



# The consequences of managerial indiscretions: Sex, lies, and firm value<sup>☆</sup>

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## ABSTRACT

Personal managerial indiscretions are separate from a firm's business activities but provide information about the manager's integrity. Consequently, they could affect counter-parties' trust in the firm and the firm's value and operations. We find that companies of accused executives experience significant wealth deterioration, reduced operating margins, and lost business partners. Indiscretions are also associated with an increased probability of unrelated shareholder-initiated lawsuits, Department of Justice and Securities and Exchange Commission investigations, and managed earnings. Further, chief executive officers and boards face labor market consequences, including forced turnover, pay cuts, and lower shareholder votes at re-election. Indiscretions occur more often at poorly governed firms where disciplinary turnover is less likely.

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## 1. Introduction

In 2012, the *Wall Street Journal* (WSJ) reported that Scott Thompson, Yahoo! Inc.'s chief executive officer (CEO), lied about obtaining a computer science degree. In 2007, the WSJ reported that Chris Albrecht, the head of Time Warner's HBO unit, assaulted his girlfriend outside a Las Vegas, Nevada, casino following the Oscar De La Hoya versus Floyd Mayweather Jr. boxing match. These revelations no doubt were personally embarrassing to Mr. Thompson and Mr. Albrecht, but were they important for Yahoo! and Time Warner? Do these personal indiscretions imply firm-level consequences and are signals of personal integrity important for firm value?

Despite the simplicity of this question, strong a priori arguments exist for and against an affirmative answer. Prior research indicates that illegal or opportunistic behavior affects firm value only when it results in significant legal penalties or affects the firm's contracting with counterparties in an unanticipated manner. Personal indiscretions, however, are not generally associated with significant legal penalties to the firm. The lingering economic question then is whether personal indiscretions of managers affect the firm's reputation in ways that impact counterparty transactions. If they do, the implication is that private market forces work to discipline personal misconduct.

It is possible that there is no link between a manager's personal indiscretions and the firm's operations and business relationships. Previous research finds that environmental violations tend to result in substantial legal and regulatory costs, and that the revelation of an environmental violation is associated with a significant loss in share value, but not reputational losses (Jones and Rubin, 2001). Presumably, environmental infractions do not significantly impact the firm's counterparties, i.e., its customers, suppliers, employees, and investors (Karpoff et al., 2005). Other examples of misconduct that do not correspond to reputational losses are minor regulatory violations and foreign bribery (Murphy et al., 2009; Alexander, 1999; Cheung et al., 2012; Karpoff et al., 2015). In this regard, personal indiscretions could be similar to environmental violations or foreign bribery, in that they do not affect contracting with counterparties (i.e., no reputational effect). Thus, the contention that a manager's personal life has no effect on firm operations and firm value is entirely plausible. We term this the separate affairs hypothesis.

In contrast, some argue that there is spillover from a manager's personal indiscretions to job performance and firm value, which we term the integrated affairs hypothesis. The theoretical links for spillover effects are reputational losses to the manager and the related impact on counterparty transactions. Erhard and Jensen (2014) and Erhard et al. (2014) argue that management's reputation for integrity is a factor of production. To the extent that these personal indiscretions signal low integrity, their revelation can impact the firm.<sup>1</sup>

Consider four potential sub channels for this impact. First, personal managerial guarantees can be important to the formation of profitable business relationships. Johnson et al. (2015), Cen et al. (2015), and Cremers et al. (2014) focus on how takeover defenses support such personal guarantees. Personal misconduct plausibly undermines the credibility of implicit and explicit agreements with strategic partners, employees, suppliers, customers, and owners of financial capital. A joint venture partner, for example, could decide to back out of a deal to co-locate a manufacturing facility if it infers that the cheating manager is more likely to act opportunistically. The indiscretion manager's firm would lose business, creating a reputational cost.

Second, and related, the managerial indiscretion could increase the probability that the manager will be replaced, putting any implicit guarantees of the manager in jeopardy. As Shleifer and Summers (1988) argue, the business relationship between two firms is bonded in part by the manager's personal guarantees. If the manager leaves, that bond disappears and the exposed counterparty could be less willing to conduct business with the company.

Third, the indiscretion could signal a shift in the firm's culture to one that now implicitly condones opportunistic behavior. The likelihood of engaging in questionable behavior should decline with the manager's expected costs from being caught, costs that increase with enforcement actions by the firm. Thus, a firm's counterparty could infer from a managerial indiscretion that the firm does not penalize opportunistic behavior as strictly as previously anticipated and reevaluate its business relationship with the company.

Fourth, the managerial indiscretion could reveal an increased likelihood that the managers are willing to sacrifice long-term relationships for short-term gains. The models of Shapiro (1983) and Klein and Leffler (1981) suggest that firms do not cheat their counterparties in equilibrium. An unexpected change in the costs and benefits of cheating, however, can make the benefits of short-term cheating increase relative to the long-term costs. Therefore, a managerial indiscretion could indicate the manager's benefits of cheating are higher than previously anticipated.

We argue that the revelation of an executive's personal indiscretion serves as a proxy for his lack of personal integrity and signals the value he places on his reputation. Under the integrated affairs hypothesis, this revelation decreases counterparty trust in the manager and the firm, which subsequently affects corporate relationships. Firm value is lowered either because a loss of trust damages the firm's relationships with strategic partners, financiers, and other stakeholders or because the indiscretion imposes direct costs as the firm adjusts to minimize the damage.

The importance of personal integrity to firm value has received little empirical attention. One reason for this is the difficulty in measuring the impact of integrity. Identifying executives with low integrity before corporate misdeeds are committed is challenging. In addition, measurements of losses around bad corporate behavior are intertwined with the impact of the acts themselves. An important literature focuses on allegations of fraud, shareholder lawsuits, and earnings management, and a general presumption is that executives committing these acts have

<sup>1</sup> Spanos and Angelis (2016) summarize evidence that suggests that even events such as information systems security breaches can engender a lack of trust at certain companies.

low integrity.<sup>2</sup> In that literature, the research design defines integrity by the malfeasance, making it difficult to establish a separate market reaction to the personal trait. For example, a firm typically sustains a loss in value when fraud is announced but it is difficult to know how much of the market reaction is due to a realization of low managerial integrity, the lack of firm-wide controls for misdeeds, the fraud itself, or its consequences. Moreover, we do not know the propensity for low integrity executives to commit subsequent corporate misdeeds or if personal misdeeds concern their business partners, boards, or shareholders.<sup>3</sup>

A related stream of research addresses the relevance of the tone at the top within the organization. A recent survey of CEOs and chief financial officers (CFOs) by [Graham et al. \(2016\)](#) indicates that senior management's behavior is a primary influence on corporate culture, with 85% of respondents stating that a poor culture elicits unethical or illegal activity within the organization. Consistent with these beliefs, studies by [Davidson et al. \(2015\)](#) and [Biggerstaff et al. \(2015\)](#) provide advances in linking integrity at the corporate level with other misdeeds.

[Davidson et al. \(2015\)](#) find that firms accused of fraud are more likely to employ executives who surround themselves with expensive luxury goods or have past legal infractions such as traffic violations. These firms are also more likely to just meet or beat analysts' forecasts. [Biggerstaff et al. \(2015\)](#) find that CEOs attempting to pad their pay packages from the backdating of options are also more likely to engage in other corporate transgressions. These studies suggest that executives engaging in serious corporate misdeeds could act unethically in other ways. However, the identification of integrity is revealed through a significant and subsequent corporate event (fraud or backdated options) and the product, financial, labor market, and counterparty consequences to signals of personal integrity are not examined. In addition, backward identification (implying integrity from a firm-specific event) does not reveal whether the general population of low integrity executives is more likely to commit corporate offenses, as the identification is conditioned on illicit corporate behavior.

