

# Drilled to obey? Ex-military CEOs and financial misconduct

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**Research Summary:** We examine the influence of CEOs' military background on financial misconduct using two distinctive datasets. First, we make use of accounting and auditing enforcement releases (AAER) issued by the U.S. Securities and Exchange Commission (SEC), which contain intentional and substantial cases of financial fraud. Second, we use a dataset of "lucky grants," which provide a measure of the likelihood of grant dates of CEOs' stock options having been manipulated. Results for both datasets indicate that CEOs who served in the military are less inclined to be involved in fraudulent financial reporting and to backdate stock options. In addition, we find that these relationships are moderated by board oversight (CEO duality and independent directors in the board).

**Managerial Summary:** CEOs who formerly served in the U.S. military are prevalent among U.S. firms. The military puts strong emphasis on the obedience of its personnel. In this study, we test if time spent in the military leads individuals to be more obedient to rules and regulations in the years after they have left the military and become CEOs. Our findings strongly suggest that CEOs who served in the U.S. military are less likely to be involved in financial misconduct. We also find evidence that tougher board oversight strengthens this relationship. Our findings have implications for regulators, auditors, practitioners, and researchers who are interested in determinants of and mechanisms to prevent fraud and stock option backdating.

#### KEY WORDS

backdating, board oversight, CEOs, fraud, military

## 1 | INTRODUCTION

Prominent fraud scandals at large companies such as Tyco and WorldCom Inc., the collapse of Enron Corporation, or the option backdating scandal in 2006 led to tremendous damage not only to firms' stakeholders but also to society at large (Beasley, Carcello, Hermanson, & Neal, 2010; Narayanan, Schipani, & Seyhun, 2007). Consequently, regulators, auditors, and researchers in different areas have started to investigate determinants of fraudulent financial reporting and backdating as well as mechanisms to prevent such misconduct. Accordingly, this topic has also sparked interest among academic scholars in management (for an overview see Greve, Palmer, & Pozner, 2010 or Schnatterly, Gangloff, & Tuschke, 2018). While prior work has mainly focused on corporate governance mechanisms to explain the occurrence of financial misconduct (Harris & Bromiley, 2007; O'Connor, Priem, Coombs, & Gilley, 2006; Zhang, Bartol, Smith, Pfarrer, & Khanin, 2008), the character of CEOs has received much less attention. This is surprising given that the empirical evidence clearly suggests that in many of these tremendously damaging cases of financial fraud or stock option backdating, the CEO was directly involved (Baucus, 1994; Beasley et al., 2010).

In our paper, we follow the theoretical perspective of upper echelon researchers who have devoted considerable attention to the role of demography-based characteristics (e.g., education and functional experiences), cognitive bases, and values of CEOs in corporate strategy and decisions (Hambrick & Mason, 1984). We focus on CEOs who served in the military (hereafter, "ex-military CEOs") and test their influence on the propensity for financial misconduct. Among the population of CEOs, a history in the military is rather common. For example, in the 1980s, an astonishing 59% of firms listed in Standard & Poor's 500 index were headed by ex-military CEOs. Following the retirement of World War II and Korean War veterans, this percentage has declined steadily, but it is still substantial: it stood at 8.4% in 2006 (Duffy, 2006). Furthermore, commentators have noted a recent trend of firms specifically targeting former military personnel as new hires (O'Keefe, 2010). We argue that the military instills its personnel with values such as loyalty and integrity as well as a willingness to follow an order of command, and thus that ex-military CEOs exhibit a character that is comparatively more likely to obey rules and regulations and stick to accounting practices that conform to U.S. GAAP. More specifically, we hypothesize that ex-military CEOs have a lower propensity to engage in fraudulent financial reporting and in the backdating of stock option grants.

We look at two different forms of financial misconduct and use two distinctive datasets. The U.S. Securities and Exchange Commission's (SEC) Accounting and Auditing Enforcement Releases (AAERs) for the time period from 1992 to 2011 provide our measure of fraudulent financial reporting. The second dataset consists of "lucky grants" for the period of 1996 to 2005 and measures the likelihood that CEOs' stock option grants were backdated. While the former dataset includes detected fraud cases, the latter ensures that empirical results are not driven by any kind of (un)observed factors that make fraudulent behavior of certain firms more likely to be identified. These two datasets also allow us to distinguish fraudulent behavior that is profitable for CEOs only (lucky grants) from actions that might also benefit other managers and stakeholders (AAERs).

Our study makes a number of important contributions. We add to the literature by building on upper echelon theory in that we demonstrate that service in the U.S. military can serve as an indicator for obedience and law-abiding behavior, which matter in the context of financial misconduct. By proposing that CEOs' military service reflects a character that is more likely to obey rules and regulations, we complement research that uses demographic characteristics or more multifaceted measures

as proxies for CEOs' values and personalities, which matter in decision making (Bertrand & Schoar, 2003; Chin, Hambrick, & Treviño, 2013; Crossland, Zyung, Hiller, & Hambrick, 2014; Dahl, Dezso, & Ross, 2012; Lewis, Walls, & Dowell, 2014). Furthermore, we advance research on the determinants of financial misconduct. While most of the respective literature places focus on governance mechanisms (Harris & Bromiley, 2007; O'Connor et al., 2006; Zhang et al., 2008), we complement the few studies that show that the character of CEOs is also an important determinant of fraud (Schrand & Zechman, 2012; Troy, Smith, & Domino, 2011).

## 2 | THEORETICAL BACKGROUND AND HYPOTHESES

### 2.1 | Financial misconduct

Financial misconduct encompasses corporate actions that are deemed illegitimate from a legal, regulatory, or ethical viewpoint. Fraudulent financial reporting captures accounting-rule violations such as manipulation of records, omission of relevant information from financial statements, misapplication of accounting principles, or misappropriation of assets. Thus, fraudulent financial reporting refers to a presentation of financial statements that do not conform to U.S. GAAP. In contrast to reporting errors, fraudulent reporting has to be committed intentionally, which means that others are purposely misled (Beasley, 1996). CEOs particularly hold a position in which they can directly or at least indirectly manipulate financial reports, and they may intentionally do so because financials reflect their managerial skills (Baucus, 1994; Daboub, Rasheed, Priem, & Gray, 1995; Zahra, Priem, & Rasheed, 2005). In addition, incentives and pressures could motivate CEOs to engage in fraudulent reporting that might directly translate into gains or losses for themselves as well as for other managers and the firm (Dechow, Ge, Larson, & Sloan, 2011; S. Johnson, Ryan, & Tian, 2009). Indeed, CEOs are accused by the SEC of being involved in most fraud cases (Beasley et al., 2010).

