

The Effect of Managerial Adverse Experience on Financial Reporting

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ABSTRACT: We identify executives who have experienced significant accounting-related adverse events during their careers as a powerful setting to examine the extent to which prior professional experience can influence subsequent financial reporting policies. We find that firms led by senior financial executives who have experienced accounting-related adverse events during their careers exhibit greater unconditional accounting conservatism, a lower likelihood of experiencing future accounting-related adverse events, and less positive abnormal discretionary accruals. This effect tends to be stronger when the experience is more frequent, recent, severe, or proximate. Overall, our results reveal a meaningful relationship between managers' professional experience and accounting policies.

Data Availability: All data used in this study are obtained from publicly available sources.

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Keywords: accounting policies; adverse experience; conservatism; executives; experience; expertise; financial executives; financial reporting; managers.

I. INTRODUCTION

We investigate whether managers' adverse professional experience affects their preferences for more conservative financial reporting. Since [Bertrand and Schoar \(2003\)](#), there has been growing evidence that managerial style can affect corporate policies.¹ However, much less is known about how a manager's style is formed ([Schoar and Zuo 2017](#)). As noted in [Dittmar and Duchin \(2016\)](#), prior studies examining managerial style generally overlook professional or work-related experience and its influence on firm policies.² We posit that managers' prior adverse professional experience, which we define as having experienced accounting-related adverse events (i.e., accounting or financial reporting-related litigation, class-action litigation, receipt of an Accounting and Auditing Enforcement Release (AAER) issued by the Securities and Exchange Commission (SEC), or income-decreasing restatements) during their careers as senior financial executives, can have salient effects on their preferences toward financial reporting and

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¹ See [Bertrand \(2009\)](#) for a general review of this literature; [Plöckinger, Aschauer, Hiebl, and Rohatschek \(2016\)](#) for a review of the literature examining how executives influence financial reporting policy; and [Abernethy and Wallis \(2019\)](#) for a critique on the study of manager effects in accounting settings.

² [Bertrand and Schoar \(2003\)](#) acknowledge that they would like to investigate additional managerial characteristics, such as professional experience, but data limitations at the time of their study inhibited their ability to do so.

can shape subsequent observed accounting policy. We predict and find that accounting-related adverse experience within the senior management team can have a significant influence on financial reporting quality.

A well-known and experimentally validated behavioral tendency in psychology informs our prediction that accounting-related adverse experience can influence financial reporting. Specifically, managers who have experienced a significant adverse event during their careers tend to be more inclined to take actions to avoid negative outcomes in the future (March 1996; Denrell and March 2001; Denrell 2007; Dittmar and Duchin 2016). This tendency is rooted in adaptive learning models that predict individuals will avoid sampling from actions that have been associated with negative past events (also referred to as the “hot stove” effect). Similarly, imprinting theory from the organizational behavior literature predicts that significant events during an executive’s career can have a persistent (“imprinting”) effect on subsequent behavior (Higgins 2005; Marquis and Tilcsik 2013). We examine the extent to which adverse professional experience impacts observed financial reporting policies.

Financial reporting provides an interesting setting in which to study the influence of adverse professional experience on managers’ subsequent corporate policies. Accounting-related adverse events, such as a restatement, can generate severe negative career consequences (Desai, Hogan, and Wilkins 2006; Hennes, Leone, and Miller 2008), providing a powerful stimulus to test the extent to which adaptive learning from professional experience can affect subsequent financial reporting outcomes. Conservative financial reporting, manifesting as policies that systematically understate assets and income relative to their economic value, can be attractive to managers who have experienced adverse events. Prior literature suggests that conservative reporting reduces the likelihood of overvaluing assets (Beaver and Ryan 2005), issuing a restatement (Jones, Krishnan, and Melendrez 2008; Dechow, Ge, and Schrand 2010; Ettredge, Huang, and Zhang 2012), experiencing negative future earnings shocks (Sloan 1996; Barton and Simko 2002; Richardson, Sloan, Soliman, and Tuna 2005; Ettredge, Scholz, Smith, and Sun 2010; Baber, Kang, and Li 2011), and encountering future litigation claims (Palmrose and Scholz 2004; Lev, Ryan, and Wu 2008; Ettredge, Huang, and Zhang 2016). We build upon this evidence and predict that managers who have experienced a significant accounting-related adverse event during their careers will tend to favor accounting policies that reduce the likelihood of future accounting-related adverse outcomes.³

We use the BoardEx senior management employment history file to identify managers who have worked as CEOs and senior financial executives (e.g., CFOs, Chief Accounting Officers, Controllers, Treasurers, Vice President of Accounting or Finance, etc.) for a firm that has experienced an accounting-related adverse event (hereafter referred to as a troubled firm) and later work as CEOs and senior financial executives at a different firm. We focus on 661 executives who were holding senior financial positions at the time of the events, as adverse events at this level are likely to be more salient and have a stronger effect on subsequent behavior (Tversky and Kahneman 1973, 1974; Bordalo et al. 2012a, 2012b; Dittmar and Duchin 2016). We measure conservative financial reporting along the following dimensions: unconditional accounting conservatism (Ahmed, Billings, Morton, and Stanford-Harris 2002; Ahmed and Duellman 2013; Givoly and Hayn 2000), the likelihood of a future accounting-related adverse event (the same criteria used to identify adverse experience), and abnormal discretionary accruals (Larcker, Richardson, and Tuna 2007).⁴ Greater unconditional conservatism, a lower likelihood of future accounting-related adverse events, and less positive abnormal discretionary accruals collectively reflect more conservative financial reporting.

In our analyses, we do not directly compare financial reporting metrics before and after an adverse event for a troubled firm. Instead, we follow these managers’ professional careers when they are appointed by a new firm and examine the attributes of financial reporting of the new firm before and after the manager with adverse experience is hired into the senior management team. To alleviate concerns that our results are affected by correlated omitted firm characteristics or a time trend in financial reporting outcomes, we employ firm and year fixed effects in our regressions.

We find that firms with senior executives who have prior accounting-related adverse experience exhibit significantly more conservative financial reporting. Our results are also economically meaningful. In our baseline regressions, adverse experience raises (lowers) unconditional conservatism (discretionary accruals) by 12 (6) percent of the respective interquartile range after controlling for a number of firm and executive characteristics. Adverse experience also decreases the likelihood of future accounting-related adverse events by approximately 6 percentage points. We also observe a stronger

³ Similarly, Hirshleifer and Teoh (2009, 1074) argue that behavioral tendencies of individuals to avoid adverse outcomes (such as the “hot stove” effect) can make conservatism, which is one aspect of conservative financial reporting, more appealing because it “reduces the likelihood that future disappointments will occur.”

⁴ We follow a long stream of literature and use a measure of unconditional conservatism in our main tests, as opposed to conditional conservatism, because unconditional conservatism captures a general tendency to report more conservatively, whereas conditional conservatism is dependent on economic states. Furthermore, prior literature suggests that unconditional conservatism can “pre-exempt” conditional conservatism, and it is unconditional conservatism that immunizes accounting systems against negative future states (Qiang 2007; Ryan 2006). Because our prediction is that a manager’s adverse experience will alter the manager’s tendency toward conservative financial reporting, which, in return, avoids negative future economic states, we view tests of unconditional conservatism as best capturing our construct of interest. Nevertheless, in untabulated robustness tests, we find consistent results using a common measure for conditional conservatism, following Basu (1997), Ettredge et al. (2016), and others.

relation between accounting-related adverse experience and conservative financial reporting when the adverse experience is more frequent, recent, severe, or proximate.

Our inferences hold if we implement a propensity-score-matching (PSM) design to address observable factors that may influence the decision to hire a manager with accounting-related adverse experience (Gow, Larcker, and Reiss 2016; Shipman, Swanquist, and Whited 2017). We also control for the effect of management changes and other potentially relevant executive characteristics. In further tests, we observe significantly more conservative financial reporting for the manager's new firm than the prior firm during the manager's tenure (but prior to the adverse event). This result supports our findings by providing evidence that managers with adverse experience are learning from the adverse event and alleviates concerns that such managers have always preferred more conservative accounting policies. This result also suggests that these managers are not simply employing the same policies of their previous (troubled) firm. Moreover, we find a decrease in two of the three conservative financial reporting measures after the manager's departure, which allays concerns that managers with adverse experience are systematically sorting into more conservative firms.

Finally, we assess whether adverse experience affects other market quality metrics along the following dimensions: bid-ask spreads, stock liquidity, analyst forecasts, and downside volatility. In addition to documenting a lower likelihood of a future adverse accounting event, we find that adverse experience is associated with less future downside stock-return volatility, which suggests that the financial reporting conservatism observed among firms led by managers with adverse experience is beneficial to shareholders in that lower downside volatility reduces the likelihood of a future tail risk event (Chen et al. 2001). Overall, we interpret the collective evidence as accounting-related adverse experience leading to an improvement in financial reporting quality. We caution, however, that although our results are consistent with adaptive learning (the hot stove effect) and imprinting theory, our tests do not provide direct evidence that isolates a specific channel through which adverse experience can affect financial reporting.

Our study contributes to two different literatures. First, we contribute to the growing literature on managers' professional experience (e.g., Dittmar and Duchin 2016; U. Hoitash, A. Hoitash, and Kurt 2016; Schoar and Zuo 2017). Hoitash et al. (2016) examine CFOs with accounting backgrounds and argue that the training and experience of accountants can affect firm policies. Similarly, Schoar and Zuo (2017) investigate the effect of recessions when a CEO enters the labor market and suggest that nearly half of their recession-CEO cohort effects are explained by their initial job characteristics. These studies underscore the importance of examining the implications of managers' professional experience. As noted in Schoar and Zuo (2017) and Dittmar and Duchin (2016), evidence on how managers form their styles and how their styles evolve over their professional careers is limited. Moreover, prior literature is generally silent on the effects of professional experience, despite theory and survey evidence suggesting that it can significantly shape a manager's style (Hambrick and Mason 1984; Graham, Harvey, and Puri 2013). We provide evidence that the experience of accounting-related adverse events can influence financial executives' attitudes toward financial reporting.

Second, we advance the literature examining manager effects on financial reporting outcomes, including accounting conservatism and accruals management. Extant literature has examined personal characteristics of managers, including gender, celebrity status, narcissism, and overconfidence (Barua, Davidson, Rama, and Thiruvadi 2010; Ge, Matsumoto, and Zhang 2011; Huang, Rose-Green, and Lee 2012; Ahmed and Duellman 2013; Dejong and Ling 2013; Francis, Hasan, Park, and Wu 2015; Ho, Li, Tam, and Zhang 2015; Koh 2011; Ham, Lang, Seybert, and Wang 2017). However, prior literature has not considered managers' prior accounting-related adverse experience and subsequent financial reporting conservatism.⁵ Our finding that firms led by managers with adverse experience exhibit greater financial reporting conservatism is consistent with behavioral tendencies of individuals who have experienced negative events to take actions to avoid them in the future. In this way, our results complement studies that show more conservative financial reporting is associated with less negative outcomes (e.g., Biddle, Ma, and Song 2022; Ettredge et al. 2016; Kim and Zhang 2016; Jones et al. 2008; Dechow et al. 2010).

⁵ In contemporaneous work, Faulkner, Frost, and Garcia-Feijoo (2021) focus exclusively on CEOs who have experienced past corporate distress events (defined broadly to include stock-price shocks, cash-flow shocks, dividend shocks, and credit-rating downgrades), as well as an AAER or restatements as a non-CEO or lower-level employee, and link such experience to greater conditional accounting conservatism. Fan, Li, and Stack (2021) examine early-career exposure as rank-and-file employees to financial misconduct of CEOs and CFOs and find that such experience can affect subsequent misstatement likelihood, depending on whether the experience coincided with a regulatory investigation.