In contrast to using corporate events, we identify low integrity executives as those accused of personal indiscretions, including allegations of dishonesty, substance abuse, sexual misadventure, or violence. Our sample consists of 219 unique indiscretions and 106 related observations. These personal indiscretions are, by construction, distinct from the operations of the firm, thereby permitting us to examine market reactions to the indiscretion separate from

the reaction to the corporate malfeasance utilized in other identification strategies.<sup>4</sup>

We explore several research questions regarding the importance of a manager's personal integrity and its impact on firm value and performance. First, is there a financial market response that signals damage to the company's reputation following a personal indiscretion? Second, are there consequences in the product markets to these reputational losses? For example, the firm of an indiscretion executive could find it more difficult to maintain strategic partnerships or establish and maintain new stakeholder relationships. Third, do managerial indiscretions signal that accused executives are willing to abrogate contracts or act opportunistically? Low integrity executives could be more willing to defraud their business or financial partners, engage in conduct that becomes the target of litigation, or manipulate corporate earnings. Fourth, what are the labor market consequences to this behavior for the indiscretion managers or their monitors?

We find that announcements of managerial indiscretions are associated with a significant decline in firm value and operating performance. At the revelation of an indiscretion, there is an immediate 1.6% loss in shareholder value, which translates into an average loss of \$110 million in market capitalization. When committed by the CEO, the loss in shareholder value is 4.1% or \$226 million. The magnitude of the stock market losses suggests that investors react to more than just the monetary penalties associated with these events. Losses around the announcement of the indiscretion are consistent with at least two explanations encompassing: (1) the expected litigation, opportunity costs, or severance costs that arise as a direct result of the event and (2) the market value (reputational) adjustments to signals of low integrity. Following [Karpoff and Lott \(1993\)](#), we decompose the investor reactions into the components that reflect the direct monetary costs to shareholders and those that represent reputational damage.

To examine the channels through which the personal affairs of managers could be integrated into firm value, we examine changes in counterparty relationships in the firm's product markets. The prediction of the integrated affairs hypothesis is a decline in counterparty trust and deterioration of inter-firm relationships, as others are less willing to conduct business with a low integrity executive. Consistent with this, CEO indiscretions are associated with a significant decline in the acquisition of new major customers and joint venture partnerships, and CEO reputational costs are negatively and significantly related to the likelihood of obtaining a new major customer. Our results also indicate that operating performance suffers, as there is an abnormal decline in profit margin and return on assets

<sup>2</sup> For example, [Karpoff et al. \(2008\)](#) show that the market punishes firms indicted for corporate fraud well in excess of the stated legal penalty. [Fich and Shivdasani \(2007\)](#), along with [Gande and Lewis \(2009\)](#), study the incidence and impact of shareholder initiated class action lawsuits. [DuCharme et al. \(2004\)](#) and [Teoh et al. \(1998\)](#) examine the impact of earnings management on shareholder wealth.

<sup>3</sup> We examine a pool of executives exhibiting signals of low integrity. For ease of exposition, we use the phrase "low integrity executive."

<sup>4</sup> In addition, the 219 misdeeds in our sample are (arguably) more serious than those in [Davidson et al. \(2015\)](#). Twenty-one of their 37 observations are traffic violations. While many people have committed traffic violations, far fewer individuals have been accused of dishonesty, domestic violence, sexual misadventure, and drug charges. This is not to criticize [Davidson et al. \(2015\)](#). We are just pointing out differences in the analyses. A very interesting aspect of their study is that they find significant differences in non-fraud and fraud firms on a characteristic as simple as speeding tickets.

(ROA). We further find evidence that indiscretion managers exhibit a willingness to expropriate stakeholders. Firms of indiscretion executives are significantly more likely to manipulate earnings or commit unrelated malfeasance that becomes the target of shareholder class action lawsuits or Department of Justice (DOJ) and Securities and Exchange Commission (SEC) fraud charges. Our results suggest that much of the effects we observe are attributable to reputational damage.

Finally, the labor market exhibits a meaningful response to the indiscretion disclosures in our sample. CEOs are disciplined for their personal missteps, particularly for those indiscretions imposing large stock price hits or reputational damage. The risk of turnover increases substantially for CEOs committing indiscretions, as the probability of CEO turnover rises by 41% following an indiscretion. Boards impose financial discipline on the surviving CEOs, who see an average drop in salary and bonus of around \$400,000. In keeping with prior work on directors' career concerns (Cai et al., 2009), we find that corporate directors at indiscretion firms lose a small but significant percentage of shareholder votes. The magnitude is comparable to that observed when the firm is targeted by litigation. The effect is heightened for indiscretions committed by a member of the board. The loss in shareholder support is primarily related to the reputational damage associated with the indiscretion.

Our research is related to two streams of literature. The first examines the importance of top management as a factor of production. Existing work shows the role top management teams play in either creating or destroying shareholder value (e.g., Fama and Jensen, 1983; Lang et al., 1989). The second studies the importance of reputation and trust in economic exchange (Blau, 1964; Tirole, 1996; Jones and Rubin, 2001; Karpoff et al., 2005, 2008). Mutual trust between two economic agents can reduce transaction costs if it mitigates the need for excessive contracting (Williamson (1975)). Because not all outcomes are contractible, the consequences of managerial indiscretions can be substantial. Our work sheds additional light on the question of how trust facilitates contracting, production, and exchange. While these two areas of literature typically focus on activities at the corporate level, our paper contributes by showing the link between nonbusiness activities, integrity, and firm value. As far as we know, our paper is the first to examine shareholder wealth effects surrounding ex ante signals of low integrity revealed in an executive's personal life and how these signals impact corporate relationships in the product markets.

## 2. Hypotheses development

### 2.1. Separate affairs hypothesis

The literature investigating the importance of an executive to the firm concentrates on technical skills and experience (Rosen, 1981; Bertrand and Schoar, 2003). If these are the only relevant factors, then pure managerial talent is the dominating force in an executive's contribution to the company and managerial indiscretions are immaterial for firm value. Viewed this way, managers are able to com-

pletely separate their personal and professional lives and only their raw abilities matter.

Kaplan et al. (2012) support the notion that only talent is relevant to firm value. Using a detailed sample of CEO ability and personality assessments from an executive search company employed by private equity firms, they find that venture capital and leveraged buyout clients value the hard abilities of potential managers and that only quantitative skills impact the success of a private equity deal. Soft skills, such as personal integrity or team-working ability, do not appear to improve performance and could even negatively affect outcomes. Brown et al. (2012) also find evidence consistent with the separate affairs hypothesis in the private equity industry. Even when hedge funds are not forthcoming about past legal infractions, investors are not dissuaded from chasing the highest returning funds. Frank and Goyal (2007) find that while compensation packages and education significantly explain the firm's capital structure, other personal traits exhibit no relation. These results imply that firm value is dependent largely on the skills and talents each executive brings to the firm.