Backdating of stock options as another form of financial misconduct directly translates into a benefit for CEOs only (Bebchuk, Grinstein, & Peyer, 2010; Narayanan et al., 2007). Backdating is an opportunistic practice related to the timing of stock option grants, which are often part of CEOs' compensation packages. The majority of options are granted "at the money," which means that their exercise price equals the market value of the underlying stock on the grant date. The lower the exercise price, the higher the value of options. Hence, CEOs prefer to be granted options when stock prices are at their lowest value. Options are labeled backdated if the grant date of the stock option is a date in the recent past on which the stock price was lower than on the day of the actual compensation decision. In such a case, CEOs benefit from the lower exercise price. The practice of backdating is legal in itself as long as it is communicated to shareholders and the SEC, is correctly reflected in earnings and taxes, and does not involve the forging of documents. But if all of these conditions are met, there would be little reason to backdate option grants. In fact, in most cases, firms either fail to comply with the accounting requirements or disclose backdating in an incorrect manner, making most of the cases illegal (Bebchuk et al., 2010; Lie, 2005; Yermack, 1997). Although the stock option plan has to be approved by shareholders and administration of the size and timing of the grants is assigned to the compensation committee, CEOs often exert influence on the timing of compensation committee meetings or committees' decisions due to their close relationships with individual members (Lie, 2005; Narayanan & Seyhun, 2008; Yermack, 1997). Moreover, in many cases, CEOs make a proposal regarding the grant's parameters, which is simply countersigned by the compensation committee (Yermack, 1997).

## 2.2 | CEOs' military background and financial misconduct

As we have illustrated, CEOs could be directly or indirectly involved in fraudulent financial reporting and stock option backdating. Hambrick and Mason's (1984) upper echelon perspective posits that strategic choices and firm performance are strongly influenced by executives' values and personalities. Background characteristics such as education, functional, and other career experiences can serve as proxies for a CEO's personality or values that provide filters for executives' interpretation of the environment and the organization and that consequently influence the decisions that they take (Hambrick, 2007; Hambrick & Mason, 1984; for reviews see Carpenter, Geletkanycz, & Sanders, 2004; Finkelstein, Hambrick, & Cannella, 2009). Manipulation of financial statements is among those decisions that are influenced by CEOs' characteristics (Schrand & Zechman, 2012; Troy et al., 2011).

We posit that CEOs' service in the military influences the occurrence of financial misconduct. In accordance with research that has focused on idiosyncratic differences in functional and educational backgrounds (Barker III & Mueller, 2002; Bertrand & Schoar, 2003; Lewis et al., 2014), we argue that a military background also reflects a certain character that, in turn, influences the CEO's decisions. This might result from two processes: selection and socialization. Personality influences one's choice to enter the military, and military service also influences personality (Jackson, Thoemmes, Jonkmann, Lüdtke, & Trautwein, 2012). In both cases, CEOs with similar backgrounds reflect similar values and show similar behavior (Finkelstein & Hambrick, 1996).

With regard to the first of these two processes, individuals might self-select into the military due to their personal characteristics, or the military might screen and select candidates that already have specific values. With regard to our study focus, individuals who attach importance to discipline, serving others before self, and obedience to rules might be more likely to be drawn into the U.S. military. For example, the U.S. military explicitly states that all members should be dedicated to serve through loyalty and integrity, which should bring forth allegiance and legally right behavior not only in respect of the military and its members but also in respect of the U.S. Constitution (Department of the Army, 2006). The Army's self-statement demands behavior in accordance with a code of conduct and avoidance of illegal activities (Huntington, 1957; Janowitz & Little, 1974; Wolfendale, 2009). These characteristics might play an essential role in one's entrance into the military.

As for the second process, military training encompasses several socialization processes and explicitly aims to change the personality traits and behavior of recruits once they have joined the military (Akerlof & Kranton, 2005; Arkin & Dobrofsky, 1978). For example, during extensive boot camps the status and habits of new recruits are broken down and replaced by a new, military-focused identity. The U.S. military sets high expectations in relation to required behaviors, explicit norms, and the upholding of the military culture. In addition, the U.S. military has an established incentive system to reward those who meet these expectations and to penalize those who don't. This induces changes in the personality and daily behavior of military personnel (Jackson et al., 2012).

Socialization, salient life events, and experiences such as those which come about while in the military can also induce transitions, transform life trajectories, and affect individuals' behavior outside the military and later in life (Elder, 1985, 1986; Sampson & Laub, 1990, 1992). Military service has been shown to be one of the most far-reaching experiences in changing a person's life course, as it typically occurs early in life and before many other triggering events (Elder, Modell, & Parke, 1993). For example, the CEO of Verizon, Lowell McAdam, said about his service in the Navy: "The things you learn in the service will stay with you your whole life" (Asfar, 2009).

Through its training methods, ideals, and prescriptions of appropriate behavior as outlined above, the military shapes individual personalities and induces values such as honor, integrity, and "service

before self." These, in turn, also affect individuals' later legal behavior and working life (Elder, 1986; Elder, Gimbel, & Ivie, 1991; Lipsky, 2003; MacLean & Elder, 2007; Sampson & Laub, 1992). Empirical research has shown that service in the military is a profound experience that shapes individual personalities and instills values such as honor, selflessness, and integrity through training in combat and non-combat scenarios (Elder et al., 1991; Franke, 1998, 2001). For example, Franke (1998) investigated differences in the attitudes and value orientations of first- and forth-class military cadets as well as in those of senior officers. He found that socialization at the U.S. Military Academy at West Point and further military experience enhance notions of duty and honor as well as values such as morality and integrity. Previous work in sociology has shown that socialization through military service not only enhances these values but also reduces later criminal behavior. Sampson and Laub (1996), for instance, investigated the impact of military service on the frequency of military arrests among juvenile delinquents while controlling for selection biases into the Army. Their results indicated that some delinquents were less likely to be arrested after serving in World War II and notably after overseas assignments. Bouffard (2003) corroborated the suggestion that military service reduces later criminal behavior by considering prior criminal records and including controls for selection into the military. She found military members to be less likely to come into contact with the police in comparison to men who had never served. Even when it comes to small matters such as crossing a road, military members are less likely than civilians to commit traffic violations (Rosenbloom, 2011). On the level of CEOs, Law and Mills (2017) find that firms headed by former members of the military pursue fewer strategies to avoid taxes. This is furthermore highlighted by anecdotal evidence. Steven Loranger, the former CEO of ITT and a Navy veteran, commented that "the military teaches honesty, integrity and 'doing the right thing'" (Duffy, 2006, p. 7). John Luke Jr, CEO of MeadWestvaco and an Air Force veteran, described how military veterans "operate with integrity and high ethical standards in all that they do" (Griswold, 2014).

To summarize, we argue that loyalty and integrity either make individuals more likely to serve in the military or are learned during service in the military. We further argue that these values carry over to time spent outside the military, when they are consistently applied in other jobs as well. Deciding whether or not to engage in fraudulent financial reporting and/or backdating is a situation in which CEOs are actively or at least passively involved and in which they apply their own value system. We propose that ex-military CEOs reflect values such as loyalty and integrity, which lead them to behave comparably more obediently with regard to rules and regulations such as U.S. GAAP. This decreases the likelihood that ex-military CEOs will either directly or indirectly engage in any potentially law-infringing behavior such as (a) fraudulent financial reporting and (b) stock option backdating.