II. RELATED LITERATURE AND HYPOTHESIS DEVELOPMENT

Professional Experience of Executives

March (1996), Denrell and March (2001), and Denrell (2007) examine a behavioral tendency from adaptive learning theory, which suggests that individuals learn from experience and subsequently avoid actions associated with negative outcomes. The role of adaptive learning in decision making predicts that individuals will avoid sampling from actions that have been associated with negative past events. This tendency, referred to as the hot stove effect, results in individuals favoring actions that are more conservative to avoid repeating negative outcomes. Similarly, imprinting theory suggests that an individual's experience can have persistent and long-lasting effects (Marquis and Tilcsik 2013).⁶ Higgins (2005) studies a sample of executives in the healthcare and biotech industries and suggests that the prior work experience of these executives forms how they work in the future and has a lasting impact on their subsequent careers. Hertwig, Barron, Weber, and Erev (2004) argue that when an individual faces risky and uncertain situations, prior experience plays a significant role in the individual's decision-making process, especially when the experience is gained from a rare event. Organizational behavior literature offers corroborating evidence that an individual's prior work experience influences subsequent job performance and decision-making and can carry across organizational boundaries (e.g., Melone 1994; Dokko, Wilk, and Rothbard 2009).

Studies have explored the implications of various executive experiences on firm policies (e.g., Malmendier et al. 2011; Benmelech and Frydman 2015; Schoar and Zuo 2017; Bernile, Bhagwat, and Rau 2017). Although offering important and interesting insights, these studies generally have a common theme: They focus on either personal experience (e.g., natural disasters or economic downturns during childhood) or experience gained prior to the executive's professional career (e.g., military experience). In contrast, Dittmar and Duchin (2016) study the professional (work-related) experience of corporate managers and show that firms led by CEOs and CFOs who have experienced financial distress events (e.g., bankruptcy, credit-rating downgrade, earnings or stock-return shock) subsequently use less debt, save more cash, and invest more conservatively. Compared to general experience, studying the professional experience of executives is important, as Gibbons and Waldman (2004) argue that on-the-job learning is an important component of task-specific human capital. Further, survey evidence suggests that executives' prior experience is an important factor that influences decision-making (Graham et al. 2013).

In accounting settings, research has found that prior professional experience of managers is associated with their subsequent behavior in management guidance strategy and tone of conference calls (Feng and Koch 2010; Hilary and Hsu 2011; Davis, Ge, Matsumoto, and Zhang 2015). Brochet and Welch (2011) find that managers' prior experience in the investment banking, management consulting, private equity, and venture capital industries is associated with their decision-making in goodwill impairment. Managers' financial literacy (e.g., CPA designation, M.B.A. degrees, and years of experience as a CFO) also shapes their financial reporting outcomes (Aier, Comprix, Gunlock, and Lee 2005; Matsunaga and Yeung 2008; Li, Sun, and Ettredge 2010). Our study advances this notion and investigates whether accounting-related adverse events experienced by financial executives during their careers influence their financial reporting preferences at their current firm.

Hypotheses

Prior literature proposes that conservative reporting, through accounting conservatism, encompasses policies that reduce the potential overstatement of assets and income relative to their economic value, lowering the likelihood of a future adverse event (Qiang 2007). Conservatism can also lower bankruptcy risk by constraining earnings management and enhancing cash positions (Biddle et al. 2022). In a similar vein, income-increasing discretionary accruals can increase the likelihood of negative future earnings surprises (Sloan 1996; Barton and Simko 2002; Richardson et al. 2005; Ettredge et al. 2010; Baber et al. 2011) and are positively related to future restatements (Jones et al. 2008; Dechow et al. 2010) and future litigation (Palmrose and Scholz 2004; Lev et al. 2008). Taken together, prior literature has shown that conservative financial reporting can lower the likelihood, and mitigate the realization, of future adverse accounting outcomes. We predict that managers who have experienced significant accounting-related adverse events during their careers will tend to favor more conservative accounting, and, hence, firms led by these managers will exhibit greater financial reporting conservatism.

⁶ Marquis and Tilcsik (2013, 199) define imprinting as "a process whereby, during a brief period of susceptibility, a focal entity develops characteristics that reflect prominent features of the environment, and these characteristics continue to persist despite significant environmental changes in subsequent periods."

We acknowledge some tension in the association between accounting-related adverse experience and subsequent financial reporting conservatism. Specifically, managers who have witnessed adverse events may place less weight on that experience if no material cost has been directly levied on them, and they may even become more comfortable facing risk and uncertainty.⁷ Eckbo, Thorburn, and Wang (2016) examine the labor market consequences of corporate bankruptcy and find that approximately one-third of incumbent CEOs of firms that have filed bankruptcy continue employment with the restructured firm or a new firm and experience no median loss in compensation. On the other hand, two-thirds of their sample CEOs leave the labor market and experience an average compensation loss of over \$7 million. Further, Gilson (1989) finds that resigned senior managers of defaulting companies are unable to find another job in an exchange-listed firm for at least three years. Desai et al. (2006) similarly observe that many senior executives face negative labor market consequences following an earnings restatement. However, recognizing that negative experiences may not necessarily lead to greater preferences toward more conservative financial reporting, we view this as an interesting empirical question and state our hypothesis in null form.

H: Accounting-related adverse experience of financial executives does not affect financial reporting.

The psychology literature suggests that past experience may be more influential when it is more salient (e.g., Tversky and Kahneman 1973, 1974; Bordalo, Gennaioli, and Shleifer 2012a, 2012b; Dittmar and Duchin 2016). Financial executives who have witnessed repeated adverse events may be more affected by such experience, reinforcing a stronger preference toward conservative reporting practices. Similarly, recent adverse experience can be more salient in a financial executive's mind when making decisions, resulting in a stronger preference for conservative reporting. Further, financial executives who have experienced career consequences (e.g., accepting a lower-rank position at a subsequent firm) may be more inclined than executives who have experienced less negative career outcomes to take actions to avoid such outcomes in the future, which leads to a greater preference toward conservative reporting. Lastly, the salience of experience can also vary with the proximity of the managers' role to financial reporting at the time of the adverse event. It is plausible that the managers who have direct oversight over financial reporting at the time of adverse events exhibit a stronger "hot stove" effect. Accordingly, in cross-sectional analyses, we examine whether the effect of accounting-related adverse experience on subsequent financial reporting outcomes is related to the salience (i.e., frequency, recency, severity, and proximity) of the adverse experience.

III. METHODOLOGY

Empirical Model

To test our hypothesis, we estimate the following regression model with an attribute of financial reporting (*CON-ACCRUAL*, *FUTURE ADVERSE*, *DAC*) as the dependent variable (firm and year subscripts are omitted for brevity).

$$\text{Fin. Reporting Attribute} = \beta_0 + \beta_1 \text{ADVERSE EXP} + \beta_k \text{Controls} + \text{fixed effects} + \varepsilon. \quad (1)$$

Our variable of interest is *ADVERSE EXP*, which equals 1 if a senior financial executive currently working for the firm has prior accounting-related adverse experience at a different firm, and 0 otherwise. If prior adverse experience affects managers' preference for accounting conservatism (*CON-ACCRUAL*), we would expect a positive and significant coefficient estimate for β_1 . Similarly, if prior adverse experience reduces the likelihood of the firm encountering another adverse event in the future and lowers discretionary accruals (*FUTURE ADVERSE* and *DAC*), we would expect a negative and significant coefficient estimate for β_1 in specifications examining the likelihood of future accounting-related adverse events and subsequent discretionary accruals.

We include a wide array of control variables, based on firm and executive characteristics, informed by related financial reporting literature (e.g., Armstrong, Gow, and Larcker 2013; Ahmed et al. 2002; Ahmed and Duellman 2013; Aier et al. 2005; Barua et al. 2010; Francis et al. 2015; Ge et al. 2011; Huang et al. 2012; Ho et al. 2015; Hoitash et al. 2016; Li et al. 2010; Matsunaga and Yeung 2008; Schrand and Zechman 2012). Appendix A provides detailed definitions. To summarize briefly, we control for firm size, growth opportunities, leverage, operating and stock performance, probabilities of litigation and default, sales growth, advertising and research and development expenditures, and cash flow and operating uncertainty.

⁷ In a nonaccounting setting, Bernile et al. (2017) examine the effect of early-life natural disasters on subsequent CEO behavior and find that firms led by CEOs who have witnessed disasters without extreme negative consequences exhibit more aggressive financial policies.

We also control for a number of executive characteristics at the senior management level that may affect conservative financial reporting, such as the average age of executives (*AVG AGE*), the percentage of female executives (*FEMALE%*), and the percentage of executives who have an accounting education (*ACCT EDU%*). Prior studies show that these demographic factors may affect general conservatism (e.g., [Truett 1993](#); [Serfling 2014](#)), accounting conservatism (e.g., [Francis et al. 2015](#); [Ho et al. 2015](#)), earnings management (e.g., [Barua et al. 2010](#); [Huang et al. 2012](#)), and general corporate policies (e.g., [Hoitash et al. 2016](#)). These senior executive demographic factors are obtained from BoardEx and computed at the firm-year level. We also include compensation incentives of the top paid executives, as prior research shows that compensation incentives can affect executive risk-taking (e.g., [LaFond and Roychowdhury 2008](#); [Ahmed and Duellman 2013](#); [Armstrong et al. 2013](#)). Specifically, we control for the level of cash-based compensation, as well as the portfolio delta and vega sensitivities of senior executive compensation.⁸ The compensation data are collected from Execucomp for all executives covered and computed at the firm-year level. We control for CEO overconfidence using the *Holder-67* measure following [Ahmed and Duellman \(2013\)](#), as well as two firm-level overconfidence measures capturing overinvestment in capital assets and excess growth in sales.^{9,10}

We include two additional control variables to alleviate concerns that our results may be affected by contemporaneous changes in debt contracting or investment, respectively. Specifically, we collect news items for the announcements of debt financing, as well as seeking acquisitions or investments from the Capital IQ Key Developments database.¹¹ We include firm fixed effects in all regressions to control for time-invariant firm characteristics that could jointly affect the presence of managers with accounting-related adverse experience and financial reporting. We also include year fixed effects to account for changes in financial reporting attributes over time. Finally, to address serial correlation within firms, we cluster standard errors at the firm level ([Petersen 2009](#)).¹²

Accounting-Related Adverse Experience

We define adverse experience as prior professional experience as a senior financial executive at a firm that experienced a significant accounting-related adverse event. To identify such experience, we first construct a sample of adverse events that have a close connection to financial reporting: class-action lawsuits, accounting or financial reporting-related litigation, receipt of an AAER, or an income-decreasing restatement. These adverse events are identified by using information available in Audit Analytics, the Stanford Law School Securities Class Action Clearinghouse (SCAC) database, and the Berkeley Center for Financial Reporting and Management (CFRM). To identify accounting or financial reporting-related litigation, we focus on legal cases that involve accounting malpractice and financial reporting in the Audit Analytics' Legal Case and Legal Parties file. We obtain data on class-action lawsuits and AAERs from the SCAC and the CFRM databases, respectively. Lastly, we identify income-decreasing restatements from the Audit Analytics' Non-Reliance Restatements file. We use restatements that are classified by Audit Analytics as accounting irregularities, financial fraud, misrepresentation, or accounting failures, and we focus on material restatements that reduce earnings. This step results in a sample of firms that have experienced accounting-related adverse events and the timing of these adverse events.