Auditing standards explicitly exclude personal executive indiscretions in the analysis of noncompliance with laws and regulations. For example, guidelines by the American Institute of Certified Public Accountants state:

"Noncompliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management, or employees of the entity."<sup>5</sup> Also "[i]llegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities."<sup>6</sup>

Our first hypothesis asserts that no spillover effects exist from personal to corporate actions. Implicit is the assumption that signals of low integrity do not imply professional misbehavior.

*Hypothesis 1. (Separate affairs hypothesis). Personal managerial indiscretions have no bearing on firm value or performance.*

### 2.2. Integrated affairs hypothesis

In contrast are arguments suggesting that personal indiscretions do impact firm value and performance. The indiscretion can disrupt and distract the executive from optimal performance and create associated morale problems within the firm. In the Becker (1965) model, managers allocate time in a utility-maximizing manner and tradeoff labor for productive outcomes with the rewards from private life activities. Thus, managerial indiscretions can adversely affect firm performance as the executive reallocates time to private life activities and away from more productive endeavors at the firm. Also, boards often fire managers and a scandal increases the chance of dismissal (Ertugrul and Krishnan, 2011). The potential or actual dismissal of any

<sup>5</sup> See AU-C Section 250, Consideration of Laws and Regulations in an Audit of Financial Statements, paragraph 11.

<sup>6</sup> See AU Section 317, Illegal Acts by Clients, paragraph 2.



executive following an indiscretion can disrupt the firm's ongoing operations.

However, the primary channel through which personal indiscretions are likely to impact firm value stems from the importance of reputation and trust in economic exchange (Blau, 1964; Tirole, 1996). Tirole (1996) notes the importance of reputation and trust due to the inability to write complete contracts. Fukuyama (1995) describes trust as the set of reciprocal moral habits and obligations that are internalized, thereby reducing the propensity for wealth expropriation. As such, trust among agents can serve as an intermediary when unexpected issues arise, incentivizing individuals and corporations to engage in exchanges that would not otherwise occur.

Shapiro (1983) argues that firm value depends on counterparty trust and that establishing a reputation for fair dealing is a costly signal. Supporting empirical evidence indicates that firm value declines when trust is violated at the corporate level (e.g., Murphy et al., 2009; Karpoff et al., 2015). A number of other papers posit that managers' personal characteristics play an important role in establishing counterparty trust (e.g., Klein and Leffler, 1981; Shleifer and Summers, 1988), but little direct evidence shows that this is true. At least some existing empirical work suggests that such concerns are superfluous and only the raw managerial talent matters to investors (Kaplan et al., 2012; Brown et al., 2012).

Executives who commit indiscretions choose to place themselves in the potentially distracting situation, and this insight into their personal utility function reflects upon their character. Indiscretions can credibly signal that the executive does not highly value their reputation. Erhard and Jensen (2014) and Erhard et al. (2014) argue that managerial integrity is a necessary factor of production. As the integrity of management becomes impaired, organizational performance suffers.<sup>7</sup>

Implicit in these statements is the assumption that personal indiscretions are correlated with a manager's willingness to act opportunistically or to abrogate implicit contracts. A firm's profit stream can rely on its (and its managers') reputational capital, as the price a firm is able to charge and the likelihood of repeated or future business are functions of this capital (Shapiro, 1983; Klein and Leffler, 1981; Karpoff and Lott, 1993). Thus, firm value depends on how much the firm's counterparties (i.e., customers, investors, employees, suppliers) trust the firm not to cheat them. Shleifer and Summers (1988), along with recent work by Cen et al. (2015), Johnson et al. (2015), and Cremers et al. (2015), use this idea to show that shareholders benefit from stable, long-term relationships.

The integrated affairs hypothesis holds that personal indiscretions matter because the firm's counterparties are

less willing to do business with the firm if they believe their expected costs have increased. This could result from an expectation of being cheated or an expectation that the firm will not fulfill some explicit or implicit agreement. As a result, investors anticipate that this reassessment will lead to declines in operating performance and firm value suffers. In this scenario, contracts and controls become substitutes for trust and additional transaction costs are incurred (Williamson, 1975). Empirical research shows that a lack of trust among economic agents can result in severe penalties in the marketplace (Atanasov et al., 2012; Bauer and Braun, 2010; Chemmanur and Paeglis, 2005; Karpoff et al., 2008; Yermack, 2006). Although each of these studies examines business-related activities and not personal indiscretions, the implication is that negative signals regarding the character and integrity of management adversely affect firm value.

Graham et al. (2016) report that an overwhelming majority (76%) of CEOs and CFOs surveyed indicated that trust was a key factor in determining the effectiveness of culture. Over 50% of these same executives stated they would not acquire another firm at any price if the target company did not have an effective culture. This evidence is consistent with Murphy et al. (2009), who find that product market discipline is most severe in the wake of related-party financial misconduct. It is also consistent with Karpoff et al. (2008), who find that the reputational penalties for fraud are increasing in the firm's dependence upon implicit contracts. If managerial indiscretions signal a duplicitous manager, then these allegations should lead to a decline in counterparty trust and difficulty in obtaining and maintaining meaningful business relationships.

Anecdotal evidence also suggests that personal reputation impacts firm value. Stephen McClellan, a 32-year Wall Street veteran and 19-year *Institutional Investor* All-American analyst notes that:

“a critical part of the investment appraisal and company evaluation process is gauging management effectiveness, quality, *character*, and *values*. I am put off by executives with a litany of ex-wives, messy public divorces, marriages to bimbos, visits to strip clubs, [or] heavy drinking.” (McClellan, 2008), emphasis added.<sup>8</sup>

*Hypothesis 2. (Integrated affairs hypothesis). Personal indiscretions are associated with losses in firm value, operating performance, and strategic partnerships or stakeholder relationships.*

<sup>7</sup> The authors utilize the analogy of removing spokes from a wheel to demonstrate the impairment of integrity. A complete wheel does not guarantee a fast bike, but the removal of spokes from the wheel impairs the performance of such a machine. An organization in which top management does not maintain integrity, i.e., keeps its word, will not achieve its full potential in the context of its employees, suppliers, or customers due to a lack of trust among agents. Such an environment would require excessive contracting and high residual losses.

<sup>8</sup> Similarly, when Veritas Software Corp. disclosed that its CFO, Ken Lonchar, falsified his personal credentials, immediate concern arose in the marketplace for the firm itself. Merrill Lynch analyst Scott Phillips downgraded Veritas after the Lonchar disclosure. “Our first concern is that the CFO's falsification of his educational credentials could suggest the financials are suspect” (Reuters News Service, 2002). In another example, Maryland U.S. attorney Thomas DiBiagio noted during the prosecution of alleged corporate looter, Nathan Chapman, that “if their life is a lie, it's not confined to their personal life. If they are lying to their wives, there's huge potential they are also lying to their colleagues, their board of directors and potentially their auditors” (USA Today, 2004).

### 2.3. Shady firm–shady manager optimality

CEO selection is not an exogenous process, but rather a choice conditioned on the industry characteristics in which the firm resides (Datta and Rajagopalan, 1998). Executives charged with corrupt acts at their firms often claim they were striving to maximize firm value.<sup>9</sup> Some firms could believe that hiring a shady manager is optimal because of the nature of their business. For example, Mironov (2015) finds that firms with criminally inclined CEOs outperform their more honest counterparts in corrupt environments. Thus, a penchant for duplicitous behavior could be viewed as an asset in certain shady industries. Some types of firms could, or likely, purposefully hire shady managers and optimally have a high likelihood of restatements, lawsuits, or SEC actions. Hence, the observation that personal indiscretions are associated with corporate offenses is also consistent with some firms viewing hiring shady managers as optimal. In our sensitivity tests we are careful to recognize and explore this possibility.