**Hypothesis 1 (H1)** *Firms headed by ex-military CEOs have a lower propensity to be involved in fraudulent financial reporting.*

**Hypothesis 2 (H2)** *Ex-military CEOs are less inclined to backdate their stock option grants.*

### 3 | METHODOLOGY

#### 3.1 | Data and sample

We consider two different kinds of datasets to test our hypotheses. The datasets differ with respect to our two distinctive dependent variables. Our first dependent variable is financial *fraud*. The data

comes from U.S. SEC's AAER. We obtained our sample from Dechow et al. (2011), which contains AAERs issued between May 1982 and September 2011.<sup>1</sup> The database lists firms subject to enforcement actions for allegedly misstating their quarterly or annual financial statements. Furthermore, it specifies the nature of misconduct and the reporting period that was required to be restated. As a result, we can refer to a sample of firms that intentionally violated the reporting requirements of the Security and Exchange Act of 1934 and directly align the misstating to the respective CEO. We used firms that we could match to Compustat's ExecuComp database, which provides information about pivotal variables. Since ExecuComp starts in 1992, we considered data from all firms with documented fraud cases in 1992 or later. A firm could commit fraud over several years, but treating each event as an independent observation would overstate our test statistics, because it is likely that subsequent fraud events depend on the initial decision to commit fraud. Furthermore, the first misstep of one CEO could lead the corporation down a slippery slope, and later acts of fraud may not necessarily be attributable to subsequent CEOs. After the first year of fraud, CEOs face a different situation than they face in contemplating misstatement for the first time (Ashforth & Anand, 2003; Schrand & Zechman, 2012; Troy et al., 2011). Therefore, we only considered the year when each company first engaged in fraudulent reporting, and we excluded the subsequent years. We identified 127 fraud cases in total.

For our analysis, we used a matched-sample design, because fraud cases are rare events, thus making random sampling infeasible. This is the usual approach in studies of infrequent occurrences (Holford, 2002) and has also been applied in studies of financial misstatements (Arthaud-Day, Certo, Dalton, & Dalton, 2006; O'Connor et al., 2006). We followed the respective research and matched each fraudulent firm with a unique non-fraudulent firm on the following observable variables that have been found to be important predictors of fraud: similar size (measured in sales) in the same year, and the same two-digit standard industry classification (SIC; Harris & Bromiley, 2007; S. Johnson et al., 2009; Troy et al., 2011). We dropped firms for which we could not identify a corresponding firm within the same SIC and year. We also excluded matched pairs if sales differed by more than 30% (S. Johnson et al., 2009), and we were unable to include some of the initial fraudulent firms due to missing information on our independent or control variables. In total, we found close matches (with average relative size = 0.98, SD = 0.108) for 103 fraud firms.<sup>2</sup>

In our second analysis, we focused on *lucky grants* of CEOs using a dataset by Bebchuk et al. (2010). The dataset covers a subsample of public U.S. firms that granted at-the-money and unscheduled options to their CEOs from 1996 to 2005.<sup>3</sup> Thus, our sample is restricted to CEOs who received at least one option grant (lucky or unlucky) during this period. An option grant is categorized as "lucky" if it was given on the day which had the lowest stock price of the month. With this measure, we focus on instances of backdating with the greatest economic significance to CEOs and shareholders. Although being "lucky" does not necessarily indicate whether CEOs actually backdated their grants, this measure provides a good proxy for opportunistic timing (Bebchuk et al., 2010) and gives us the ability to control for the purposeful engagement of CEOs and the individual benefit that they would obtain. We used all observations that we could match to Compustat's ExecuComp database and for which we had full information on all our independent or control variables. The final dataset consists of 2,926 firm-year observations and 1,265 individual CEOs.

<sup>1</sup>A description of the data collection is available in Dechow et al. (2011).

<sup>2</sup>Relative size is calculated as sales of matched firm divided by sales of fraud firm. Thus, a relative size of 1 would indicate a perfect match.

<sup>3</sup>For further explanations on the construction of this dataset, see Bebchuk et al. (2010).

## 3.2 | Variables

### 3.2.1 | Dependent variables

We constructed the following dependent variables from our two datasets. The variable *fraud* is a binary variable equal to 1 for all fraudulent firms and to 0 for all matched control firms. In our second dataset, *lucky grant* is a binary variable with a value of 1 when at least one option grant to the CEO during year  $t$  was given on a day which had the lowest stock price of the month. The variable is equal to 0 otherwise.

### 3.2.2 | Independent variable

In both samples, our main independent variable is *ex-military CEO*. For each CEO, we hand-collected biographical information from Marquis Who's Who, BoardEx, and the Notable Names Database (NNDB). Marquis Who's Who contains self-reported information on a variety of areas, such as educational history, and also has a specific field for information on service in the military. BoardEx is the largest available dataset with information on members of boards of directors. NNDB is a large database with biographical information on persons of public interest. To provide further information on the nature of CEOs' service in the military (e.g., their rank, length of service, branch they served in, and participation in major international conflicts such as the Vietnam War), we hand-collected detailed information from corporate filings and websites; press releases; CEO interviews, speeches, biographies, and obituaries; laudatory speeches; and several online databases that contain executive biographies (e.g., those of *Forbes* and *Business Week*). We used the information to construct the binary variable *ex-military CEO*, which is equal to 1 if a CEO served in any of the branches of the U.S. military (Army, Marine Corps, Air Force, Navy, and Coast Guard), including the reserves. Table 1 provides more detailed information on our sample of military CEOs, including their rank in the military (e.g., captain, general, or lieutenant), the military branch that they served in, and, if applicable, whether they served in a major conflict.

### 3.2.3 | Control variables

We include several variables to control for corporate governance mechanisms that have been suggested in prior research to increase the strength of oversight and thus to reduce the likelihood of financial misconduct (Bebchuk et al., 2010; Dalton, Daily, Ellstrand, & Johnson, 1998; Davidson, Jiraporn, Kim, & Nemec, 2004; R. Johnson, Hoskisson, & Hitt, 1993). In both datasets, we account for the presence of military veterans on firms' boards of directors with the dummy variable *military*

**TABLE 1** Descriptive statistics of CEOs' military rank, branches, and participation in wars

Rank	#	Military branch	#	Wars	#
Captain	22	Army	67	World War II	6
Colonel	1	Marine corps	14	Korean War	4
Commander	4	Navy	49	Vietnam War	20
General	1	Air force	18	Gulf Wars	1
Lieutenant	31	Coast guard	1		
Officer	40	Army reserve	9		
Sergeant	2	Marine corps reserve	1		
		Navy reserve	9		

*Note.* # displays number of CEOs in both datasets (not CEO-year observations). CEOs may have had multiple ranks or served in multiple wars. For some CEOs, the military branch, rank, or participation in wars is not known.

director, which is equal to 1 if at least one board member had served in the military.<sup>4</sup> We include *CEO duality*, which is a dummy variable coded with 1 when the CEO is also chairperson of the board in the respective year and 0 otherwise.