Next, we use the BoardEx Senior Management Employment History file to identify managers working at the troubled firm during the adverse events. BoardEx tracks executives' professional experience (e.g., company names, position titles, and start and end dates) as early as their entry-level positions, enabling us to observe executives' prior professional experience beyond the top-five highest-paid senior-level positions reported in Execucomp. We include both CEOs and senior financial executives (e.g., CFOs, Treasurers, Controllers, Chief Accounting Officers, Vice Presidents or Directors

⁸ Delta (vega) captures the sensitivity of executives' stock and option holdings to a 1 percent (0.01) increase in stock price (volatility). We follow the procedures in [Core and Guay \(2002\)](#) in calculating delta and vega.

⁹ In untabulated tests, we confirm that our inferences are unchanged when controlling for a *Holder-67* measure for all financial executives covered in Execucomp.

¹⁰ In our setting, the hot stove effect is not simply the opposite manifestation of overconfidence. Specifically, the overconfidence literature consistently characterizes overconfidence as the tendency to overestimate one's own ability to control the outcome of a decision (e.g., setting narrow confidence bands around a decision in the presence of uncertainty) (e.g., [Malmendier and Tate 2005, 2008](#); [Malmendier, Tate, and Yan 2011](#); [Ahmed and Duellman 2013](#)). In contrast, the hot stove effect is rooted in adaptive learning and reflects the tendency of individuals to display preferences against alternative actions that have led to poor outcomes in the past ([Denrell and March 2001](#); [Denrell 2007](#)). Thus, the "illusion of control" and "better-than-average" effects, which are innate fixtures in defining overconfidence, are not simply the opposite of adaptive learning from negative experience. Rather, we view overconfidence as a separate managerial characteristic that affects firm outcomes, rather than an opposite reflection of our construct of interest.

¹¹ These news items are collected from the Capital IQ Key Development database using event type ID 3 (Seeking Acquisitions/Investments) and 42 (Debt Financing Related).

¹² We remove firm clustering for some later analyses conducted using smaller subsamples of firms, and thus fewer firms to form clusters, which decreases the consistency of firm clustering ([Petersen 2009](#)). In the absence of firm clustering, we use heteroskedastic-consistent standard errors.

of accounting or finance, etc.) who were working at the troubled firms during the adverse events. This step results in a sample of managers with accounting-related adverse experience.

Finally, we use BoardEx to track the managers' career paths following their adverse experience. Doing so allows us to observe managers' subsequent financial reporting outcomes, rather than the troubled firms' reaction to adverse events. Specifically, we identify managers who later assume a new senior position (including CEO, CFO, and other senior financial executive positions) at a different firm. Once these managers are identified from the BoardEx file, we use the start and end dates of their positions to match to a firm-year sample (described in more detail below). The primary variable of interest (*ADVERSE EXP*) equals 1 if one or more members of the senior management team (CEO, CFO, and other senior financial executives) have prior accounting-related adverse experience at a troubled firm during their prior professional career, and 0 otherwise.¹³

Sample

We obtain data to construct financial reporting outcomes and several control variables from Compustat. Some control variables require additional coverage in the Capital IQ, CRSP, and Execucomp databases. Because of regulatory and institutional differences, we omit firms in the utility and financial industries (Standard Industrial Classification (SIC) codes: 4800–4900 and 6000–6999). Although the first AAER occurred in the 1970s (and the other earliest adverse events occurred in the 1990s), our regression sample starts in 1993 due to the availability of control variables (e.g., compensation incentives).¹⁴ Our primary regression sample ends in 2015 (2010 for tests of the likelihood of a future adverse event). After merging our primary variable of interest (*ADVERSE EXP*) with our firm-year panel of financial reporting outcomes and control variables, our main regression sample contains 20,773 firm-year observations for 1,838 unique firms, and 661 unique managers with prior accounting-related adverse experience.

Our regression sample includes firms that have and have not experienced adverse events. Although the identification of adverse experience is at a different (i.e., prior) firm, we allow the current (i.e., new) firms to experience a subsequent adverse event after employing a manager with adverse experience. Doing so alleviates the concern that limiting our sample to firms that have never experienced an adverse event may pick up a systemic sorting by managers with adverse experience into certain firms that have an innately lower likelihood of having an adverse event, if such a phenomenon exists.¹⁵

Financial Reporting Outcomes

We examine financial reporting outcomes along the following dimensions: unconditional accounting conservatism, the likelihood of a future accounting-related adverse event, and discretionary accruals. We first focus on unconditional conservatism, as it captures a general tendency to report conservatively, whereas the literature regards conditional conservatism as being triggered upon the realization of negative news.¹⁶ To measure unconditional accounting conservatism, we use the persistent usage of negative accruals (*CON-ACCRUAL*) developed by Givoly and Hayn (2000), who suggest that the sign and magnitude of accumulated accruals over time can reveal the degree of reporting conservatism. This measure is also used in related research (e.g., Ahmed et al. 2002; Ahmed and Duellman 2013; Biddle et al. 2022; Francis et al. 2013; Francis et al. 2015). For ease of interpretation, we multiply this measure by negative one so that larger values of *CON-ACCRUAL* reflect more conservative financial reporting (i.e., more persistent use of negative accruals).¹⁷

¹³ Although Dittmar and Duchin (2016) study experience at all ranks (CEO, top-five executives, and other lower-rank positions) at troubled firms, focusing on the adverse experience of the CEO and senior financial executives is appropriate in our setting, as these executives that have a closer connection to financial reporting and negative events experienced at this level are likely to have a stronger effect. In later tests, we examine the effects of experiencing adverse events as junior and nonfinancial executives on financial reporting.

¹⁴ Because we require adverse experience to be with a different firm during a manager's prior professional career, relatively few firms have such managers during the 1990s. Our results continue to hold if we limit the regression sample period to post-SOX years. This additional test allows some time to observe managers who obtain adverse experience from accounting and financial reporting-related litigation, class-action lawsuits, and restatements, where the initial data coverage by related databases started in the 1990s. Indeed, Table 1 reveals that the average adverse experience occurred over six years ago.

¹⁵ In robustness tests discussed later, we observe no evidence of an event prior to the hiring of a manager with adverse experience affecting financial reporting outcomes. In further robustness tests, we confirm that our main results continue to hold after controlling for a recent adverse event at the new firms that employ managers with adverse experience.

¹⁶ Beaver and Ryan (2005) discuss the distinctions between unconditional and conditional conservatism. Using a general model that accounts for both types of conservatism, they show that because of the judgment and caution in applying accounting rules (which are labeled as "frictions"), unconditional conservatism can preempt the application of conditional conservatism, especially when the news is not sufficiently adverse. Further, Qiang (2007) notes that unconditional conservatism immunizes accounting systems against future negative outcomes. Basu (2005) provides the historical context why two forms of conservatism exist. For a general review of the conservatism literature, see Watts (2003a, 2003b).

¹⁷ Because *CON-ACCRUAL* is calculated over a three-year window, we omit years that are not associated with the manager's tenure to ensure that the measure reflects the influence of the manager with adverse experience. Specifically, for the first (second) year of the manager's employment at the current firm, *CON-ACCRUAL* is measured over a one-year (two-year) window.

We next examine the likelihood of a future accounting-related adverse event (*FUTURE ADVERSE*), defined as accounting and financial reporting-related litigation, class-action litigation, income-decreasing restatement, or issuance of an AAER. Notably, these are the same events that we use to define the adverse experience, thereby providing a more direct test of whether the initial stimuli underlying the adverse experience has a connection to the likelihood of similar events occurring in the future, in a manner consistent with the hot stove effect. *FUTURE ADVERSE* takes the value of one if there is at least one adverse event in year $t+1$ to year $t+5$. To allow a future adverse event to emerge, we end the regression sample that uses *FUTURE ADVERSE* as the dependent variable in 2010, five years earlier than the sample used for the other two reporting outcomes.

Finally, we examine discretionary accruals (*DAC*) as a more general measure of accounting discretion. We measure discretionary accruals as the residual from the modified-Jones model controlling for operating cash flow and book-to-market ratio, per Larcker et al. (2007), to account for unexpected accruals due to firm growth and extreme performance. We retain both the sign and magnitude of discretionary accruals to capture accounting discretion.

IV. RESULTS

Accounting-Related Adverse Experience

Table 1 presents descriptive details of managers with accounting-related adverse experience. Panel A depicts the prior positions and titles when these managers experienced an adverse event at their previous firm. Panel B shows the current positions and titles of these managers at their current firm (which is different from the troubled firm, where they acquired their adverse experience).¹⁸ Panel C reports additional characteristics of the managers with adverse experience. Panel D reports the distribution of the adverse experience in our regression sample when *ADVERSE EXP* equals 1.

In our sample of managers with accounting-related adverse experience, the average age is 51 years old, and 11 percent of them are female. Approximately 49 percent of these managers have an M.B.A. degree. On average, these managers have been in their current positions for about three years, and their initial adverse experience occurred about six years ago. Nearly 39 percent of the managers accept board seats at another firm, and, for those who do assume external board positions, they hold about four board seats. The most common types of adverse experiences are accounting and financial reporting-related litigation, followed by class-action lawsuits and income-decreasing restatements. AAERs are the least common type of adverse experience.

Summary Statistics

Table 2, Panel A presents summary statistics for the primary regression sample. The mean statistics of financial reporting attributes (*CON-ACCRUAL*, *FUTURE ADVERSE*, and *DAC*) are consistent with prior studies (e.g., Ahmed and Duellman 2013; Larcker et al. 2007). The main variable of interest, *ADVERSE EXP*, turns on for about 12 percent of firm-year observations. Among the 1,838 unique firms in our sample, 536 (29 percent) have hired a manager with adverse experience at some point during the sample period. Table 2, Panel B reports the industry distribution of adverse experience for both firm-year observations and unique firms. The percentage of adverse experience is computed by scaling the number of adverse observations (firms) against the total number of observations (firms) in each industry group. Services, manufacturing, wholesale trade, and retail trade have a relatively high proportion of adverse experience, whereas agriculture, forestry, fishing, mining, construction, and transportation report a lower proportion of adverse experience. Public administration has no presence of adverse experience. Table 2, Panel C reports summary statistics of additional variables used to test the salience of adverse experience. Detailed definitions of these variables are included in Appendix A. We discuss the motivation for these variables in a later section.

Regression Results

Table 3 presents regression results testing the effect of adverse experience on financial reporting attributes (*CON-ACCRUAL*, *FUTURE ADVERSE*, and *DAC*). As discussed previously, higher values of *CON-ACCRUAL* reflect a greater accumulation of negative accruals (more unconditional accounting conservatism), and lower values of *FUTURE ADVERSE* and *DAC* imply better financial reporting quality. In the first regression, the coefficient estimate for *ADVERSE EXP* is 0.005 (p-value < 0.05), suggesting that firms led by senior financial executives with prior

¹⁸ We observe a low proportion of CEOs and similar titles in our sample, which is anecdotally consistent with the inferences from prior research that CEOs who experience adverse corporate events have limited subsequent mobility (e.g., Gilson 1989; Desai et al. 2006; Eckbo et al. 2016).