## 3. Data

### 3.1. Sample construction

To test our hypotheses, we construct a sample of managerial indiscretions and a control sample. The first is a sample of alleged offenses in the personal environments of executives, occurring between 1978 and 2012. We identify the cases using targeted search strings in the Factiva, LexisNexis, and ProQuest news retrieval services.<sup>10</sup> The announcement date is the date of the first news article mentioning the event. The sample is arranged along four categories of indiscretions: sexual misadventure, substance abuse, violence, and dishonesty. Sexual misadventure refers to extramarital affairs, senior-subordinate inter-office romances, accusations of sexual harassment, and the like. Substance abuse cases are arrests for driving under the influence (DUI), illicit drug use, etc. Violence refers to instances of domestic violence, sexual battery, rape, or assault.<sup>11</sup> Dishonesty cases include falsifying credentials, perjury, and plagiarism. Typical examples of each of these indiscretion types are provided in Table 1.<sup>12</sup>

<sup>9</sup> See Bartov et al. (2002) and Murphy et al. (2011) for the ex ante shareholder wealth motivations for earnings management or malfeasance.

<sup>10</sup> The following is an example LexisNexis search string that searches for dishonesty: (CEO OR COO OR CFO OR executive OR president OR chairman OR director) w/p (lied OR lie OR credentials OR resume OR dishonest OR plagiarism OR falsification OR falsified OR padded resume OR lied on resume).

<sup>11</sup> Some violence acts, such as sexual battery or rape, can also be classified as sexual misadventure. The distinction is made here because these cases are criminal in nature as opposed to the strictly personal or civil complaints involved in the misadventure category.

<sup>12</sup> Indiscretions are categorized according to the primary offending action, but some instances involve multiple indiscretion types (e.g., violence resulting from substance abuse). Twenty-six indiscretions involve two categories and three involve three categories, but many of these had a clear dominant categorization. Out of the 325 sample observations, 16 observations (11 primary firm and five secondary firm) required some judgment regarding classification category. A common example among these 16 cases is an extramarital affair in which violence or drug use was also

Sexual misadventure and dishonesty allegations represent the breaking of explicit or implicit agreements in the executive's personal or professional environment, and substance abuse and violence are violations of the executive's legal obligations. All of these activities are tangential to the operating and financial decisions of the firm and to the normal business-related activities of the executive. Items such as fraud, embezzlement, excessive perks or pay, and securities violations, which also can signal the integrity of the executive, are excluded as they could be undertaken to further the goals of the organization and can have an ambiguous impact on future performance. Moreover, each of these business-related activities is likely to be associated with wealth changes to the firm regardless of the impact of managerial integrity because they present tangible losses in cash flow or increases in risk.

We identify 437 potential indiscretion observations involving C-level executives [CEO, chief operating officer (COO), CFO], division heads, vice presidents, or board members. After screening for complete data, we retain a final sample of 219 distinct indiscretions involving 195 unique executives (a handful are within-sample repeat offenders).<sup>13</sup> Because the executives in our sample frequently have positions at multiple firms (e.g., a CEO with an outside directorship), we have a total of 325 unique executive-firm-year observations, which are summarized in Table 2, Panel A. The existence of multiple roles for some of our executives introduces within-indiscretion variation that allows us to further examine the importance of certain firm-specific characteristics (e.g., executive title, method of disclosure, founder status). Out of the 325 observations, we classify 219 as primary firm and 106 as secondary firm observations to indicate the executive's principal place of employment. Our paper's conclusions are unaffected if we restrict the analysis to the 219 primary firm observations.

### 3.2. Sample characteristics

We detail the incidence of indiscretion types in Panel B of Table 2. About 47% of the indiscretions (153 of 325) involve sexual misadventure. Dishonesty accounts for 33% of the observations, and substance abuse and violence account for 11% and 9%, respectively. Panel C reveals the initial source of public information about the alleged indiscretion. About 22% of our observations are disclosed through press releases by the executive's firm, and the

alleged. For these cases, we classify each as sexual misadventure. All tests were reexamined with these observations removed and using the alternative classifications for these observations. The results are qualitatively unchanged and are reported in Online Appendix Tables OA 1 and OA 2.

<sup>13</sup> Sixty-two observations were excluded because insufficient information exists to substantiate the alleged indiscretion for our analysis (e.g., no specific date from the news stories, details of the case are unclear, etc.). Eighteen were excluded because the executive was no longer at the firm when the event was reported (e.g., Thrifty Payless was spun-off from K-Mart in the midst of an alleged affair involving Thrifty's CEO). Six observations were excluded because they were not completely unrelated to company business. Fourteen were eliminated because the company was not yet publicly traded at the time of the announcement. The remaining 12 were excluded because they had insufficient information on Center for Research on Securities Prices (CRSP) and Compustat to conduct our primary tests.

**Table 1**

Examples of alleged managerial indiscretions.

Executive	Company	Title	Notes	Media citation
Sexual misadventure: Mark V. Hurd	Hewlett Packard Co.	Chairman, chief executive officer (CEO), and president	Dismissed for allegedly harassing Hewlett Packard contract employee and violations of the company's standards of business conduct. Hurd admits to not living up to "standards and principles of trust" upon termination.	"HP CEO Mark Hurd resigns amid sexual harassment probe," <i>Forbes.com</i> (8/6/2010)
Mossimo Giannulli	Mossimo Inc.	Chairman of the board	Accused of creating a "severe, pervasive, sexually hostile work environment" and of wrongful termination in retaliation for complaints.	"Former worker accuses Mossimo fashion executives of sexual harassment," <i>Knight Ridder Tribune Business News</i> (1/25/2000)
David C. Colby	Wellpoint Inc.	Executive vice president (EVP), chief financial officer (CFO), and vice chairman	Accused of orchestrating numerous, simultaneous affairs (at least one with a Wellpoint employee). An internal probe deemed the actions a violation of the company's code of conduct.	"WellPoint finds itself embroiled in private drama—ex-finance chief's web of multiple romances entangles health giant," <i>Wall Street Journal</i> (6/12/2007)
Substance abuse: William D. Parker	US Airways Group Inc.	Chairman and CEO	Arrested for driving under the influence (DUI) while leaving the FBR Open golf tournament just hours after failed merger bid for Delta.	"US Airways CEO admits 2 prior DUI convictions: Parker says he was in his 20s at time, makes apology," <i>McClatchy Tribune Business News</i> (2/10/2007)
Peter H. Coors	Molson Coors Brewing Co.	Chairman	Cited for DUI and failure to observe a traffic control device.	"Pete Coors is issued a charge of DUI," <i>Wall Street Journal</i> (7/14/2006)
Dale M. Gibbons	Zions Bancorporation	EVP and CFO	Arrested for charges of drug possession and child abuse. Salt Lake County Sheriff's office investigations revealed significant quantities of methamphetamine at his home and his 15-year old daughter intoxicated and comatose.	"CFO of parent company arrested," <i>Las Vegas Sun</i> (6/22/2001)
Violence: Herbert H. Haft	Dart Group Corp.	Chairman and CEO	Wife alleges domestic violence and numerous affairs in divorce filing.	"Hafts take fight to divorce court; wife alleges physical, verbal, financial abuse in separation filing," <i>Washington Post</i> (08/11/1993)
Charles E. Johnson	Franklin Resources Inc.	President	Charged with misdemeanor domestic violence battery, felony false imprisonment, and misdemeanor child endangerment. Allegedly beat his wife in front of his children.	"Franklin Resources exec charged with beating wife in Hillsborough," <i>Associated Press Newswires</i> (10/2/2002)
Patrick J. Naughton	Infoseek Corp.	Executive vice president products	Attempted to solicit an undercover Federal Bureau of Investigation agent posing as a 13-year old girl. Infoseek was Disney's partner in the Go.com Internet portal at the time.	"Infoseek executive, due for Disney post, charged with luring minor on Internet," <i>Wall Street Journal</i> (9/20/1999)
Dishonesty: Scott Thompson	Yahoo! Inc.	CEO, president, and director	Falsely claimed to possess a computer science degree from Stonehill College. Does hold an accounting degree.	"Yahoo cites 'Inadvertent Error' in CEO academic record," <i>Wall Street Journal</i> (5/4/2012)
James J. Minder	Smith & Wesson Holding Corp.	Chairman of board	Failed to disclose 15-year term in prison for armed robbery.	"Smith & Wesson chief quits over crime," <i>CNNMoney.com</i> (2/27/2004)
Kenneth E. Lonchar	Veritas Software Corp.	Executive vice president and CFO	Claimed unearned master of business administration degree from Stanford University.	"Veritas says books are clean, even if CFO's past muddled," <i>Dow Jones News Service</i> (10/3/2002)