We also include some dataset-specific controls following the respective stream of research (e.g., Bebchuk et al., 2010; Troy et al., 2011). In the *fraud* dataset, we additionally control for *board size*, measured as the total number of directors in the year the fraud started. To test the influence on our second dependent variable, *lucky grant*, we added more board controls due to the specific nature of this type of fraud and the availability of data. (The inclusion of these variables in the *fraud* dataset would also lead to a significant loss in sample size.) *Independent board* refers to the number of independent directors on the board. *Independent compensation committee* is coded with 1 if the compensation committee consists of independent directors only and 0 otherwise. The dummy *5% blockholder on compensation committee* is coded with 1 if there is at least one director who holds 5% or more of the shares in the company and 0 otherwise. All these corporate governance and board variables are from BoardEx and RiskMetrics.

In both datasets, we include proxies for other demographic characteristics and experiences of CEOs that have been suggested in the literature to potentially affect fraudulent behavior (e.g., Troy et al., 2011). We use the dummy variable *CEO MBA*, which is coded with 1 if the CEO holds an MBA degree and 0 otherwise. To obtain data on CEOs' MBA qualifications, we used information from the same sources from which we collected information about CEOs' service in the military. We also control for *CEO age* at the beginning of the respective year. In addition, the corporate governance literature suggests that position-based characteristics of CEOs and equity-based incentives influence misconduct (Harris & Bromiley, 2007; Jensen & Meckling, 1976; O'Connor et al., 2006; Zhang et al., 2008). Hence, we include *CEO tenure* as the natural log of 1 plus the number of years that the CEO served in the company. We include *CEO ownership*, which is measured through dividing shares in the firm owned by the CEO (excluding options) by the number of shares outstanding in the year of the fraud. The variable *CEO options to compensation* is the lagged value of options granted to the CEO in the previous year (estimated using the Black-Scholes methodology) divided by total compensation. These variables are from ExecuComp and/or Compustat.

In addition, we control for several firm financial conditions, since financial pressure might enhance the likelihood of financial misconduct (Baucus, 1994; Daboub et al., 1995; Dechow et al., 2011; Zahra et al., 2005). More specifically, we include accounting returns, with return on assets (*ROA*) computed as the net income divided by the year-end assets. *Book to market* is the book value of equity divided by the market value of equity.<sup>5</sup> We lagged these variables by one year. We account for size, year, and industry effects via our matched-pair design and our conditional estimation in the *fraud* dataset, and therefore we only include *size*, measured as the logarithm of sales, year, and industry dummies in our *lucky grant* dataset.<sup>6</sup> All these variables are from Compustat. Finally, we control in both datasets for the ratio of total shares held by dedicated institutional investors to total shares outstanding—*dedicated ownership*—which prior research has shown to affect fraud (e.g., Burns,

<sup>4</sup>Results are robust to using different specifications of this variable such as the number of military directors present on a board or the sum of the years of their service. Results are also not affected by controlling for the presence of military directors on the compensation committee for the *lucky grant* dataset and on the audit committee for the *fraud* dataset.

<sup>5</sup>As these variables are ratios and are thus prone to extreme values in either direction if one of the components becomes either very small or large, we winsorized our measure for *ROA* and *book to market* at the 1 and 99% levels. The results were qualitatively unaffected if we did not winsorize.

<sup>6</sup>Following industry categories constructed as in Troy et al. (2011): SIC *construction* (SIC 15–17), SIC *manufacturing* (SIC 20–39), SIC *transportation* (communication and energy: SIC 40–49), SIC *wholesale* (and retail trade: SIC 50–59), SIC *finance* (insurance and real estate: SIC 60–67), SIC *services* (SIC 70–89), and SIC *other* (other industries: SICs 01–14 and 90–99).

Kedia, & Lipson, 2010; Chhaochharia, Kumara, & Niessen-Ruenzi, 2012; Shi, Connelly, & Hoskisson, 2017). We followed the methodology of Bushee (1998, 2001) to identify dedicated institutional investors among all the institutional investors reported in the Thomsen Reuter Institutional (13F) Holdings database.

### 3.3 | Analysis

We test the effect on *fraud* with conditional logit regressions that estimate logit regressions with fixed effects for each pair. This procedure is the standard for matched case-control samples with binary dependent variables (Holford, 2002; O'Connor et al., 2006; Zhang et al., 2008).

In our *lucky grant* dataset, we had multiple observations for each CEO that were not independent from each other. We therefore use generalized estimating equations (GEE) that account for the non-independence of observations to estimate our models (Liang & Zeger, 1986). We specify a binomial distribution with a logit link function and an exchangeable covariance structure of the repeated measurements. We use robust (Huber-White sandwich) standard errors in all models (Wooldridge, 2002).<sup>7</sup>

As in any study dealing with corporate decision making, our results could be affected by endogeneity (Bascle, 2008; Hamilton & Nickerson, 2003). In our study, endogeneity may arise due to unobserved variables that are correlated with both CEOs' military service and misconduct. This concern is heightened because CEOs are not assigned randomly but are endogenously chosen by firms, which also provide the environment for misconduct. For example, some boards select CEOs with a military background, or these CEOs self-select into specific companies or industries in which, due to some unrelated reasons, misconduct is also less likely to occur. However, we believe that endogeneity is less of a problem in the *fraud* dataset, as we implicitly control for unobservable variables that are similar across firms of similar size, in the same industry, and in the same year.

To address concerns about endogeneity in the *lucky grant* dataset, we follow an approach utilized in prior studies and ran a two-stage model as a robustness check (Crossland et al., 2014; Wiersema & Zhang, 2011). In our first-stage model, we regress *ex-military CEO* on a variety of antecedent variables that might predict the probability that the company is headed by an ex-military CEO and that a CEO has a military background. Our proxy for *ex-military CEO* needed to be uncorrelated with pre-entry conditions to account for the possibility that ex-military CEOs are drawn to specific companies or situations. Thus, we regress *ex-military CEO* against antecedent variables that capture key aspects of CEOs' entry conditions: *ROA*, *ROA change*, *book to market*, and *sales* in the year prior to becoming CEO, and *industry* dummies. Moreover, our strategy is based on the fact that the probability of being drafted into military service differs by birth cohort due to the heightened demand of age-eligible men during periods of war and conflict (Angrist, 1990; Angrist & Krueger, 1994; Bedard & Deschenes, 2006).

Similar approaches have been applied before in the economics and finance literature (Benmelech & Frydman, 2015; Lin, Officer, Ma, & Zou, 2011). As we do not expect that birth cohort per se will affect fraudulent behavior, we use birth cohort dummies as instruments in addition to our antecedent variables. While CEOs' age might influence backdating, our cohort dummies identify CEOs who are within similar age brackets but have a different likelihood of having served in the U.S. military. We created birth cohort dummies that equaled 1 in the following scenarios: if the CEO was born between 1920 and 1927 (because 66 to 76% of men born in these years are World War II veterans); if the CEO was born between 1928 and 1930 (as 65% of these men served in the military

<sup>7</sup>We cluster at the CEO level, but results do not change if we clustered at the firm level.

in either World War II or the Korean War); if the CEO was born between 1931 and 1936 (because 50 to 65% of men born in this age bracket served in the Korean War); and if the CEO was born between 1950 and 1953 (since this cohort was very likely to be drafted into the Vietnam War). Of all these variables, pre-entry sales, industry, and birth cohort dummies significantly predict the likelihood of being/having an ex-military CEO. Thus, in a first-stage probit regression (untabulated), we regress *ex-military CEO* on these variables. In the second step, we use the residuals from the first-stage model as a revised ex-military CEO measure. The residuals can be seen as a part of *ex-military CEO* that is uncorrelated with these predictors of having a CEO with a military background (Wiersema & Zhang, 2011).