TABLE 1
Descriptive Statistics for Adverse Experience and Manager Characteristics

Panel A: Adverse Experience at Prior Companies (Firm-Years)

| Titles | Count | Percentage (%) |
|--------------------------------------|------------|----------------|
| CEO/President/Managing Director | 80 | 3.36 |
| CFO | 838 | 35.15 |
| Chief Accounting Officer | 162 | 6.80 |
| Controller | 571 | 23.95 |
| Director-Accounting or Finance | 181 | 7.59 |
| Treasurer | 277 | 11.62 |
| Vice President-Accounting or Finance | <u>275</u> | <u>11.53</u> |
| Total | 2,384 | 100.00 |

Panel B: Current Positions in New Companies (Firm-Years)

| Titles | Count | Percentage (%) |
|--------------------------------------|------------|----------------|
| CEO/President/Managing Director | 54 | 2.27 |
| CFO | 1,392 | 58.39 |
| Chief Accounting Officer | 226 | 9.48 |
| Controller | 221 | 9.27 |
| Director-Accounting or Finance | 38 | 1.59 |
| Treasurer | 258 | 10.82 |
| Vice President-Accounting or Finance | <u>195</u> | <u>8.18</u> |
| Total | 2,384 | 100.00 |

Panel C: Manager Characteristics (Firm-Years)

| Characteristic | n | Mean | Std. Dev. | p25 | p50 | p75 |
|--|-------|-------|-----------|-------|-------|-------|
| Age | 2,384 | 50.92 | 6.28 | 46.00 | 51.00 | 55.00 |
| Female | 2,384 | 0.11 | 0.32 | 0.00 | 0.00 | 0.00 |
| M.B.A. degree | 2,384 | 0.49 | 0.50 | 0.00 | 0.00 | 1.00 |
| Tenure at current position | 2,384 | 3.03 | 2.24 | 1.00 | 2.00 | 4.00 |
| Sits on board | 2,384 | 0.39 | 0.49 | 0.00 | 0.00 | 1.00 |
| Number of board seats | 922 | 3.66 | 3.32 | 1.00 | 2.00 | 5.00 |
| Frequency of adverse experience (in times) | 2,384 | 4.31 | 3.20 | 2.00 | 4.00 | 6.00 |
| Recency of adverse experience (in years) | 2,384 | 6.47 | 3.71 | 4.00 | 6.00 | 9.00 |

Panel D: Accounting-Related Adverse Experience (Firm-Years)

| Type | n | % |
|---|------------|--------------|
| AAER | 186 | 7.80 |
| Accounting and financial reporting litigation | 894 | 37.50 |
| Class-action lawsuit | 813 | 34.10 |
| Restatement | <u>491</u> | <u>20.60</u> |
| Total | 2,384 | 100.00 |

Panel A reports the titles of managers with prior accounting-related adverse experience at the time they acquired such experience (e.g., class-action lawsuits, accounting or financial reporting-related litigation, an accounting and auditing enforcement release, or an income-decreasing restatement). Panel B reports the titles of the managers at a new firm subsequent to their adverse experience. Panel C reports characteristics of the managers, including age, gender, education, the number of years serving in the current position, whether the manager serves on a corporate board (if so, the number of seats occupied), how many times the managers have experienced the adverse events, and the number of years since the initial event. Finally, Panel D reports the distribution of the adverse experience in the sample when *ADVERSE EXP* equals 1.

TABLE 2
Summary Statistics and Industry Distribution of Adverse Experience

Panel A: Summary Statistics

| Variable | n | Mean | Std. Dev. | p25 | p50 | p75 |
|----------------------------|--------|--------|-----------|--------|--------|--------|
| <i>CON-ACCRUAL</i> | 20,773 | 0.011 | 0.051 | -0.012 | 0.008 | 0.030 |
| <i>FUTURE ADVERSE</i> | 15,753 | 0.268 | 0.443 | 0.000 | 0.000 | 1.000 |
| <i>DAC</i> | 20,670 | 0.005 | 0.082 | -0.027 | 0.011 | 0.045 |
| <i>ADVERSE EXP</i> | 20,773 | 0.115 | 0.319 | 0.000 | 0.000 | 0.000 |
| <i>MTB</i> | 20,773 | 3.209 | 3.145 | 1.517 | 2.309 | 3.651 |
| <i>LEV</i> | 20,773 | 0.226 | 0.158 | 0.098 | 0.217 | 0.329 |
| <i>SIZE</i> | 20,773 | 7.237 | 1.610 | 6.142 | 7.158 | 8.307 |
| <i>ROA</i> | 20,773 | 0.083 | 0.126 | 0.032 | 0.086 | 0.145 |
| <i>RETURN</i> | 20,773 | 0.207 | 0.605 | -0.137 | 0.111 | 0.395 |
| <i>LITIGATION</i> | 20,773 | 0.075 | 0.081 | 0.028 | 0.048 | 0.089 |
| <i>DEFAULT</i> | 20,773 | 0.023 | 0.084 | 0.000 | 0.000 | 0.001 |
| <i>SALES GROWTH</i> | 20,773 | 0.115 | 0.262 | -0.002 | 0.079 | 0.185 |
| <i>R&D AD</i> | 20,773 | 0.035 | 0.055 | 0.000 | 0.014 | 0.047 |
| <i>CFO</i> | 20,773 | 0.104 | 0.083 | 0.062 | 0.101 | 0.147 |
| σ REVENUE | 20,773 | 0.264 | 0.243 | 0.114 | 0.196 | 0.330 |
| <i>AVG AGE</i> | 20,773 | 60.631 | 7.176 | 55.500 | 60.000 | 65.000 |
| <i>FEMALE%</i> | 20,773 | 0.121 | 0.242 | 0.000 | 0.000 | 0.000 |
| <i>ACCT EDU%</i> | 20,773 | 0.467 | 0.397 | 0.000 | 0.500 | 1.000 |
| <i>CASH COMP</i> | 20,773 | 5.580 | 2.062 | 5.763 | 6.168 | 6.554 |
| <i>COMP DELTA</i> | 20,773 | 3.878 | 2.052 | 2.935 | 4.244 | 5.295 |
| <i>COMP VEGA</i> | 20,773 | 2.587 | 1.804 | 0.986 | 2.775 | 3.976 |
| <i>CEO OVERCONFIDENCE</i> | 20,773 | 0.364 | 0.481 | 0.000 | 0.000 | 1.000 |
| <i>OVER INVEST</i> | 20,773 | 0.584 | 0.493 | 0.000 | 1.000 | 1.000 |
| <i>OVER GROWTH</i> | 20,773 | 0.341 | 0.474 | 0.000 | 0.000 | 1.000 |
| <i>DEBT FINANCING NEWS</i> | 20,773 | 0.275 | 0.447 | 0.000 | 0.000 | 1.000 |
| <i>INVESTMENT NEWS</i> | 20,773 | 0.285 | 0.452 | 0.000 | 0.000 | 1.000 |

Panel A reports descriptive statistics for the variables used in the primary analyses. All variables are defined in [Appendix A](#).

(continued on next page)

accounting-related adverse experience exhibit greater unconditional conservatism. In the second and third regressions, the coefficient estimates for *ADVERSE EXP* are -0.063 and -0.004 (p -value < 0.05), respectively, suggesting that firms led by senior financial executives with prior adverse experience exhibit a lower likelihood of a future adverse event and less positive discretionary accruals, respectively. In terms of magnitude, adverse experience raises (lowers) unconditional conservatism (discretionary accruals) by 12 (6) percent of the respective interquartile range after controlling for a number of firm and executive characteristics. Adverse experience also lowers the likelihood of a future accounting-related adverse event by 6.3 percentage points.¹⁹ Overall, this pattern suggests that adverse experience results in an improvement in subsequent financial reporting outcomes.

Most of the control variables for firm characteristics are in the predicted directions. With respect to the demographic characteristics of managers, we find the percentage of executives with accounting education (*ACCT EDU%*) is negatively associated with *CON-ACCRUAL*. We do not find other demographic characteristics significantly affecting financial reporting outcomes in our sample firms, which is anecdotally consistent with the mixed results in [Ge et al. \(2011\)](#). With respect to the compensation incentives of top-paid executives, we find that portfolio cash is positively associated with *CON-ACCRUAL*, whereas the portfolio delta and vega are negatively associated with *CON-ACCRUAL*. Consistent with [Armstrong et al. \(2013\)](#), portfolio vega is positively associated with *DAC*. With respect to personality

¹⁹ We calculate the economic magnitude by dividing the coefficients of *ADVERSE EXP* in [Table 3](#) by the interquartile ranges of financial reporting attributes reported in [Table 2](#), Panel A.

TABLE 2 (continued)

Panel B: Industry Distribution of Adverse Experience

| SIC Code | Industry Group | Adverse Experience # of Observations (Unique Firms) | No Adverse Experience # of Observations (Unique Firms) | Percentage of Adverse Experience (%) |
|-----------|------------------------------------|---|--|--|
| 0000–0099 | Agriculture, Forestry, And Fishing | 1 (1) | 80 (9) | 1.23 (10.00) |
| 1000–1999 | Mining and Construction | 113 (26) | 1,520 (134) | 6.92 (16.25) |
| 2000–3999 | Manufacturing | 1,329 (292) | 10,364 (978) | 11.37 (22.99) |
| 4000–4799 | Transportation | 10 (4) | 789 (64) | 1.25 (5.88) |
| 5000–5999 | Wholesale Trade and Retail Trade | 332 (79) | 2,629 (275) | 11.21 (22.32) |
| 7000–8999 | Services | 599 (142) | 2,942 (387) | 16.92 (26.84) |
| 9000–9999 | Public Administration | 0 (0) | 65 (9) | 0.00 (0.00) |
| Total | | 2,384 (536) | 18,389 (1,772) | |

Panel B reports the industry distribution (by SIC code) for the primary sample.

Panel C: Summary Statistics for the Salience of Experience

| Variable | n | Mean | Std. Dev. | p25 | p50 | p75 |
|-----------------------|--------|-------|-----------|-------|-------|-------|
| <i>EXP_FREQ</i> | 6,733 | 1.528 | 2.807 | 0.000 | 0.000 | 2.000 |
| <i>EXP_RECENCY</i> | 6,733 | 0.047 | 0.064 | 0.000 | 0.000 | 0.125 |
| <i>UPWARD_MOVE</i> | 20,773 | 0.043 | 0.204 | 0.000 | 0.000 | 0.000 |
| <i>NO_UPWARD_MOVE</i> | 20,773 | 0.096 | 0.295 | 0.000 | 0.000 | 0.000 |
| <i>JUNIOR_EXP</i> | 20,773 | 0.068 | 0.252 | 0.000 | 0.000 | 0.000 |

Panel C reports the summary statistics of the salience variables used in Table 4.

All variables are defined in Appendix A.

characteristics, and consistent with Ahmed and Duellman (2013) and Schrand and Zechman (2012), we observe that managerial overconfidence is negatively associated with *CON-ACCRUAL* and positively associated with *FUTURE ADVERSE*.²⁰ Finally, we find that managerial overconfidence is negatively associated with *DAC* in our sample, suggesting less positive (or more negative) discretionary accruals.²¹

The Salience of Adverse Experience

In this section, we explore cross-sectional variation in the salience of adverse experience. Specifically, we examine the following dimensions of salience: (1) the number of adverse events experienced; (2) the recency of adverse experience; (3) career consequences; and (4) junior experience. These dimensions capture the frequency, recency, severity, and proximity of the experience, respectively. Table 4 presents the results.

In Panel A, we examine the number of adverse events experienced to date by the managers and their effect on financial reporting. Managers can experience multiple adverse events during their professional careers, presenting an interesting question of whether repeated adverse events make financial executives incrementally more conservative. Bordalo et al. (2012a, 2012b) suggest that repeated experience can have a stronger influence on decision making. However, if the negative experience is severe, it may be enough to leave an imprinting effect on subsequent behavior. To answer this

²⁰ In further tests, we control for additional characteristics of managers with adverse experience, such as their industry experience (based on the number of years the managers have worked in the same two-digit SIC industry), their experience in managing a firm during recessions, growing up during the Depression era, age, gender, and accounting education. We continue to find that adverse experience is associated with an increase in conservatism and less positive discretionary accruals. Although the coefficient of interest in the *FUTURE ADVERSE* regression is negative, but ultimately insignificant, the plethora of additional managerial characteristics likely limits our ability to observe a significant relation between adverse experience and a within-firm reduction in the likelihood of future adverse events.