remainders are revealed through legal filings (37%) and media reports (41%). Insider whistleblowing appears unlikely for the vast majority of our observations as they involve public announcements arising from criminal actions, such as substance abuse and violence, or sexual misadventure announced through legal actions. In unreported re-

sults, we find that only 4% of our sample observations result from an internal tip or company investigation.

Panel D shows the roles of the 195 unique executives accused of indiscretions. At their primary firms, about 11% are directors only, 46% are CEOs, and the remaining 43% are other subordinate executives (i.e., other C-level officers

**Table 2**

Sample constitution and indiscretion executive characteristics.

This table presents the composition of our 325 sample observations from 1978 to 2012. Panel A reports the number of observations by executive identity and their role at the sample firms. *Number of executives* indicates unique executives, and *number of indiscretions* and *primary firm observations* indicates the number of unique events. Some sample executives hold multiple offices at different firms. We identify their *primary firm* as the place of primary employment and the *secondary firm* as the office of any ancillary appointment. Panel B itemizes the sample observations by indiscretion type. *Sexual misadventure* refers to noncriminal illicit sexual activity, *substance abuse* represents cases of drug or alcohol abuse, *Violence* reflects cases of battery or criminal sexual violence, and *dishonesty* represents cases of public dishonesty, such as plagiarism or résumé fraud. More thorough descriptions of each indiscretion is provided in the text. Panel C shows the method of disclosure. *Company press release* indicates a company-revealed indiscretion. *Legal filing* indicates that a major legal filing publicized the disclosure. *Media report* notes cases in which the media discovers indiscretion. Panel D details the title held by the executive. *Director* indicates the executive's only role at the firm is that of chairman of the board or a corporate director. For corporate officers, these titles are further disaggregated by whether the executive is either the company's CEO or a *subordinate executive* holding some other title at the company (president, chief financial officer, chief operating officer, division head, etc.). *Founding family executive* indicates the indiscretion executive is a member of the founding family. Panel E describes the type of executives involved in the 219 sample primary firm indiscretions as well as the outcome of each event for the executive. Proportions are provided for the subset of observations with complete data. *Age* and *male* indicate the age and gender of the offending executive. *Repeat offender* indicates that the executive has been accused of another indiscretion in the past. *Executive turnover* indicates whether the executive leaves the firm within 30 days of the first disclosure of the indiscretion. Panel F reports the direct costs resulting from the managerial indiscretions. *Corporate lawsuit* and *material legal expenses* indicate the proportion of the 325 observations that involve a lawsuit or an associated legal expense (legal defense fees, settlement, etc.). *Corporate settlement* indicates that there is some form of corporate settlement even if it is not material enough to be disclosed. *Legal fees* or *settlement disclosed* is the proportion of observations in which the firm discloses the legal expenses relating to the indiscretion. *Legal expense amount* is the dollar amount of settlements or legal fees for those cases in which it is disclosed. *Opportunity costs* can be measured in 65 cases and include time away from work for the company, *Training or rehab* for substance abuse, lost hours due to a *suspension* or other time *out of work*, time spent in *jail or court* defending or serving time for the indiscretion. *Opportunity cost (in days)* and *opportunity cost (amount)* reflect the number of days and value lost due to the indiscretion. In 32 cases, there is a *severance* package paid to the executive at turnover and this is reported in *severance amount*. *Fired for cause* indicates the cases in which the executive is officially fired "for cause" as opposed to just tendering their resignation. *Forfeiture of pay* indicates the executive lost pay either by clawbacks, forfeiture of unvested stock and options, or loss of bonuses, and *forfeiture of pay amount* details the dollar amount lost. *Disruption costs* add up the dollar value of the litigation expenses, opportunity costs, severance packages, and any other direct costs associated with the indiscretion, while *disruption costs to sales* normalizes this figure by firm net revenues. *Reputational costs* equal the abnormal market value loss at the announcement, as determined by the  $(-1, +1)$  cumulative abnormal return (CAR) times the pre-event market value of equity, minus the total disruption costs. *Reputational costs to sales* normalize this figure by firm net revenues. All reported values are winsorized at the 1st and 99th percentiles.

Panel A: Frequency of sample observations				
Category	Number of executives	Number of indiscretions and primary firm observations	Secondary firm observations	Total observations
In-sample single offenders with one role	124	124	0	124
In-sample single offenders with multiple roles	54	54	87	141
In-sample repeat offenders with one role	10	24	0	24
In-sample repeat offenders with multiple roles	7	17	19	36
Total	195	219	106	325
Panel B: Frequency by indiscretion type				
Type of indiscretion	Executives		Primary and secondary observations	
	Number	Percentage	Number	Percentage
Sexual misadventure	92	47.2	153	47.1
Substance abuse	17	8.7	35	10.8
Violence	13	6.7	29	8.9
Dishonesty	73	37.4	108	33.2
Total	195	100.0	325	100.0
Panel C: Initial source of disclosure				
Type of indiscretion	Executives		Primary and secondary observations	
	Number	Percentage	Number	Percentage
Company press release	49	25.1	72	22.2
Legal filing	73	37.4	121	37.2
Media report	73	37.4	132	40.6
Total	195	100.0	325	100.0

(continued on next page)