## 4 | RESULTS

Table 2 displays the means, standard deviations, and zero-order correlations for all variables included in the *fraud* dataset. In this sample, 32 (15.53%) of the CEOs have a military background. The average service in the military of the CEOs in this sample is 4.07 years (the minimum is 1 year; the maximum is 10 years).

Table 3 reports the results of conditional logit regressions on the first dependent variable, *fraud*. Model 1 consists of the control variables only. In Model 2, we also include the main effect of *ex-military CEO* to test Hypothesis 1. The coefficient for *ex-military CEO* is negative and statistically significant ( $b = -1.00, p = .03$ ), which provides support for our hypothesis that firms headed by ex-military CEOs are less likely to commit financial fraud. We include option and ownership controls in Model 3 to show that our finding is robust toward these changes ( $b = -1.13, p = .04$ ), but as sample size and model fit decrease, we keep only the controls used in Model 2 for further analyses. For an economic interpretation, we display effect sizes in the form of odds ratios of Model 2 in the next column. Odds ratios indicate how a change in the independent variable (*ex-military CEO*) changes the

**TABLE 2** Descriptive statistics for fraud

Variables	Mean	S.D.	1	2	3	4	5	6	7	8	9	10	11	12	13
1 Fraud	0.50	0.50	-												
2 Ex-military CEO	0.16	0.36	-0.16	-											
3 Military director	0.52	0.50	-0.07	0.01	-										
4 CEO duality	0.65	0.48	0.09	0.09	-0.04	-									
5 Board size	9.59	3.31	-0.09	0.15	0.33	0.03	-								
6 CEO MBA	0.33	0.47	-0.01	0.10	0.05	0.06	0.10	-							
7 CEO age	54.00	7.94	-0.10	0.25	0.17	0.15	0.26	-0.01	-						
8 CEO tenure	1.85	0.70	0.10	0.12	-0.04	0.25	0.01	-0.17	0.34	-					
9 CEO ownership	0.02	0.05	0.14	0.02	-0.12	0.10	-0.19	-0.05	0.04	0.25	-				
10 CEO option to compensation	0.42	0.31	-0.00	0.00	0.08	-0.04	-0.07	-0.01	-0.12	0.01	-0.13	-			
11 ROA	0.16	0.09	-0.13	0.06	0.09	0.05	0.07	0.01	0.04	0.00	0.05	-0.12	-		
12 Book to market	0.54	0.26	0.08	-0.03	0.20	0.03	0.16	0.05	0.09	-0.03	-0.01	-0.13	-0.44	-	
13 Size	7.49	1.64	0.01	0.11	0.40	0.21	0.63	0.03	0.24	0.01	-0.20	-0.02	0.08	0.16	-
14 Dedicated ownership	0.07	0.10	-0.08	0.06	-0.07	0.01	0.01	-0.01	0.02	0.01	0.01	0.02	0.02	-0.05	-0.07

Note. N = 195–206. For *CEO ownership* and *CEO option to compensation*, results rely on fewer observations due to missing data. All other results are based on 206 observations.

TABLE 3 Conditional logit regression results for fraud

Variables	(1)	(2)	(3)	Odds ratio	(4)
Ex-military CEO		-1.00 (0.03)	-1.13 (0.04)	0.37 (0.03)	
Military director	-0.18 (0.59)	-0.20 (0.55)	-0.45 (0.27)	0.82 (0.55)	-0.28 (0.41)
CEO duality	0.20 (0.57)	0.22 (0.54)	-0.02 (0.96)	1.24 (0.54)	0.07 (0.85)
Board size	-0.12 (0.10)	-0.11 (0.13)	-0.09 (0.34)	0.89 (0.13)	-0.11 (0.17)
CEO MBA	0.30 (0.41)	0.30 (0.42)	0.21 (0.66)	1.35 (0.42)	0.34 (0.37)
CEO age	-0.04 (0.10)	-0.02 (0.29)	-0.01 (0.65)	0.98 (0.29)	-0.03 (0.25)
CEO tenure	0.52 (0.04)	0.60 (0.02)	0.63 (0.04)	1.82 (0.02)	0.62 (0.02)
CEO ownership			6.90 (0.06)		
CEO option to compensation			-0.21 (0.71)		
ROA	-2.70 (0.22)	-2.77 (0.22)	-3.71 (0.21)	0.06 (0.22)	-2.75 (0.24)
Book to market	1.06 (0.20)	1.11 (0.17)	0.80 (0.45)	3.02 (0.17)	1.22 (0.14)
Dedicated ownership	-1.26 (0.49)	-1.27 (0.49)	-0.26 (0.88)	0.28 (0.49)	-1.08 (0.56)
Ex-military CEO without duality					-2.17 (0.09)
Ex-military CEO with duality					-0.75 (0.16)
Number of observations	206	206	170	206	206
Wald chi <sup>2</sup>	14.66	19.67	19.54	19.67	20.13
Pseudo R <sup>2</sup>	0.11	0.15	0.17	0.15	0.16

Note. p-values are in parentheses. Highest variance inflation factor (VIF) was less than 1.38 in Model 2 and 1.54 in Model 3 and mean VIFs were not significantly greater than 1.

odds for the occurrence of the (*fraud*) event (Long, 1991).<sup>8</sup> The odds ratio of 0.37 for *ex-military CEO* indicates that having a CEO who served in the military decreases the odds of experiencing a fraud event by 63%.

Descriptive statistics of the *lucky grant* dataset are displayed in Table 4. In this dataset, analyses rely on 2,926 observations for 1,265 individual CEOs, of whom 213 (16.84%) have served in the military. The average service in the military of the CEOs in this sample is 6.38 years (the minimum is 1 year; the maximum is 38 years).

<sup>8</sup>We do not report marginal effects because the calculation and interpretation of effect sizes in conditional logit models provide some difficulties. Besides the issues associated with limited dependent variable models, conditional logit models have a conditional distribution and use fixed effects for each matched pair, which is not necessarily equal to 0. In our case, each matched pair has one fraud and one non-fraud firm, and the probabilities depend on the overall frequency of fraud in the population.

Table 5 displays the results of our GEE analysis in which we test Hypothesis 2. Model 1 includes controls only. In Model 2, we add the main effect of *ex-military CEO*. As hypothesized, the coefficient of *ex-military CEO* is negative and statistically significant ( $b = -0.36, p = .06$ ). This indicates that firms headed by CEOs who served in the military are less prone to grant stock options at the lowest price of the month. Consequently, opportunistic timing would be less likely when the CEO has a military background, which supports Hypothesis 2. The size of the main effect of *ex-military CEO* on the probability of *lucky grants* is also economically meaningful. The marginal effect computed at the mean value of all variables indicates that the probability of having lucky grants is 2.79 percentage points lower for ex-military CEOs (the probability decreases from 9.90 to 7.11%,  $p = .04$ ). In Model 3 of Table 4, we display the results of the two-stage approach in which we control for endogeneity. The results from these analyses are qualitatively similar to our main findings ( $b = -0.15, p = .01$ ).

