial reporting fraud allegations have the following distinguishing features:

- They typically have aggressive merger and acquisition strategies, which is consistent with evidence of managerial hubris. There is extensive research showing that hubris-driven CEOs are more likely, for example, to engage in takeovers that are not value-enhancing (e.g., Nortel);
- They have complex corporate structures, with several layers of holdings and affiliated companies, often in offshore centres (e.g., Semi-Tech or Hollinger);
- Their business model is often unique, i.e., they may be the only firm in Canada providing such services or products, thus impeding comparative analysis (e.g., Livent in live shows);
- Their CEOs and/or other senior executives have received numerous awards, prizes, distinctions or other forms of public recognition (e.g., honorary doctorates from universities);
- They have received favourable media profiles;
- They are market “darlings”, managing successful initial public offerings or other public financings through reputable investment banks and receiving positive recommendations from stock market analysts;
- They still have their founder involved, either as CEO or executive chair.

“WE ARGUE THAT, FED BY FAWNNG PRAISE FROM EXTERNAL PARTIES, CEOs AND EXECUTIVES AT THE FAILED FIRMS DEVELOPED AN EXAGGERATED SELF-WORTH AND BECAME IMMUNE TO (OR INTOLERANT OF) CRITICISM, THUS REINFORCING THEIR OVER-CONFIDENCE.”
Aggressive M&A strategies, complex corporate structures and unique business models are conducive to financial reporting manipulations as they put the firms’ accounting systems under tension. However, they also contribute to hubris as they elevate executives’ visibility within the media and financial markets. They also serve to further inflate hubris tendencies as they build up the ego of the executives on the receiving end of the praise. In contrast, our control sample firms did not exhibit the same features to the same extent. The differences were quite striking. Hence, we conclude that managerial hubris, as proxied by the attributes highlighted above, seems to be a consistent presence in firms subject to allegations of financial reporting fraud.

**BUT, WHAT ABOUT GOVERNANCE?**

Surprisingly, almost all failed firms in our sample possessed all the accepted visible signs of good governance such as an independent board, an audit committee, reputable auditors, prestigious investment bankers and even star directors. For instance, Livent’s board was a who’s who of Toronto’s financial and legal elite. Hence, board-driven governance did not show itself to be a firewall against value-destructive actions by management. Thus, either the board and other players such as auditors and investment bankers involved were incompetent but in awe of the hubris-driven managers or, far more likely, they simply fully trusted these hubris-driven managers.

**LESSONS TO BE LEARNED**

That CEOs and other senior executives are self-confident, and even somewhat arrogant, is often taken for granted. How would they otherwise attain such a high position? However, in his book *From Good to Great*, Jim Collins refers to his top achievers as being humble and modest: hence, we should probably revisit our priors as to the profiles of successful CEOs and executives. Moreover, assuming some degree of self-confidence is needed and useful to lead an organization, our findings suggest that there is a certain boundary which, if crossed, leads executives into hubris territory where their decisions and vision start diverging from common sense and become instead idiosyncratic if not random. The CEO (or other senior executives) is assumed to hold the truth, and it is self-evident. In such a context, directors, auditors or analysts should start questioning the quality and soundness of executive decision-making. Moreover, if a CEO or senior executive attracts and holds all spotlights upon him or her, hubristic tendencies are probably not far behind. These tendencies may reveal themselves in value-destroying M&A deals or new ventures but, also, in financial misreporting and irregularities. Checks and balances are always needed, especially if a firm and its senior management look as if they can do no wrong.

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