**Table 2a**  
(continued)

Panel D: Title held by executive					
Executive role	Executives		Primary and secondary observations		
	Number	Percentage	Number	Percentage	
Founding family executive	45	23.1	62	19.1	
Director	21	10.8	119	36.6	
CEO	90	46.2	113	34.8	
Subordinate executive	84	43.1	93	28.6	
Total	195	100	325	100	
Panel E: Personal characteristics for primary firm observations (N = 219)					
Characteristic	Sexual misadventure	Substance abuse	Violence	Dishonesty	Full sample
Age	51.7	52	50.1	53.3	52.16
Male	97.10%	95.00%	100.00%	95.10%	96.30%
Repeat offender	33.01%	55.00%	33.33%	16.05%	28.77%
Executive turnover	33.98%	20.00%	53.33%	38.27%	35.62%
Panel F: Direct costs resulting from managerial indiscretions					
Cost category	Number		Mean		
Litigation expenses:					
Corporate lawsuit	325		22.77%		
Material legal expenses	325		15.38%		
Corporate settlement	325		14.77%		
Legal fees or settlement disclosed	325		10.46%		
Legal expense amount	34		\$2,247,610		
Opportunity costs:					
Opportunity cost	325		20.00%		
Training or rehab	65		18.46%		
Suspension or out of work	65		18.46%		
Jail or court	65		80.00%		
Opportunity cost (in days)	65		27.82		
Opportunity cost (amount)	65		\$27,465		
Severance and mitigating compensation costs					
Severance	325		9.85%		
Severance amount	32		\$3,613,113		
Fired for cause	325		6.77%		
Forfeiture of pay	325		4.92%		
Forfeiture of pay amount	16		\$8,072,126		
Total direct disruptive and reputation costs:					
Disruption costs	325		\$616,399		
Disruption costs to sales	325		0.19%		
Reputational costs	325		\$109,295,830		
Reputational costs to sales	325		6.28%		

or division heads). The director, CEO, and subordinate observations in the full sample are 37%, 35%, and 29%, respectively.

### 3.3. Personal characteristics and outcomes for indiscretion executives

Table 2, Panel E, reports the participants, characteristics, and outcomes according to the type of alleged indiscretions. The executives charged with indiscretions are, on average, about 52 years old and almost exclusively male (96%). The probability of turnover increases significantly for executives charged with indiscretions, as 36% of our 219 primary firm executives are terminated within 30 days of committing an indiscretion. In Panel F, we distinguish the types of costs associated with an indiscretion. We collect data on direct costs imposed on the firm because of the indiscretion, including legal costs from defending the executive, payouts to plaintiffs in a settled lawsuit, opportunity

costs due to the unavailability of the executive, and severance costs associated with terminating the executive.

For the legal expenses, we conduct a thorough review of the company's SEC filings around the announcement of the indiscretion for all 325 of our observations. If the litigation costs are deemed material, they are required to be disclosed in the 10-K or 10-Q filings under the section Legal Proceedings by Item 103 of Regulation S-K. Occasionally, an executive's personal legal defense is granted as a form of pay and is listed as an item under Other Compensation, so we search corporate proxy statements for evidence of such disclosures. Because the company determines what constitutes a material legal expense, we also search Factiva, LexisNexis, and Google for news of litigation against the executive or firm, or both. We follow up any mention of a lawsuit with the clerk of courts, circuit court, or the US Courts' PACER (Public Access to Court Electronic Records) service to get details on local, regional, and federal court cases. We separately track any disclosed legal expenses and corporate settlements to the plaintiffs.

Seventy-four indiscretions (23% of the sample) elicit some sort of lawsuit naming the company, and 50 (15%) of the cases involve the company mounting a material legal defense. For those firms disclosing the dollar amount of their legal exposure, settlements and legal fees average a total of \$2.2 million.

Time away from the job also represents an opportunity cost to shareholders. Accordingly, we search news stories, SEC filings, court records, and state statutes for criminal penalties to determine how many days an indiscretion took the executive away from the office. The observable opportunity costs largely fit into the categories of sensitivity training and rehab, suspension, and time spent in jail or court proceedings. Among the 325 indiscretions, 65 (20%) evoke some form of measureable opportunity cost. The average time lost is approximately 28 days and the average cost is \$27,465. The relatively small daily compensation for corporate directors pushes this figure toward zero. Time away is difficult to value. As a proxy, we use the daily pay rate for the executive from the disclosed salary or retainer at the firm.

About 10% (32) of the executives resigning from their positions as a result of the indiscretion are provided severance pay in conjunction with their turnover. To tabulate these costs, we search the corporate proxy statements and news stories for evidence of severance packages. For these 32 executives, the average severance pay was just over \$3.6 million. Approximately 7% of the sample was fired for cause. While not used in our primary tests, most (5% out of 7%) executives that were fired for cause were forced to forgo unvested stock and option grants. Similarly, some retained executives forfeited their annual bonus or faced other monetary penalties for their actions, which mitigated the costs facing the firm in light of an indiscretion revelation. We search corporate proxy statements for evidence of these forfeitures of compensation and collect any instances thereof. The average forfeited compensation is approximately \$8 million.

The disclosure of an indiscretion has implications for not only the tangible dollar losses, but also the value of the firm's reputation when dealing with its customers, suppliers, employees, and investors. Using standard event-study methods (Brown and Warner, 1985), we assume that the firm's stock price reactions in the three days surrounding the announcement date represent an unbiased forecast of the total expected costs facing shareholders as a result of the indiscretion. Following Karpoff and Lott (1993), we partition the total cost of the indiscretion into its direct monetary or disruption cost component (*Disruption Cost*) and its reputational component (*Reputational Cost*).

#### Total Cost of Indiscretion

$$= \text{Market Value Loss at Announcement} \quad (1)$$

$$= \text{Disruption Cost} + \text{Reputational Cost}. \quad (2)$$

The *Market Value Loss at Announcement* is the abnormal total dollar return from the Center for Research on Securities Prices (CRSP) value-weighted three day cumulative abnormal return (CAR), multiplied by the pre-event market capitalization of the firm. The disruption cost is de-

fined as the sum of all the direct monetary and opportunity costs associated with the indiscretion. The reputational cost is the difference between the total cost of the indiscretion and the disruption cost. The statistics at the bottom of Panel F of Table 2 report the aggregate disruption cost and the average residual reputational cost. For each firm we also calculate the ratio of disruption costs or reputational loss relative to sales and reports the average across all firms. The average disruption cost is approximately \$600,000 and represents only 0.19% of sales. In comparison, the mean reputational cost is around \$109 million and represents 6.3% of sales. This provides preliminary evidence that the reputational damage contributes significantly to the loss in value of the average indiscretion firm. This is consistent with Karpoff and Lott (1993) who show, in the corporate setting, that the reputational losses surrounding fraud prosecutions account for over 93% of the market reaction as opposed to the direct court penalties or fines.

#### 3.4. Indiscretion and panel data sample characteristics

To investigate the characteristics and impact of managerial indiscretions relative to the population of publicly traded firms, we assemble a panel data set of indiscretion and non-indiscretion firms from the universe of companies listed in the Compustat, ExecuComp, and RiskMetrics merged database with complete data for our tests. Since we require data on the governance structure of the firm from RiskMetrics, whose coverage begins in 1996, we restrict this sample to the 1996–2012 time period. After imposing these restrictions, we have a total of 15,950 firm-year-observations.