#### 4.1 | Supplemental analyses

We further test whether fraudulent behavior of ex-military CEOs is contingent on the context (Hambrick & Cannella, 2004; Treviño, 1986). If CEOs differ in their motivation toward compliance with rules and regulations (Fong & Tosi, 2007), company-internal controls may also have unequal effects across different CEOs. In line with the arguments of agency theory, conflicts between agents and principals—which can occur in the case of financial misconduct—can be reduced by governance mechanisms such as stronger oversight by the board of directors (Daily, Dalton, & Cannella, 2003; Hillman & Dalziel, 2003; Jensen, 1993; Jensen & Meckling, 1976). Board oversight has been shown to be stronger if the CEO and board chair positions are separate (Beatty & Zajac, 1994; Rechner & Dalton, 1991) and when the board has more independent members (Beasley, 1996; Bebchuk et al., 2010; Davidson et al., 2004; Harris & Bromiley, 2007; O'Connor et al., 2006; Zhang et al., 2008). We use these two governance variables to examine whether stronger board oversight moderates the relationship between ex-military CEOs and financial misconduct.

To test for the moderation effect of *CEO duality* on the relationship between *ex-military CEO* and *fraud*, we split *ex-military CEO* into two variables: *ex-military CEO without duality* (this variable has a value of 1 for all military CEOs without CEO duality and 0 otherwise) and *ex-military CEO with duality* (respectively). This method is equivalent to adding an interaction term of *ex-military CEO* and *CEO duality* to the model, but since we use a binary moderator, the coefficients are easier to interpret. The results using the *fraud* dataset are displayed in Model 4 of Table 3 and show that the coefficient on *ex-military CEO without duality* is significantly negative ( $b = -2.17, p = .09$ ) and on *ex-military CEO with duality* is negative but insignificant ( $b = -0.75, p = .16$ ). The Wald chi-square test statistic that tests whether these two coefficients are different is significant (chi-square = 5.59,  $p = .06$ ). Thus, this result indicates that board oversight in the form of separating the CEO position from the board chair position strengthens the negative relationship between *ex-military CEO* and *fraud*. In the *lucky grant* dataset (displayed in Model 4 of Table 5), the coefficient on *ex-military CEO without duality* is negative but insignificant ( $b = -0.32, p = .46$ ) and on *ex-military CEO with duality* is negative and significant ( $b = -0.37, p = .07$ ). The chi-square test statistic is insignificant (chi-square = 3.59,  $p = .17$ ), which means that the results do not provide support for a moderating effect of *CEO duality* on the relationship between *ex-military CEO* and *lucky grants*.

We also test for a moderation effect of the number of independent board members on the relationship between ex-military CEOs and option backdating. The negative and statistically significant coefficients on *independent board* in Models 1 and 2 of Table 5 show that boards with more independent directors are less likely to be engaged in opportunistic timing. In Model 5, we add the interaction term of *ex-military CEO* and *independent board*, which is negative and significant ( $b = -0.23$ ,

**TABLE 4** Descriptive statistics for lucky grants

	<b>Variables</b>	<b>Mean</b>	<b>SD</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>	<b>11</b>	<b>12</b>	<b>13</b>	<b>14</b>	<b>15</b>
1	Lucky grant	0.10	0.30	-														
2	Ex-military CEO	0.17	0.37	-0.04														
3	Military director	0.66	0.47	-0.04	0.07	-												
4	CEO duality	0.66	0.48	-0.01	0.14	0.08	-											
5	Independent board	6.55	2.61	-0.08	0.03	0.26	0.15	-										
6	Independent compensation committee	0.73	0.44	-0.01	-0.00	-0.02	0.02	0.28	-									
7	5% blockholder on compensation committee	0.76	0.43	-0.01	0.00	0.01	-0.04	-0.00	-0.05	-								
8	CEO MBA	0.37	0.48	-0.01	0.07	-0.01	-0.06	0.12	0.09	-0.03	-							
9	CEO age	55.73	7.11	-0.04	0.26	0.08	0.27	0.07	-0.01	0.02	-0.06	-						
10	CEO tenure	1.85	0.71	0.00	0.13	-0.04	0.35	-0.07	-0.01	0.02	-0.09	0.42	-					
11	CEO ownership	0.02	0.05	0.02	0.06	-0.07	0.11	-0.22	-0.10	0.02	-0.10	0.15	0.27	-				
12	CEO option to compensation	0.40	0.28	0.04	-0.04	-0.02	-0.01	-0.06	0.04	-0.05	0.00	-0.12	-0.03	-0.09	-			
13	ROA	0.13	0.09	0.03	-0.01	-0.02	-0.02	-0.16	-0.00	0.00	0.02	-0.03	0.00	-0.01	0.04	-		
14	Book to market	0.65	0.26	-0.04	0.06	0.09	0.07	0.20	-0.01	-0.06	0.00	0.12	-0.01	0.03	-0.21	-0.54	-	
15	Size	7.63	1.35	-0.03	0.01	0.23	0.11	0.41	0.04	-0.00	0.04	0.05	-0.11	-0.14	0.02	0.12	-	
16	Dedicated ownership	0.07	0.08	0.01	-0.02	0.03	0.03	-0.07	-0.09	-0.09	-0.02	-0.04	-0.02	-0.05	0.06	0.07	-0.02	

Note. N = 2,926. Descriptives of *independent board* are uncentered. The variable was centered in multivariate analysis.