²¹ This latter result is consistent with Hsieh et al. (2014) and suggests that *DAC* may be a noisier proxy than *CON-ACCRUAL* or *FUTURE ADVERSE*, at least with respect to testing the extent to which overconfidence is related to financial reporting attributes.

TABLE 3
Adverse Experience and Financial Reporting

| Variable | CON-ACCRUAL | FUTURE ADVERSE | DAC |
|----------------------------|----------------------|-----------------------|----------------------|
| <i>ADVERSE EXP</i> | 0.005** (0.002) | -0.063** (0.027) | -0.004** (0.002) |
| <i>MTB</i> | 0.001*** (0.000) | 0.003 (0.002) | -0.000 (0.000) |
| <i>LEV</i> | -0.011** (0.005) | 0.073 (0.055) | -0.004 (0.005) |
| <i>SIZE</i> | 0.003** (0.001) | 0.070*** (0.016) | -0.004*** (0.001) |
| <i>ROA</i> | -0.235*** (0.007) | 0.012 (0.042) | 0.661*** (0.010) |
| <i>RETURN</i> | 0.003*** (0.001) | 0.012** (0.006) | -0.001 (0.001) |
| <i>LITIGATION</i> | 0.007 (0.006) | 0.196*** (0.053) | -0.051*** (0.007) |
| <i>DEFAULT</i> | 0.034*** (0.006) | 0.033 (0.042) | -0.017*** (0.006) |
| <i>SALES GROWTH</i> | -0.005** (0.002) | 0.021 (0.014) | -0.031*** (0.003) |
| <i>R&D AD</i> | 0.060** (0.027) | 0.156 (0.203) | -0.116*** (0.032) |
| <i>CFO</i> | 0.315*** (0.010) | 0.028 (0.062) | -1.081*** (0.013) |
| <i>σ REVENUE</i> | -0.011*** (0.003) | 0.070*** (0.026) | -0.006* (0.003) |
| <i>AVG AGE</i> | -0.000 (0.000) | -0.002 (0.001) | 0.000 (0.000) |
| <i>FEMALE%</i> | -0.002 (0.002) | -0.028 (0.031) | -0.001 (0.002) |
| <i>ACCT EDU%</i> | -0.004*** (0.002) | 0.001 (0.020) | 0.000 (0.001) |
| <i>CASH COMP</i> | 0.002*** (0.000) | -0.002 (0.004) | -0.000 (0.000) |
| <i>COMP DELTA</i> | -0.001*** (0.000) | 0.000 (0.006) | -0.000 (0.001) |
| <i>COMP VEGA</i> | -0.001* (0.000) | 0.004 (0.007) | 0.001*** (0.001) |
| <i>CEO OVERCONFIDENCE</i> | -0.002** (0.001) | -0.003 (0.013) | -0.002** (0.001) |
| <i>OVER INVEST</i> | -0.004*** (0.001) | 0.018* (0.010) | 0.001 (0.001) |
| <i>OVER GROWTH</i> | -0.000 (0.001) | 0.017*** (0.006) | -0.006*** (0.001) |
| <i>DEBT FINANCING NEWS</i> | 0.001 (0.001) | -0.004 (0.008) | -0.001** (0.001) |
| <i>INVESTMENT NEWS</i> | -0.002*** (0.001) | 0.027*** (0.010) | -0.001 (0.001) |
| Observations | 20,773 | 15,753 | 20,670 |
| Adjusted R ² | 0.523 | 0.557 | 0.801 |

*, **, *** Denote significance at the 10 percent, 5 percent, and 1 percent levels, respectively, based on two-sided tests.

This table reports the effect of accounting-related adverse experience on financial reporting. To mitigate the influence of outliers, all variables are Winsorized at the 1 percent and 99 percent levels. Standard errors are clustered by firm and reported below each coefficient in parentheses. All regressions include firm fixed effects and fiscal year fixed effects.

All variables are defined in [Appendix A](#).

TABLE 4
Saliency of Adverse Experience

Panel A: Frequency of Adverse Experience

| Variable | <i>CON-ACCRUAL</i> | <i>FUTURE ADVERSE</i> | <i>DAC</i> |
|-------------------------|---------------------|-----------------------|---------------------|
| <i>EXP_FREQ</i> | 0.001*** (0.000) | -0.010* (0.006) | -0.001** (0.000) |
| Control variables | Included | Included | Included |
| Observations | 6,733 | 4,910 | 6,719 |
| Adjusted R ² | 0.534 | 0.558 | 0.781 |

Panel B: Recency of Adverse Experience

| Variable | <i>CON-ACCRUAL</i> | <i>FUTURE ADVERSE</i> | <i>DAC</i> |
|-------------------------|---------------------|-----------------------|----------------------|
| <i>EXP_RECENCY</i> | 0.049*** (0.016) | -0.332* (0.190) | -0.035*** (0.012) |
| Control variables | Included | Included | Included |
| Observations | 6,733 | 4,910 | 6,719 |
| Adjusted R ² | 0.534 | 0.557 | 0.781 |

Panel C: Career Consequences

| Variable | <i>CON-ACCRUAL</i> | <i>FUTURE ADVERSE</i> | <i>DAC</i> |
|---|---------------------|-----------------------|----------------------|
| <i>UPWARD_MOVE</i> | -0.003 (0.003) | 0.028 (0.041) | 0.002 (0.003) |
| <i>NO_UPWARD_MOVE</i> | 0.007*** (0.002) | -0.080*** (0.030) | -0.006*** (0.002) |
| Coefficient difference test: (p-value) <i>UPWARD_MOVE</i> = <i>NO_UPWARD_MOVE</i> | (0.013) | (0.025) | (0.030) |
| Control variables | Included | Included | Included |
| Observations | 20,773 | 15,753 | 20,670 |
| Adjusted R ² | 0.523 | 0.557 | 0.801 |

Panel D: Junior Experience

| Variable | <i>CON-ACCRUAL</i> | <i>FUTURE ADVERSE</i> | <i>DAC</i> |
|---|--------------------|-----------------------|---------------------|
| <i>ADVERSE_EXP</i> | 0.005** (0.002) | -0.063** (0.027) | -0.004** (0.002) |
| <i>JUNIOR_EXP</i> | -0.000 (0.002) | -0.004 (0.025) | -0.003* (0.002) |
| Coefficient difference test: (p-value) <i>ADVERSE_EXP</i> = <i>JUNIOR_EXP</i> | (0.040) | (0.057) | (0.393) |
| Control variables | Included | Included | Included |
| Observations | 20,773 | 15,753 | 20,670 |
| Adjusted R ² | 0.523 | 0.557 | 0.801 |

*, **, *** Denote significance at the 10 percent, 5 percent, and 1 percent levels, respectively, based on two-sided tests.

This table reports various tests for the saliency of adverse experience. In Panels A and B, the regression sample is restricted to firms that have employed managers with the adverse experience identified in Section III. In Panels C and D, the regression sample is the same sample as Table 3. To mitigate the influence of outliers, all variables are Winsorized at the 1 percent and 99 percent levels. Standard errors are clustered by firm and reported below each coefficient in parentheses. All regressions include firm fixed effects and fiscal year fixed effects.

All variables are defined in Appendix A.

question, we examine the sample of hiring firms and replace *ADVERSE EXP* with a continuous variable (*EXP FREQ*), capturing the number of adverse events experienced to date by the manager.²² We find the continuous measure (*EXP FREQ*) has a statistically significant and positive estimate in the *CON-ACCRUAL* regression (p-value < 0.01), suggesting a positive association between the number of adverse events and the level of accounting conservatism in firms that employ managers with adverse experience. We also observe significant and negative estimates on *EXP FREQ* in the *FUTURE ADVERSE* (p-value < 0.10) and *DAC* regressions (p-value < 0.05), suggesting a negative relation between the number of adverse events and the probability of a future adverse event, and less positive discretionary accruals in firms that employ managers with multiple adverse events.

In Panel B, we examine the recency of adverse experience and its effect on financial reporting. According to Watson's (1930) recency law, "the last response an organism makes in a learning situation will be the first one it makes when it reencounters that situation." To the extent that more recent events have stronger effects on decision-making, we may observe a stronger association between adverse experience and financial reporting when the experience has occurred more recently. However, we may not observe such an association if the adverse events are severe enough to leave a lasting imprint. To investigate this question, we replace *ADVERSE EXP* with a continuous variable (*EXP RECENCY*), calculated as the inverse ratio of the number of days since the adverse event (in logarithmic form). When there is more than one adverse event, we use the average to compute *EXP RECENCY*. For years when managers with adverse experience are not present, we set *EXP RECENCY* to zero. Thus, *EXP RECENCY* is increasing in the recency of the adverse event. Similar to the test sample in Panel A, we conduct a within-firm analysis of the firms that employ a manager with adverse experience. We find that *EXP RECENCY* has a statistically significant and positive estimate (p-value < 0.01) in the *CON-ACCRUAL* regression, suggesting a positive relation between the recency of adverse events and the level of accounting conservatism in firms that employ managers with adverse experience. We also observe statistically significant and negative estimates on *EXP RECENCY* in the *FUTURE ADVERSE* (p-value < 0.10) and *DAC* regressions (p-value < 0.01), suggesting that the recency of adverse events is related to a reduction in the likelihood of a future adverse event and less positive (or more negative) discretionary accruals in firms that employ managers with adverse experience.

We next turn our attention to the severity of adverse experience based on whether the manager experienced a career consequence following the adverse experience. In Panel C, we partition *ADVERSE EXP* into two separate indicators: *UPWARD MOVE* and *NO UPWARD MOVE*. Specifically, we compare the position titles of the managers at their current firms with their previous position titles when they experienced an adverse event at the troubled firm. If the manager's current position title is ranked higher than her original title (e.g., CEO at the current firm and was a CFO at the troubled firm), we code *UPWARD MOVE* as one. If the manager's current position title is ranked similar to or lower than her original title (e.g., CFO at the troubled firm and now is a CFO, controller, treasurer, or accounting officer at the current firm), we code *NO UPWARD MOVE* as one. We then estimate this specification in our main sample to examine whether the effect of adverse experience is stronger when the manager experiences a lateral or downward move based on position titles following the adverse events. We indeed observe that, among executives accepting an upward move following the adverse experience, there is no association between accounting-related adverse experience and financial reporting. In contrast, we observe a significant relation between adverse experience and financial reporting for executives who subsequently accept a lateral or downward position. Similarly, in untabulated analyses, we find that the effect of adverse experience on financial reporting attributes tends to be stronger if the hiring firms are smaller than the troubled firms in terms of total assets or market capitalization. Overall, these results suggest that the severity of the experience (through career consequences) has a stronger effect on financial reporting.²³

Finally, we examine the effect of adverse experience occurring in nonsenior financial executive positions. Specifically, we examine adverse experience gained while the executive holds junior roles (e.g., accountants) and nonfinancial roles (e.g., marketing, operations, human resources, etc.). We collectively refer to such experience as *JUNIOR EXP*, and we conjecture that witnessing accounting-related adverse events in junior and nonfinancial roles does not

²² We conduct a within-firm analysis of the firms that employ a manager with adverse experience for this test. For years when the managers are not present, we set *EXP FREQ* to zero. In case there are multiple managers with adverse experience in a firm, we focus on the one with the highest frequency of adverse experience to date. In untabulated tests, we also use an executive-firm-year approach and observe qualitatively consistent results. In another untabulated analysis, we explore whether employing more than one manager with adverse experience has incrementally greater effects on conservative financial reporting and find that having multiple managers with adverse experience leads to a larger reduction in the likelihood of a future adverse event and less positive discretionary accruals.