Table 3 presents the summary statistics for our indiscretion and panel data sets. The mean (median) level of sales and market capitalization at our indiscretion firms are \$21.4 billion (\$2.2 billion) and \$23.5 billion (\$2.4 billion), respectively. The average (median) Tobin's *q* ratio is 2.25 (1.47). The typical firm in our indiscretion sample is profitable on an operating basis, with a mean (median) operating return on assets (OROA) of 6.4% (11.1%). These figures are comparable to those found in other corporate work (Yermack, 1996, 2006; Coles et al., 2008). Strikingly, 59% of the sample observations are classified as having occurred at a family-managed firm. This is significantly higher than the incidence of family-managed firms found in typical studies of US industrial companies and meaningfully larger than the proportion in our panel data set [Anderson and Reeb (2003) report family ownership at about one-third of Standard & Poor's (S&P) 500 firms].<sup>14</sup>

<sup>14</sup> We identify family firms in several ways. First, we identify family firms using the data collected by Anderson and Reeb (2003) and made publicly available on their website (<http://www.davidreeb.net/cv-data.html>). Second, we examine the titles held by the members of the top management team and note whether any of them hold the title of founder. We also classify any firm as a family firm whenever a managing executive's name is the same as the firm's name, as well as those instances in which an executive's tenure precedes the listing of the firm on CRSP and Compustat by at least 3 years. Finally, we review each news story to see whether the firm itself is founder-managed or family-controlled.

**Table 3**

Sample statistics.

This table presents sample summary statistics for 325 managerial indiscretion observations from 1978 to 2012 and 15,950 firm-year observations from the EXECUCOMP and RiskMetrics universe from 1996 to 2012. *Sales* and *Market value* are the net revenues and market value of common equity, respectively, in millions of dollars. *Leverage* is total liabilities divided by total assets. *CAPX* is capital expenditures to sales. *Diversification* is the number of business segments. *Firm age* is the number of years the firm is listed by the Center for Research in Security Prices or COMPUSTAT. *OROA* is earnings before interest, taxes, depreciation, and amortization (EBITDA) to total assets. *Tobin's q* is computed as the market value of equity plus the book value of assets less the book value of assets all over the book value of assets. *Stock return* is the buy-and-hold raw stock return for the fiscal year in which the indiscretion occurs. *CEO ownership* is the percentage of common stock held by the chief executive officer. *CEO age* and *CEO tenure* are the age and job tenure of the primary CEO. *Family-managed firm* is a (0, 1) indicator of whether the company is a family held or founder-managed firm (but does not indicate that the indiscretion executive is a member of this family). *CEO-chairman* is an indicator of whether the CEO is also the chairman of the board. *Outside director ownership* is the aggregate percentage ownership of the common shares held by all of the independent directors on the board. *Board size* is the number of directors on the board, and *large board* indicates that the board size is over the median of all firms. *Percent independent directors* is the percentage of the board composed of outsiders as defined by RiskMetrics. *Non-independent board* is an indicator of whether 50% of the board is classified as non-independent. *Hand-picked board* is an indicator of whether 50% or more of the independent directors have a tenure shorter than that of the CEO. *Busy board* is an indicator of whether 50% or more of the outside directors hold three or more total directorships. *Poor monitoring index* is a (0, 4) index summing *large board*, *non-independent board*, *hand-picked board*, and *busy board*. All reported values are winsorized at the 1st and 99th percentiles.

Characteristic	Mean		Median	
	Managerial indiscretions (N = 325)	Panel data sample (N = 15,950)	Managerial indiscretions (N = 325)	Panel data sample (N = 15,950)
Firm characteristics (t):				
Sales (millions of dollars)	21,442	5890	2231	1719
Market value (millions of dollars)	23,478	8354	2353	1948
Leverage	0.64	0.53	0.61	0.54
CAPX	0.23	0.07	0.04	0.04
Diversification	3.03	3.13	3.00	3.00
Firm age	26.14	31.67	18.00	26.00
Performance characteristics (t):				
OROA	6.36%	13.82%	11.13%	13.29%
Tobin's q	2.25	1.89	1.47	1.52
Stock return	1.97%	12.31%	0.00%	8.86%
CEO characteristics (t – 1):				
CEO ownership	6.66%	2.14%	0.34%	0.29%
CEO age	54.56	55.83	54.00	56.00
CEO tenure	7.49	7.88	5.00	5.82
Governance characteristics (t – 1):				
Family-managed firm	0.59	0.34	1.00	0.00
CEO-chairman	0.58	0.61	1.00	1.00
Outside director ownership	1.70	1.21	0.12	0.28
Board size	10.26	9.30	10.00	9.00
Large board	0.54	0.42	1.00	0.00
Percent independent directors	63.43%	69.82%	66.67%	72.73%
Non-independent board	0.19	0.11	0.00	0.00
Hand-picked board	0.61	0.53	1.00	1.00
Busy board	0.33	0.19	0.00	0.00
Poor monitoring index	1.67	1.26	2.00	1.00

### 3.5. Association between managerial indiscretions and observable firm characteristics

We begin our regression analysis by examining whether certain observable firm characteristics are associated with indiscretion announcements. Arguably, the incidence of managerial indiscretions is endogenously related to the firm characteristics we study and establishing causality is problematic. Therefore, we view the results in this subsection as suggestive of associations, not definitive determinants.

In Table 4, we report the results of logistic regressions using the 15,950 panel data observations. The dependent variable in Models 1–4 is a (0, 1) indicator of whether any indiscretion, a CEO indiscretion, or a non-CEO indiscretion occurs. Our models also include governance characteristics such as CEO and director ownership, CEO age, CEO

tenure, and family-managed status.<sup>15</sup> We also add standard firm controls such as firm size, firm age, industry-adjusted ROA, industry-adjusted Tobin's q, leverage, and capital expenditures. All control variables are computed using the most recent fiscal year-end data immediately preceding the indiscretion announcement. Each model includes industry and year fixed effects, and the reported p-values are com-

<sup>15</sup> Anderson et al. (2009) find that family-led firms are associated with greater information asymmetry, larger agency costs, and lower firm performance for all but the most transparent family firms. Anderson et al. (2015) find that over 70% of federal enforcement actions for fraud occur at family firms. Arguably, given their substantial personal investment in the company, corporate founders make less of a distinction between themselves and their firms. Consequently, founders could be especially prone to engage in indiscretions or have boards that are more likely to overlook transgressions.

**Table 4**

Association between managerial indiscretions and observable firm characteristics.

This table presents logistic regressions that model the association between managerial indiscretion announcements and observable firm characteristics. The dependent variable in Models 1–4 is a (0, 1) indicator variable signifying whether an *indiscretion*, *CEO indiscretion*, or a *non-CEO indiscretion* occurred in the fiscal year. The dependent variable in Models 5 and 6 is a (0, 1) indicator of whether an indiscretion is disclosed by an outside entity (e.g., law enforcement, media) instead of through a company press release. *Firm size* is the natural log of net sales. *Industry-adjusted ROA* is earnings before interest, taxes, depreciation, and amortization (EBITDA) to assets minus the industry median value. *Industry-adjusted Tobin's q* is Tobin's *q* minus the industry median value. *Shady industry (noncompliance)* indicates the firm resides in an industry with a degree of regulatory noncompliance greater than the median for all industries (Kedia et al., 2016), and *Shady industry (BPI)* denotes firms in sectors with grand bribery scores less than the median value of the Transparency International's 2011 Bribe Payers Index (BPI) (Karpoff et al., 2015). All other variables are defined in Table 3. Each model includes industry and year fixed effects and *p*-values are computed using robust Rogers (1993) firm-clustered standard errors.