**TABLE 5** GEE analysis results for lucky grants

<b>Variables</b>	<b>(1)</b>	<b>(2)</b>	<b>(3)</b>	<b>(4)</b>	<b>(5)</b>
Ex-military CEO (residual in (3))		-0.36 (0.06)	-0.15 (0.01)		-0.56 (0.01)
Military director	-0.15 (0.25)	-0.14 (0.29)	-0.06 (0.70)	-0.14 (0.29)	-0.13 (0.34)
CEO duality	0.07 (0.64)	0.09 (0.54)	0.13 (0.42)	0.10 (0.54)	0.08 (0.59)
Independent board	-0.09 (0.03)	-0.09 (0.02)	-0.07 (0.13)	-0.09 (0.02)	-0.06 (0.14)
Independent compensation committee	0.04 (0.80)	0.05 (0.76)	0.13 (0.51)	0.05 (0.76)	0.07 (0.68)
5% blockholder on compensation	0.13	0.14	0.15	0.14	0.14
Committee		(0.38)	(0.35)	(0.39)	(0.35)
CEO MBA	0.01 (0.94)	0.04 (0.80)	0.09 (0.57)	0.03 (0.80)	0.02 (0.87)
CEO age	-0.02 (0.10)	-0.01 (0.21)	-0.01 (0.31)	-0.01 (0.21)	-0.02 (0.16)
CEO tenure	0.08 (0.48)	0.08 (0.48)	-0.03 (0.85)	0.08 (0.48)	0.09 (0.44)
CEO ownership	-0.09 (0.94)	-0.06 (0.97)	-1.08 (0.65)	-0.05 (0.97)	-0.20 (0.88)
CEO option to compensation	0.24 (0.30)	0.24 (0.29)	0.28 (0.31)	0.24 (0.30)	0.23 (0.32)
ROA	-0.02 (0.98)	0.02 (0.97)	-0.33 (0.72)	0.03 (0.97)	0.01 (0.99)
Book to market	-0.08 (0.80)	-0.07 (0.82)	-0.08 (0.82)	-0.07 (0.82)	-0.08 (0.79)
Size	0.03 (0.65)	0.03 (0.67)	0.01 (0.85)	0.03 (0.67)	0.02 (0.77)
Dedicated ownership	-0.31 (0.73)	-0.33 (0.71)	-0.68 (0.51)	-0.33 (0.71)	-0.35 (0.69)
Ex-military CEO without duality				-0.32 (0.46)	
Ex-military CEO with duality				-0.37 (0.07)	
Ex-military CEO × independent board					-0.23 (0.00)
Constant	-2.33 (0.00)	-2.59 (0.00)	-2.29 (0.01)	-2.59 (0.00)	-2.43 (0.00)
Number of observations	2,926	2,926	2,410	2,926	2,926
Wald chi <sup>2</sup>	61.87	70.75	45.03	71.42	71.62

Note. *p*-values are in parentheses. Year and industry dummies are included in all models, but not displayed in Table 5. Highest VIF was 1.97 and mean VIF was not significantly greater than 1.

$p = .00$ ). As recommended by Wiersema and Bowen (2009), we also compute conditional marginal effects of *ex-military CEO* at low ( $-1\text{ SD}$ ), mean, and high values ( $+1\text{ SD}$ ) of *independent board* on the probability of receiving a *lucky grant*. The z-statistic is insignificant at values of board independence lower than the mean. However, at higher levels of board independence (mean and  $1\text{ SD}$  above the mean), CEOs with military service are less likely to have lucky option grants.<sup>9</sup>

## 5 | DISCUSSION

Our results indicate that ex-military CEOs are less likely to be engaged in financial misconduct. We find this effect in two different settings: first, when CEOs engage in financial fraud that might be conducted also on behalf of the firm; and second, when CEOs backdate stock options that mainly provide benefits to themselves. In our supplemental analyses, we also find some evidence that this relationship is moderated by board oversight. Interestingly, oversight and ex-military CEOs have additive effects. Ex-military CEOs who do not serve as chairperson of the board are significantly less likely to be involved in fraud. Furthermore, ex-military CEOs have a lower propensity to backdate stock options than those without such a background, and this effect is stronger if the board consists of a higher number of independent directors. Thus, ex-military CEOs might be much more likely to follow rules and regulations if there is some internal control as well. This suggests that CEOs with a military background might be obedient not only to governmental rules and regulations but also to internal control mechanisms.

In non-tabulated auxiliary analyses, we also tested if differences in terms of the military branch served in, length of military service, higher military ranks, or participation in major international conflicts affect the likelihood of financial misconduct. We did not find any evidence that this is the case. While there is evidence that, compared to the Navy and Air Force, the Army grants its personnel more flexibility in terms of how closely they have to follow rules and procedures (e.g., Groysberg, Hill, & Johnson, 2010), our non-findings are in line with evidence, for example, from studies that examine the effect of military experience on tax avoidance (e.g., Law & Mills, 2017) or on firms' financial policies (Benmelech & Frydman, 2015). It therefore seems that the differences across military branches are not strong enough to lead to measurable differences with regard to financial fraud and option backdating. In addition, life course theory states that life trajectories are affected by intensive but rather short transition periods (Elder, 1985). These transitions may occur during a limited period of time—mainly when an individual exhibits heightened susceptibility to environmental influences—but the experiences gained in that period exert a persistent influence on behavior (Immelmann, 1975). Hence, only a few years of service in the military—even just one or two years—might be sufficient to bring about a long-lasting change in military personnel's character so that they are more obedient to the law.

Our findings are valuable contributions to theoretical and empirical research in management and provide important implications for research in strategic management and corporate governance. Our study demonstrates that the military background of CEOs can be used as a proxy for an obedient and law-abiding personality that directly impacts financial misconduct. As we find this effect for two different kinds of transgressions in which individual CEOs (backdating of CEO stock options) and/or their organizations (fraudulent financial reporting) are responsible and possible beneficiaries, we demonstrate that military CEOs are less likely to be corrupt individuals or to lead corrupt organizations (Pinto, Leana, & Pil, 2008). Upper echelon scholars have mainly relied on functional and

<sup>9</sup>Results of these analyses are available from authors upon request.

educational experiences of CEOs to predict managerial decisions and performance. For example, scholars have used CEOs' functional backgrounds in areas such as finance, engineering, or marketing, as well as CEOs' holding of MBA degrees, to investigate the influence of these factors on company acquisitions, diversification decisions, or environmental disclosure policies (Barker III & Mueller, 2002; Bertrand & Schoar, 2003; Jensen & Zajac, 2004; Lewis et al., 2014). And instead of relying on demographic proxies, recent work in this area has started to use more complex measures such as the general economic conditions present when CEOs first entered the job market (Bianchi & Mohliver, 2016), CEOs' career variety (Crossland et al., 2014), or their political ideologies (Chin et al., 2013) to investigate personality traits and values. We contribute to this research in that we show that military service is an indicator of a character that obeys rules and regulations and complies with internal control mechanisms. While we add to the very few papers that use CEOs' characteristics to explain fraudulent financial reporting (e.g., Schrand & Zechman, 2012; Troy et al., 2011) and are the first to look at their influence on backdating, other researchers could use military service as a proxy for obedient behavior and investigate the link to other legal requirements such as environmental or occupational health and safety regulations.

Military organizations instill an identity in their personnel that is associated with values of honor, loyalty, integrity, the prioritizing of "service before self," and obedience to an order of command (Akerlof & Kranton, 2005; Hiatt, Carlos, & Sine, 2018). Because training in the military is a transitional time in individuals' lives, it shapes individual personalities and has a long-lasting impact on people's trajectories in life (Elder, 1986; Elder et al., 1991; MacLean & Elder, 2007; Sampson & Laub, 1992). Our study suggests that ex-military personnel and the companies hiring them benefit from the changes in individuals' personalities instilled during this transitional period. Firms led by ex-military CEOs are less likely to be implicated in cases of financial misconduct. We thus complement the findings of Hiatt et al. (2018), who provide evidence that organizational ties to high-ranking military officers can be beneficial for new ventures. The results of our paper suggest that the benefits to firms from employing ex-military CEOs extend beyond providing firms with ties to the military.