²³ In untabulated tests, we employ a similar process and use separate indicators capturing more versus less severe experience from restatements classified as errors, versus irregularities, per Hennes et al. (2008). Although the coefficients for less severe experience are visually smaller than more severe restatements, and insignificant in two of the regressions, F-tests of coefficient equality fail to confirm that the magnitudes are smaller for error-based restatements. We emphasize that using restatements classified as errors to capture less severe experience is noisy, as some error-based restatements could have an influence on subsequent managerial financial reporting preferences if the outcome of the restatement is consequential.

provide the same first-hand adverse shock as for the senior financial executive. In other words, the lack of proximity of junior and nonfinancial roles to reporting decisions weakens the salience of such experience. Consistent with this conjecture, results in Panel D indicate that adverse experience obtained while the executive is holding more junior positions does not bear a significant relationship to two of the three financial reporting attributes. Overall, results from these cross-sectional analyses suggest that adverse experience has a stronger effect on subsequent financial reporting when the experience is more frequent, recent, severe, and proximate (i.e., obtained while holding a senior-level position within the firm).

V. ADDITIONAL ANALYSES

Propensity Score Matching

In this section, we implement a propensity-score-matching technique to more thoroughly account for the observable factors that might influence the decision to hire a manager with adverse experience. To this end, we estimate a first-stage logit regression that explains the likelihood of hiring, for the first time, a manager with adverse experience in the senior management team. Note our first-stage model differs from model (1) because there can be different determinants for the decision to hire and the outcome of hiring managers with adverse experience. We model the first-time hiring of a manager with adverse experience by firm size, leverage, company age, market-to-book ratio, stock performance, operating performance, litigation and default risk, executive turnover, and firms in the same industry and geographical locations that have experienced adverse events, as well as board connections (firm and time subscripts are omitted for brevity).²⁴

$$\begin{aligned} \text{FIRSTADVERSE EXP HIRE} = & \gamma_0 + \gamma_1 \text{ROA} + \gamma_2 \text{DEFAULT} + \gamma_3 \text{EXEC TURNOVER} + \gamma_4 \text{SIZE} \\ & + \gamma_5 \text{RETURN} + \gamma_6 \text{VOLATILITY} + \gamma_7 \text{MTB} + \gamma_8 \text{LEV} + \gamma_9 \text{FIRM AGE} \\ & + \gamma_{10} \text{IND ADVERSE} + \gamma_{11} \text{MSA ADVERSE} + \gamma_{12} \text{STATE ADVERSE} \\ & + \gamma_{13} \text{ADVERSE CONNECTION} + \varepsilon. \end{aligned} \quad (2)$$

Table 5, Panel A presents the results from this estimation. The model performs reasonably well in predicting the first-time hire of a manager with adverse experience, as the area under the receiver operating curve (ROC) is over 0.75 (Hosmer and Lemeshow 2000). The Chi-square goodness-of-fit test statistic is insignificant, indicating that the regression model is not misspecified. Further, the model correctly classifies over 95 percent of observations. After estimating the first-stage logit regression, we match (without replacement) firms that have hired, for the first time, a manager with adverse experience in the senior management team (treatment firms) to firms that have never hired a manager with adverse experience (control firms) within the same industry. We also require the matched control firms to have hired a manager without adverse experience within the most recent three years. We use a caliper of 0.15 on the propensity score (P_SCORE), yielding a matched sample consisting of 277 matched pairs. In untabulated tests, we confirm that the matched sample is balanced along most of the dimensions, except for firm size, leverage, and age, which we control for in the second-stage regressions. Next, we estimate a difference-in-differences model using the matched sample and report the results in Table 5, Panel B. We include all available data for the period before and after a manager with adverse experience is hired in the senior management team. We then augment model (1) by replacing $ADVERSE EXP$ with three variables: $HIRING FIRM$, $POST$, and $HIRING FIRM \times POST$.²⁵ The difference-in-differences estimator ($HIRING FIRM \times POST$) captures the difference in financial reporting between treatment firms and control firms following the first-time appointment of a manager with adverse experience at a treatment firm.²⁶ We find corroborating evidence for our main hypothesis that firms led by managers with adverse experience exhibit greater accounting conservatism, lower likelihood of a future adverse event, and less positive discretionary accruals. We also note the estimates on $HIRING FIRM \times POST$ are comparable to the estimates in Table 3 and suggest that our findings on the effects of

²⁴ All explanatory variables in this regression are lagged, except for company age ($FIRM AGE$), expected default frequency ($DEFAULT$), and the number of executive changes during the most recent three years ($EXEC TURNOVER$). Appendix A provides detailed definitions of these variables.

²⁵ See Appendix A for detailed definitions. Because we include firm fixed effects, the estimator for $HIRING FIRM$ is omitted (as it is absorbed in the firm fixed effect). Because the timing of hiring differs by firm, the estimator for $POST$ is not omitted.

²⁶ We assess the parallel trends assumption underlying our difference-in-differences design (Roberts and Whited 2013) by including additional indicator variables that turn on three years, two years, and one year prior to the hiring event, as well as their interactions with $HIRING FIRM$. As shown in the figures plotting the 90 percent confidence intervals for the difference-in-differences estimators, there is no evidence that treatment and control firms have systematically different trends prior to the hiring event.

TABLE 5
Additional Analyses

Panel A: First Stage of Propensity Score Matching

| Variable | <i>FIRST ADVERSE HIRE</i> | <i>FIRST ADVERSE HIRE</i> |
|------------------------------------|---------------------------|---------------------------|
| <i>ROA</i> | −0.254 (0.179) | −0.048 (0.233) |
| <i>DEFAULT</i> | −0.184 (0.666) | −0.490 (0.710) |
| <i>EXEC TURNOVER</i> | 0.350*** (0.023) | 0.333*** (0.023) |
| <i>SIZE</i> | 0.039 (0.035) | 0.062 (0.043) |
| <i>RETURN</i> | −0.149 (0.099) | −0.165 (0.116) |
| <i>VOLATILITY</i> | −1.347 (0.971) | 2.325** (1.047) |
| <i>MTB</i> | 0.032*** (0.010) | 0.030*** (0.010) |
| <i>LEVERAGE</i> | −1.291*** (0.343) | −0.776** (0.365) |
| <i>FIRM AGE</i> | −0.009*** (0.003) | −0.010*** (0.004) |
| <i>IND ADVERSE</i> | 0.004*** (0.001) | −0.000 (0.002) |
| <i>STATE ADVERSE</i> | 0.001 (0.001) | 0.000 (0.001) |
| <i>MSA ADVERSE</i> | 0.013*** (0.002) | 0.015*** (0.003) |
| <i>ADVERSE CONNECTION</i> | 0.002 (0.004) | 0.004 (0.004) |
| Year fixed effects | — | Yes |
| Industry fixed effects | — | Yes |
| Observations | 14,565 | 12,483 |
| Area under ROC | 0.753 | 0.784 |
| Correctly classified | 96.39% | 95.77% |
| χ^2 goodness-of-fit (p-value) | (1.000) | (1.000) |
| Pseudo R ² | 0.097 | 0.134 |

*, **, *** Denote significance at the 10 percent, 5 percent, and 1 percent levels, respectively, based on two-sided tests.

Panel A reports the first-stage prediction model of the first-time hiring of a manager with adverse experience. To mitigate the influence of outliers, all variables are Winsorized at the 1 percent and 99 percent levels. Standard errors are reported below each coefficient in parentheses. All variables are defined in [Appendix A](#).

(continued on next page)

managers with adverse experience on financial reporting are robust to using a more restrictive (propensity score matching) design.

[Figure 1](#) depicts the differences in financial reporting attributes (*CON-ACCRUAL*, *FUTURE ADVERSE*, and *DAC*) between firms that hire managers with adverse experience (hiring firms) and firms that never hire such managers (nonhiring firms) surrounding the immediate years of hiring. We use the propensity-score-matched sample to estimate a supplemental difference-in-differences analysis with multiple year dummies, an approach similar to [Bertrand and Mullainathan \(2003\)](#), and plot the 90 percent confidence interval of the difference-in-differences coefficients. During the three years prior to hiring, the financial reporting attributes are comparable between hiring firms and nonhiring firms, which also supports the parallel trends assumption ([Roberts and Whited 2013](#)). Following the hiring of managers with

TABLE 5 (continued)

Panel B: Second Stage of Propensity Score Matching

| Variable | <i>CON-ACCRUAL</i> | <i>FUTURE ADVERSE</i> | <i>DAC</i> |
|----------------------------------|---------------------|-----------------------|----------------------|
| <i>POST</i> | -0.001 (0.002) | -0.054*** (0.020) | 0.003 (0.002) |
| <i>HIRING FIRM</i> × <i>POST</i> | 0.008*** (0.002) | -0.044* (0.026) | -0.006*** (0.002) |
| Control variables | Included | Included | Included |
| Observations | 6,860 | 5,279 | 6,805 |
| Adjusted R ² | 0.526 | 0.559 | 0.781 |

*, **, *** Denote significance at the 10 percent, 5 percent, and 1 percent levels, respectively, based on two-tailed tests.

Panel B reports the effect of accounting-related adverse experience on financial reporting in a propensity-score-matched sample. Treatment is defined as the first-time hiring of a manager with adverse experience. To mitigate the influence of outliers, all variables are Winsorized at the 1 percent and 99 percent levels. Heteroskedasticity-consistent standard errors are reported below each coefficient in parentheses. All regressions include firm fixed effects and fiscal year fixed effects.

All variables are defined in [Appendix A](#).

Panel C: Exogenous and Quasi-Exogenous Hiring

| Variable | <i>CON-ACCRUAL</i> | <i>FUTURE ADVERSE</i> | <i>DAC</i> |
|----------------------------------|--------------------|-----------------------|-------------------|
| <i>POST</i> | 0.006 (0.005) | 0.010 (0.053) | -0.001 (0.005) |
| <i>HIRING FIRM</i> × <i>POST</i> | 0.009 (0.006) | -0.131** (0.063) | -0.001 (0.005) |
| Control variables | Included | Included | Included |
| Observations | 897 | 712 | 878 |
| Adjusted R ² | 0.548 | 0.554 | 0.851 |

*, **, *** Denote significance at the 10 percent, 5 percent, and 1 percent levels, respectively, based on two-tailed tests.

Panel C reports the effect of adverse experience on financial reporting in a subsample of managers with adverse experience who are hired for exogenous or quasi-exogenous reasons (e.g., the predecessors die, naturally retire, or resign not because of poor performance). Specifically, for each of these hiring events, we match a control firm that has hired a manager without adverse experience in the most recent three years. To mitigate the influence of outliers, all variables are Winsorized at the 1 percent and 99 percent levels. Heteroskedasticity-consistent standard errors are reported below each coefficient in parentheses. All regressions include firm fixed effects and fiscal year fixed effects.

All variables are defined in [Appendix A](#).

(continued on next page)

adverse experience, hiring firms experience an increase in conservative financial reporting. Specifically, hiring firms exhibit significantly greater conservatism and less positive discretionary accruals in years following the hiring. Both effects manifest fairly quickly after the first-time appointment of a manager with adverse experience. In contrast, the likelihood of a future adverse event declines significantly for hiring firms beginning two years after the hiring of a manager with adverse experience. Overall, these patterns continue to support our main inferences that adverse managerial experience is subsequently related to more conservative financial reporting.