Another interesting finding of our study is that variations in board characteristics—in particular, whether or not the CEO is also the chairperson and the number of independent directors on the board—moderate CEOs' exhibiting of behavior associated with their military identity. This aspect of our findings relates to identity theory, which proposes that individuals hold multiple identities that are associated with specific expected behaviors or roles (Burke, 1980; Stryker & Burke, 2000). For an individual to show behavior consistent with norms associated with a certain identity, a specific identity has to be salient. A salient identity is "highly central to an individual's global or core sense of self or is otherwise highly relevant to his or her goals, values, or key attributes" (Ashforth & Johnson, 2001, p. 32). The military identity fulfills these characteristics and is thus a salient identity. However, because the military identity involves "obey[ing] the rules of the organization and follow [ing] orders given in the chain of command" (Akerlof & Kranton, 2005, p. 17), in situations in which there is no chain of command such as when the CEO is also chairing the board, the military identity seems to be less salient, which could explain why ex-military CEOs do not exhibit behavior that conforms with the norms associated with a military identity. In contrast, the military identity is more salient to ex-military CEOs (and thus they exhibit behavior that is more strongly associated with that military identity) when they do not also occupy the chair of the board position or when the board comprises a significant number of independent directors. One potential explanation for our finding is that a strong board creates a situation familiar to CEOs from their time in the military (i.e., there is an order of command that ex-military CEOs were drilled to follow), and hence the military identity is

more salient, resulting in ex-military CEOs' exhibiting behavior in line with this identity. We encourage future research into additional factors that may affect the salience of an individual's identity.

Our results also highlight that CEO characteristics must be regarded in the agency context in situations that allow for opportunism, such as in case of financial fraud and stock option backdating (Eisenhardt, 1989; Jensen & Meckling, 1976). While fraudulent financial reporting and stock option backdating might be beneficial for CEOs, they are mostly harmful and undesirable for shareholders (Baucus, 1994; Lie, 2005). In line with the arguments of agency theory (Jensen, 1993; Jensen & Meckling, 1976), we show that in the context of stock options, board independence mitigates ex-military CEOs' propensity to backdate their options, whereas prior investigations on the relationship between board oversight and earnings manipulations has yielded mixed results (Bebchuk et al., 2010; Davidson et al., 2004; Harris & Bromiley, 2007; O'Connor et al., 2006; Zhang et al., 2008). We demonstrate that CEOs' background and firms' board oversight should not be considered independently, as fraudulent behavior committed by CEOs depends on the agency context that they are situated in (Boyd, Haynes, & Zona, 2011; Jensen & Zajac, 2004; R. Johnson et al., 1993; Schnatterly et al., 2018).

Our results also provide practical implications. For example, our findings lend support to the assumption that executives' characteristics and corporate governance mechanisms impact the probability of firms' engagement in financial fraud and the likelihood that CEOs will backdate their option grants. Thus, at least for the setting of our study, shareholders and other stakeholders can expect the likelihood of financial fraud to be lower when the firm is headed by an ex-military CEO. By using military service or other characteristics that reflect obedient behavior as a sign of decision making that conforms to rules and regulations, companies can screen a certain type of leader. Given the recent trend of firms targeting former military personnel for hiring, firms might improve law-abiding decision making by hiring military veterans as CEOs. However, this might not be seen as a substitute for corporate governance. Additional corporate governance mechanisms could foster compliance with the rules and help shareholders to reduce the likelihood of being affected by the consequences of option backdating and other financial misstatements. In the event that fraud is detected, by adopting such mechanisms shareholders can avoid tremendous losses in stock prices and reputational damages (Dyck, Morse, & Zingales, 2017; Karpoff, Lee, & Martin, 2008).

## 5.1 | Limitations and future research

As with every piece of research, this study has limitations that at the same time present fruitful avenues for future research. To begin with, the focus of our study is restricted to U.S. public firms contained in Compustat's ExecuComp database and to CEOs who gained military experience in the U.S. armed forces. The U.S. military assigns great importance to its honor code and puts great emphasis on its personnel following rules. Furthermore, in the U.S., a military background is very common among the population of CEOs and plays a prominent role in society. Thus, it is likely that, due to the specific nature of the U.S. military, results might differ if a similar study is conducted in relation to CEOs and firms located in other countries. Future research could examine the relationship between the military service of CEOs and the propensity to engage in financial fraud and backdating outside the U.S. context.

In our *lucky grant* dataset, we were only able to measure the likelihood of opportunistic timing, since our data on lucky grants does not indicate whether CEOs really backdated their grants. Nevertheless, Bebchuk et al. (2010) calculate that more than half of lucky grants arise from opportunistic timing practices. Furthermore, our dataset provides the possibility of measuring the active engagement of CEOs because they are directly involved in picking the grant date (Narayanan & Seyhun,

2008). While this dataset does not capture all forms of backdating, it captures the most severe forms and those with the greatest economic significance to CEOs and shareholders, and thus we focus on circumstances in which a CEO's character surfaces the most. In addition, this data ensures that our results are not driven by the fact that certain firms or CEOs are better at hiding fraudulent acts or less likely to be investigated by the SEC (Dyck et al., 2017). While not all option backdates have resulted in lawsuits, the *fraud* dataset, which is widely accepted by many researchers who measure financial fraud (Beasley, 1996; Dechow et al., 2011; S. Johnson et al., 2009; Troy et al., 2011), validates the results. In contrast to other databases, the source we use allows us to specify the reporting period of the misstatement and therefore to align the misconduct directly to a specific CEO. This has a pivotal advantage over other sources in that we have a sample depicting intentional violations. In line with prior literature, we did not distinguish between various forms of fraud in this dataset due to the small sample size and the fact that prior work has found consistent results among different types of fraud (Beasley, 1996; Harris & Bromiley, 2007). As we also used the *lucky grant* dataset, we have additional evidence that our results are robust toward different types of financial misconduct.

Future research could also examine if socialization in particular religions, some of which mandate full-time service for a specified period of time (e.g., the Mormon missionary service), may cause individuals to be more obedient to rules and thus less fraudulent (Tracey, 2012). In a similar vein, does studying law, a discipline whose students tend to subsequently exhibit strong adherence to the norms of their professional association (Wallace, 1995), have analogous effects on ethical behavior to service in the military? While in unreported ancillary analyses we did not find evidence that CEOs with a law degree are less likely to receive lucky grants, current scholarship in finance and economics seems to suggest that executives who studied law lead firms with better governance and firms that are less likely to be the subject of litigation (Henderson, Hutton, Jiang, & Pierson, 2017; Morse, Wang, & Wu, 2016). In our view, the differences in the results suggest that certain boundary conditions apply that prevent socialization in environments that foster loyalty to certain norms and values from translating into subsequent behavior.

Finally, while we focus in this study on loyalty and obedience to orders, the military experience is multifaceted and, for example, also induces a quest for power and authority (Huntington, 1957). Hence, future research could investigate how other aspects of military experiences affect firms' governance or strategy, or CEOs' relations with the members of the board of directors.

## 6 | CONCLUSION

Financial misconduct has severe and long-lasting consequences for companies and their stakeholders. Our findings show that ex-military CEOs are less likely to lead organizations that cook the books and to time their own stock options opportunistically. These findings have far-reaching implications for firms—for example, with regard to hiring decisions and the implementation of governance mechanisms—but also for researchers, regulators, auditors, and other decision makers who are interested in mechanisms that prevent corporate misconduct.

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