Quasi-Exogenous Manager Changes

As we discuss in the preceding sections, the choice to hire managers with adverse experience, particularly for their expertise in managing firms in adverse states, may be endogenous and thus represent a potential validity threat. We further address this concern by using a small subsample of exogenously and quasi-exogenously hired managers with adverse experience. We broadly follow the methods outlined in [Fee et al. \(2013\)](#) and [Karolyi \(2018\)](#) and define exogenous (quasi-exogenous) turnovers as manager changes due to death or significant illness (natural retirements and resignations that are not due to subpar performance).²⁷ Then, we use the propensity scores from model (2) to match these

²⁷ In addition to the procedures described in [Karolyi \(2018\)](#), we require: (1) all departing executives of the quasi-exogenous turnovers to be at least 60 years old; (2) the incoming and outgoing managers to hold similar titles (i.e., a CEO (CFO) with adverse experience replaces a CEO (CFO) without adverse experience, etc.); and (3) the departure date of outgoing managers and the onboarding of incoming managers occur within two years. We also utilize the Capital IQ Key Development database to identify additional cases of exogenous and quasi-exogenous turnovers.

TABLE 5 (continued)

Panel D: Manager Departures

| Variable | <i>CON-ACCRUAL</i> | <i>FUTURE ADVERSE</i> | <i>DAC</i> |
|-------------------------|----------------------|-----------------------|-------------------|
| <i>DEPARTURE</i> | -0.007*** (0.003) | -0.031 (0.030) | 0.004* (0.003) |
| Control variables | Included | Included | Included |
| Observations | 3,104 | 1,506 | 3,097 |
| Adjusted R ² | 0.586 | 0.726 | 0.791 |

*, **, *** Denote significance at the 10 percent, 5 percent, and 1 percent levels, respectively, based on two-sided tests.

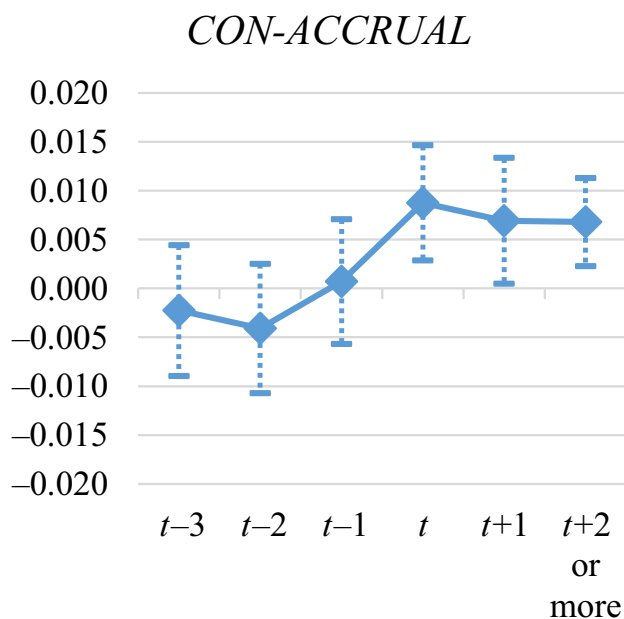
Panel D reports the effect of manager (with adverse experience) departures on financial reporting. The sample includes all years of the hiring firms after the first-time appointment of a manager with adverse experience. *DEPARTURE* equals 1 for years when adverse experience is absent in the senior management team after the first-time appointment of a manager with adverse experience. Heteroskedasticity-consistent standard errors are reported in parentheses under each coefficient. All regressions include firm fixed effects and fiscal year fixed effects.

All variables are defined in [Appendix A](#).

FIGURE 1

Changes in Financial Reporting Surrounding the Hiring of a Manager with Adverse Experience

Panel A: Unconditional Conservatism



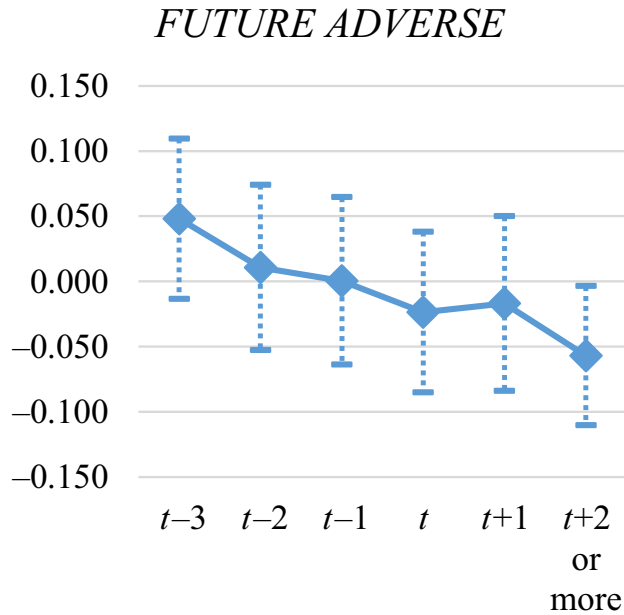
(continued on next page)

events to other hiring events of financial executives without adverse experience. These procedures result in a sample of 897 observations containing 30 (4) firms that have quasi-exogenously (exogenously) hired managers with adverse experience, as well as 34 matched control firms. We then test whether the difference-in-differences estimator is directionally consistent with our inferences from Panel B.

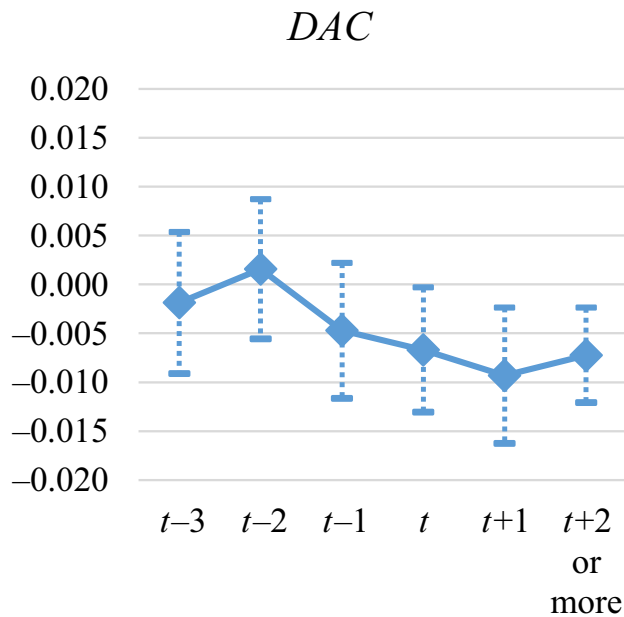
In [Table 5](#), Panel C, we continue to observe a significant and negative relation between adverse experience and the likelihood of a future adverse event in this more restrictive design (p-value < 0.10). The sign of the difference-in-differences estimator in the *CON-ACCRUAL* specification is consistent with a positive relation between adverse experience and unconditional accounting conservatism. However, the two-sided p-value is 0.122 (untabulated), narrowly missing

FIGURE 1 (continued)

Panel B: The Likelihood of Future Accounting-Related Adverse Events



Panel C: Discretionary Accruals



Panels A–C depict the difference in unconditional conservatism (*CON-ACCRUAL*), the likelihood of future accounting-related adverse events (*FUTURE ADVERSE*), and discretionary accruals (*DAC*), between hiring firms and non-hiring firms surrounding the first-time hiring of a manager with prior accounting-related adverse experience. Year *t* is the first-time hiring of a manager with prior accounting-related adverse experience using the propensity-score matched sample. The figure also plots the 90 percent confidence interval for the differences. (The full-color version is available online.)

the conventional 10 percent threshold of significance.²⁸ We also do not observe a significant coefficient in the *DAC* specification, although the sign is consistent. We note the small sample size and highly restrictive nature of this particular test and caution the reader from overgeneralizing our results. More importantly, the exercise of using quasi-exogenous hiring events is but one approach that we use to evaluate whether our results may be affected by correlated omitted firm characteristics coincident with the hiring of managers with adverse experience.²⁹

Manager Departures

We observe some manager departures during our sample period. To investigate the effect on financial reporting after a manager with adverse experience leaves the firm, we gather all firm-year observations for the hiring firms after the first-time appointment of a manager with adverse experience, then create a new indicator variable (*DEPARTURE*) that captures the absence of adverse experience in the senior management team and replace *ADVERSE EXP* with *DEPARTURE* in model (1).³⁰ Results from this analysis are reported in Table 5, Panel D. These tests confirm a reversion in accounting conservatism and discretionary accruals when managers with adverse experience leave their positions.

Learning from Adverse Experience

Our identification relies on the assumption that a manager will learn from the adverse event and subsequently become more conservative. To mitigate the possibility that these managers have always been conservative or choose to work for firms that are generally more conservative, we follow the approach taken in Dittmar and Duchin (2016) and calculate the change in financial reporting attributes between the new firms during the managers' tenure and the old firms during the managers' tenure, but prior to the adverse events. We follow the same procedure to calculate changes in control variables. The change is calculated as the average level of each variable during the managers' tenure (no longer than six years after adverse experience) at the new firm minus the average level of each variable during the managers' tenure (no longer than six years before adverse experience), but prior to an adverse event at the old firm. We then regress the change in financial reporting attributes (i.e., new firm – old firm) on an indicator for *ADVERSE EXP* and a set of changes in control variables (i.e., new firm – old firm). The units of analysis in this regression are manager – old firm – new firm combinations. This regression includes non-adverse-experience managers' movements from an old firm to a new firm as controls. Untabulated results reveal that, relative to the old (troubled) firms, hiring firms exhibit a significantly greater increase in accounting conservatism and decrease in the likelihood of a future adverse event during the adverse manager's tenure. Except for the discretionary accruals specification, which is insignificant, this validation test confirms our hypothesis and mitigates concern that unobserved managerial fixed effects (e.g., risk aversion), rather than the previous adverse experience, is driving our results. Results from this test also suggest that these managers are not simply employing the same policies of their previous firm.

Additional Dimensions of Financial Reporting

We explore additional dimensions of reporting quality, such as management guidance and 10-K disclosure tone. Specifically, we gather management guidance on earnings, sales, capital expenditures, dividends, gross margin, ROA, and operating profit from the I/B/E/S Guidance database. We define guidance as pessimistic if management guidance is below the realized value. We measure 10-K tone as the percentage of negative words in the annual 10-K filing.³¹ In untabulated results, we find that adverse experience is subsequently related to more pessimistic management earnings guidance, but no change in the pessimistic tone of the overall 10-K filing.

²⁸ In untabulated tests, if we relax the within-industry matching requirement or remove year fixed effects, we observe two-tailed significance in both the *CON-ACCRUAL* and *FUTURE ADVERSE* regressions.

²⁹ We perform additional tests by dropping two years after any CEO turnover (exogenous or endogenous). Our results, untabulated, continue to show that firms that hire a manager with adverse experience subsequently exhibit greater accounting conservatism, a lower likelihood of a future adverse event, and less positive discretionary accruals. Thus, we confirm that our results are capturing the effect of adverse experience in particular, rather than management changes in general.

³⁰ To ensure that we are picking up the effect of manager departures (i.e., not the residual effects of managers with adverse experience), when calculating *CON-ACCRUAL* for the years when *DEPARTURE* = 1, we ensure that the three-year calculation window does not overlap with the departing manager's tenure.

³¹ The classification of negative words is obtained from Bill McDonald's website at <https://sraf.nd.edu/sec-edgar-data/>

Market-Related Consequences of Adverse Experience

In untabulated exploratory analyses, we examine the market-related consequences of employing managers with adverse experience in terms of the bid-ask spread, liquidity, analyst forecast properties, and future downside volatility. We follow [Corwin and Schultz \(2012\)](#) and [Amihud \(2002\)](#) to measure bid-ask spreads and stock illiquidity, respectively. Analyst forecast accuracy (dispersion) is the absolute difference between the realized annual EPS and the consensus forecast as the percentage of the realized EPS (the standard deviation of annual EPS forecasts). Following [Chen, Hong, and Stein \(2001\)](#) and [Kim, Li, and Zhang \(2011\)](#), among others, we measure downside volatility as the natural logarithm of the ratio of standard deviation of weekly returns during down (below-mean return) weeks to the standard deviation of weekly returns during up (above-mean return) weeks measured during years $t+1$ to $t+3$. Higher downside volatility is associated with a greater likelihood of a future stock crash, a negative tail event for investors ([Chen et al. 2001](#); [Kim et al. 2011](#)). We find evidence that adverse experience is associated with lower future downside volatility, and we do not find any evidence that adverse experience negatively affects these subsequent market quality metrics. Collectively, we interpret the overall evidence from these tests as a positive consequence of hiring managers with adverse accounting experience in the sense that these actions empirically appear to reduce future tail risk (downside volatility), as well as lower the likelihood of future adverse accounting events, without having a negative effect on the information environment (bid-ask spreads and stock liquidity) or in failing to meet capital market expectations (analyst forecasts). Although these exploratory results are suggestive, we look to future research to more thoroughly examine whether and to what extent changes in reporting preferences (whether through accounting-related adverse experience or some other initial stimulus) may have an effect on market quality metrics, and therefore shareholder welfare.

Executive-Firm-Year Regression

In the main analyses, we use a firm-year approach with an *ADVERSE EXP* indicator as a straightforward method to examine the effect of adverse experience, which is also consistent with the majority of studies in the manager-effects literature. We acknowledge that a firm-year approach may lead to some sacrifice of precision; however, we choose to use a firm-year approach as our main specification for two reasons. First, the overwhelming majority (85 percent) of firm-years with adverse experience have only one manager with such experience. Thus, our firm-year approach is descriptive of observed practice. Second, by adopting a firm-year approach, we avoid oversampling from the executive team in a regression of firm-year measures of financial reporting quality. In all, we view our baseline firm-year specification as a conservative approach.³² Nonetheless, we construct an alternative sample with an executive-firm-year unit of analysis.³³ Untabulated results using this alternative design are consistent with our reported results using a firm-year unit of analysis.

VI. CONCLUSION

This study investigates the effect of prior adverse professional experience of senior financial executives on financial reporting. Our results suggest that accounting-related adverse events (i.e., class-action, accounting, and financial reporting-related litigation; receipt of an AAER; or income-decreasing restatements) experienced by financial executives during their professional careers have a meaningful effect on subsequent financial reporting attributes. Specifically, we observe higher levels of unconditional accounting conservatism, a lower likelihood of future accounting-related adverse events, and less positive accruals discretion for firms led by senior financial executives who have experienced a significant accounting-related adverse event at another firm during their career. We find that adverse experience has a stronger

³² Prior studies using BoardEx data acknowledge that the quality of BoardEx coverage has significantly improved over time, especially after 2000 (e.g., [Chu and Davis 2016](#); [Engelberg, Gao, and Parsons 2013](#); [Liu 2014](#); [Khanna, Kim, and Lu 2015](#); [Brochet, Miller, and Srinivasan 2014](#)). In a firm-year unit of analysis, if the BoardEx employment history file fails to identify a manager's prior employment at a troubled firm, our identification strategy would treat such a manager (who indeed has witnessed an adverse event, but is not included in BoardEx due to lack of coverage in early years) as a manager without adverse experience and would bias against finding a result.

³³ To construct a sample for the executive-firm-year unit of analysis, we identify all senior financial executives (e.g., CEO, CFO, Chief Accounting Officer, Controller, Treasurer, VP-Finance, etc.) using the BoardEx senior management employment history file. Our source file contains 26,405 financial executives at 7,536 unique firms (on average, about four unique financial executives per firm) during our sample period. Next, we merge the identified senior financial executives with the firm-level measures of financial reporting metrics and most of the control variables. In this finer specification, age, gender, and accounting education can be measured at the executive level, rather than a firm-level average. However, due to the limitation in compensation coverage, compensation incentives (i.e., *CASH COMP*, *COMP DELTA*, and *COMP VEGA*) are measured at the C-suite level, and overconfidence measures are necessarily at the CEO or firm level, consistent with related research. Effectively, the final sample is the intersection of BoardEx, Compustat, CRSP, and Execucomp, provided relevant variables are available. Our final sample of the executive-firm-year unit of analysis is about 2.4 times the firm-year unit sample, anecdotally suggesting that, on average, we have complete data coverage of at least two financial executives per firm-year.

effect when the manager has experienced multiple events or when the event has occurred recently. We also find that the effect of prior experience is stronger when the event is followed by a lateral or downward career move or when the executive held a role that is closer to financial reporting decisions at the time of the event. We emphasize that, although our results are consistent with adaptive learning (the hot stove effect) and imprinting theory, our tests do not provide direct evidence that isolates a specific channel through which adverse experience can affect financial reporting.

Our study provides novel evidence that an executive's prior professional experience has an effect on subsequent financial reporting. Although [Bertrand and Schoar \(2003\)](#) note that the effects of professional experience on firm policies are interesting to study, there is not much empirical evidence examining this important characteristic of executives. Our study helps fill this void. Second, we provide a view from an accounting angle to contribute to recent debates on whether adverse events induce corporate executives toward more aggressive or more conservative policies ([Schoar and Zuo 2017](#); [Bernile et al. 2017](#)). Unlike prior studies that use general distress events (i.e., natural disasters or macroeconomic conditions during early life), we focus on adverse events that are relevant to accounting policies during a financial executive's professional career and examine the implications on subsequent conservative financial reporting. In doing so, we shed additional light on the extent to which adverse experience affects managerial behavior.

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APPENDIX A

| Variable | Definition |
|---------------------------------|---|
| Main variables: | |
| <i>ADVERSE EXP</i> | Equals 1 if the firm is led by a manager with accounting-related adverse experience during the current fiscal year (see Section III for details), 0 otherwise |
| <i>CON-ACCUAL</i> | Givoly and Hayn (2000) persistent usage of negative accruals, calculated by $(IB - OANCF + DP)$, scaled by average total assets, and multiplied by -1 . Higher values represent greater unconditional accounting conservatism. |
| <i>FUTURE ADVERSE</i> | Equals 1 if the firm experiences an accounting-related adverse event in the next five years (year $t+1$ to $t+5$). For the adverse events, refer to Section III for details |
| <i>DAC</i> | Signed abnormal discretionary accruals, calculated per Larcker, Richardson, and Tuna (2007) |
| Controls: | |
| <i>MTB</i> | Market-to-book value of equity, calculated as $(PRCC_F \times CSHO)/CEQ$ |
| <i>LEV</i> | Short-term and long-term debt divided by total assets, calculated as $(DLTT + DLC)/AT$ |
| <i>SIZE</i> | Natural log of total assets (AT) |
| <i>ROA</i> | Pretax book income divided by total assets (PI/AT) |
| <i>RETURN</i> | Change in the market value of equity plus dividends, divided by lagged market value of equity |
| <i>LITIGATION</i> | Kim and Skinner (2012) SUED measure, estimated using coefficients from their Table 7, column (2) |
| <i>DEFAULT</i> | Bharath and Shumway (2008) expected default frequency measure |
| <i>SALES GROWTH</i> | Percentage annual growth in total sales (SALE) |
| <i>R&D AD</i> | Total research and development expense (XRD) and advertising expense (XAD) divided by total assets (AT) |
| <i>CFO</i> | Cash flow from operations (OANCF) divided by average total assets |
| σ REVENUE | Standard deviation of the natural log of revenues from $t-5$ to $t-1$ |
| <i>AVG AGE</i> | Average age of senior financial executives covered in BoardEx |
| <i>FEMALE %</i> | Percentage of female senior financial executives |
| <i>ACCT EDU %</i> | Percentage of senior financial executives with an accounting education |
| <i>CASH COMP</i> | Natural logarithm of the portfolio cash of top-paid executives |
| <i>COMP DELTA</i> | Natural logarithm of the compensation delta of top-paid executives |
| <i>COMP VEGA</i> | Natural logarithm of the compensation vega of top-paid executives |
| <i>CEO OVERCONFIDENCE</i> | Indicator for overconfident CEO, per Ahmed and Duellman (2013) |
| <i>OVER INVEST</i> | Indicator for over-investment in capital assets, per Ahmed and Duellman (2013) |
| <i>OVER GROWTH</i> | Indicator for excess growth in sales, per Ahmed and Duellman (2013) |
| <i>DEBT FINANCING NEWS</i> | Indicator for news related to debt financing |
| <i>INVESTMENT NEWS</i> | Indicator for news related to investment and/or acquisition |
| Salience of adverse experience: | |
| <i>EXP FREQ</i> | A continuous measure capturing the frequency of prior accounting-related adverse experience, which equals the number of adverse events experienced by managers to date (we take the highest number if there is more than one manager), and 0 when no manager with prior accounting-related adverse experience is present |
| <i>EXP RECENCY</i> | A continuous measure capturing the recency of prior accounting-related adverse experience, which equals $1 \div \log(1 + \text{days since prior accounting-related adverse experience})$, and 0 when no manager with prior accounting-related adverse experience is present. We take the average number of days if there is more than one adverse event. |
| <i>UPWARD MOVE</i> | Equals 1 if the manager with adverse experience assumes a higher-ranked position at the new firm than the old firm, and 0 otherwise |
| <i>NO UPWARD MOVE</i> | Equals 1 if the manager with adverse experience assumes a similar-ranked or lower-ranked position at the new firm than the old firm, and 0 otherwise |
| <i>JUNIOR EXP</i> | Equals 1 if the current executive (e.g., CEO, CFO, or financial executive at the new firm) has prior accounting-related adverse experience as a junior employee or in a nonfinancial role at the prior firm |

(continued on next page)

APPENDIX A (continued)

| Variable | Definition |
|--------------------------------|--|
| Additional analysis variables: | |
| <i>FIRST ADVERSE HIRE</i> | Indicator for the first-time hiring of a manager with accounting-related adverse experience |
| <i>IND ADVERSE</i> | Total number of firms with accounting-related adverse experience in the same two-digit SIC industry |
| <i>MSA ADVERSE</i> | Total number of firms with accounting-related adverse experience in the same metropolitan statistical area |
| <i>STATE ADVERSE</i> | Total number of firms with accounting-related adverse experience in the same state |
| <i>EXEC TURNOVER</i> | Total number of financial executive turnover events in the past three years |
| <i>ADVERSE CONNECTION</i> | Total number of board interlocks to firms with accounting-related adverse experience as of the current year |
| <i>FIRM AGE</i> | Number of years since the first observation in Compustat |
| <i>VOLATILITY</i> | Abnormal stock-return volatility |
| <i>HIRING FIRM</i> | Equals 1 if the firm has hired a manager with accounting-related adverse experience at any point during the sample period |
| <i>POST</i> | Equals 1 for all fiscal years following the hiring of a manager with accounting-related adverse experience for treatment firms (as well as matched control firms) |
| <i>DEPARTURE</i> | Equals 1 for years when accounting-related adverse experience is absent in the senior management team after the first-time appointment of a manager with accounting-related adverse experience |

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