Variable	Indiscretion				CEO indiscretion		Non-CEO indiscretion		Outside disclosure indiscretion			
	Model 1		Model 2		Model 3		Model 4		Model 5		Model 6	
	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value
Intercept	−6.53	.00	−6.33	.00	−5.97	.00	−7.81	.00	−7.67	.00	−8.17	.00
Poor monitoring index	0.38	.00			0.54	.00	0.30	.00	0.43	.00	0.50	.00
Non-independent board			−0.11	.65								
Large board			0.46	.00								
Busy board			0.42	.01								
Hand-picked board			0.59	.00								
Shady industry (noncompliance)									−0.11	.60		
Shady industry (BPI)											0.13	.54
Firm size	0.31	.00	0.29	.00	0.15	.24	0.38	.00	0.41	.00	0.37	.00
Firm age	−0.01	.18	−0.01	.20	−0.01	.11	0.00	.44	−0.01	.19	−0.01	.11
Family-managed firm	0.94	.00	0.98	.00	1.22	.00	0.82	.00	1.06	.00	1.14	.00
Leverage	0.53	.31	0.45	.38	0.53	.55	0.54	.37	0.59	.33	0.90	.14
Capital expenditures	−0.27	.79	−0.21	.83	−0.20	.89	−0.35	.78	0.55	.62	0.04	.97
Industry-adjusted ROA	−1.73	.15	−1.76	.14	0.47	.78	−3.00	.05	−1.44	.28	−1.03	.44
Industry-adjusted Tobin's <i>q</i>	0.18	.04	0.18	.05	−0.02	.90	0.30	.01	0.13	.21	0.12	.25
CEO age	−0.02	.16	−0.02	.17	−0.03	.09	−0.01	.69	−0.01	.28	−0.01	.41
CEO ownership	0.08	.00	0.09	.00	0.10	.00	0.07	.00	0.09	.00	0.09	.00
CEO tenure	−0.07	.00	−0.08	.00	−0.05	.03	−0.09	.00	−0.08	.00	−0.09	.00
Outside director ownership	0.00	.92	0.00	.90	0.04	.31	−0.02	.59	0.02	.50	0.04	.30
Likelihood ratio	265.18	.00	271.88	.00	112.89	.00	189.52	.00	259.97	.00	249.40	.00
Pseudo <i>R</i> <sup>2</sup>	0.0276		0.0289		0.0093		0.0196		0.0304		0.0314	
<i>N</i>	15,950		15,950		15,950		15,950		15,950		15,950	

puted using robust (Rogers, 1993) firm-clustered standard errors.

To further examine whether corporate governance mitigates the occurrence or impact of managerial indiscretions, we examine four variables suggested in the literature, which we sum to form our *Poor Monitoring Index* constructed as:

*Poor Monitoring Index*(0, 4)

$$= \text{Non-independent Board}(0, 1) + \text{Large Board}(0, 1) \\ + \text{Busy Board}(0, 1) + \text{Hand-Picked Board}(0, 1), \quad (3)$$

where *Non-independent Board* (0, 1) takes on a value of one if over 50% of the outside directors are not classified as independent, *Large Board* (0, 1) is set to one if the board is larger than the median board in RiskMetrics in the year, *Busy Board* (0, 1) takes on a value of one if over 50% of the outside directors hold three or more board seats, and *Hand-Picked Board* (0, 1) is set to one if over 50% of the outside directors have a shorter tenure than the CEO.<sup>16</sup>

<sup>16</sup> As illustrative examples of the importance of these variables, see Weisbach (1988) and Dahya and McConnell (2005) for board independence, Yermack (1996) for board size, Core et al. (1999) and

The results of the control variables are reflective of prior research on corporate malfeasance. Most notably, Poor Monitoring Index is significantly positively related to the propensity for a managerial indiscretion in each of the models. The marginal effects imply that incrementing the index by one provision magnifies the association with the disclosure of an indiscretion by 10.1%.<sup>17</sup> Consistent with founders intertwining their personal and professional lives, indiscretions are announced significantly more often at family-managed firms and the economic impact is large. The marginal effects imply a sizable 41.6% increase in the partial correlation with an indiscretion.<sup>18</sup> In several of our models, we find that indiscretions are more likely to occur at larger firms and those managed by new CEOs. The significant coefficient on size is consistent with greater agency issues at larger firms or larger firms attracting increased media attention.

Fich and Shivdasani (2006) for busy boards and Coles et al. (2014) for hand-picked directors.

<sup>17</sup> The marginal effect at sample means is 0.14%. Given that the unconditional probability of an indiscretion is 1.38%, this represents a 0.14%/1.38% = 10.1% increase.

<sup>18</sup> Similarly, the marginal effect of 0.574% implies a 0.574%/1.38% = 41.6% increase in the unconditional probability of an indiscretion.

Kedia et al. (2016) show that a culture of organizational noncompliance is associated with other forms of malfeasance.<sup>19</sup> We therefore test whether the incidence of managerial indiscretions is systematically related to industry characteristics. Using the data from Kedia et al. (2016), we first identify industries in which hiring managers with low integrity could be optimal, by categorizing industries in which firms have a propensity for non-compliance with federal rules and regulations. Everything else equal, firms in these shady industries could find it optimal to hire shady managers who are willing to skirt the rules in the interest of maximizing profits. We classify industries with regulatory noncompliance scores greater than the median as *shady industry (noncompliance)*.<sup>20</sup> As an alternative, we utilize Transparency International's Bribe Payers Index (BPI), which captures the perception of foreign bribery by industry (Karpoff et al., 2015). Because lower values on this index denote greater corruption, we identify industries with grand bribery scores less than the median as *shady industry (BPI)*. Roughly half of our indiscretion announcements originate in shady industries by either of these definitions.<sup>21</sup>

In Models 5 and 6 of Table 4, we include the shady industry indicators as an additional explanatory variable. We are mindful to the possibility that, even if indiscretions are no more likely in these industries, shady firms could try to withhold their disclosure. Therefore, estimations using the indiscretion indicator as the dependent variable could bias against finding a result. To address this, we limit our dependent variable to those indiscretions that are reported by an outside disclosure source (*outside disclosure indiscretion*), such as the media or law enforcement, under the assumption that these entities are not beholden to the firm. We do not observe a positive association with the shady industry indicators, which makes the shady firm-shady manager conjecture a subsidiary concern.<sup>22</sup>

#### 4. The wealth and accounting impacts of managerial indiscretions

##### 4.1. Managerial indiscretions and firm value

Table 5 reports event-study evidence to examine the impact of managerial indiscretions on firm value using three-day (−1, +1) and five-day (−2, +2) CARs surround-

ing the announcement date. For the full sample of 325 observations, the mean (median) three-day CAR is −1.62% (−0.58%). This translates into a \$110 million (\$2.5 million) evaporation in market capitalization at the disclosure of the indiscretion. The results are similar when considering five-day windows. All values are statistically significant at the 1% level.

If personal executive behavior impacts firm value, the signal should be strongest at the executive's primary firm and for the CEO given their importance. Using the 219 primary firm observations detailed in Table 1, the mean and median three-day abnormal returns at the executive's primary firm are significantly negative, −2.34% and −1.12%, respectively. The announcement returns are also significantly more negative for CEO indiscretions. The mean (median) three-day CAR for the 113 CEO observations is −4.06% (−1.84%), implying an average shareholder wealth loss of \$226 million. The CAR for the 212 other executives and directors is an insignificant −0.32% (−0.37%).

Dramatic wealth changes at the announcement of the indiscretion could anticipate executive turnover or induce the board to dismiss the executive. Alternatively, executive turnover can signal to the market that the problems are more serious or the reputational damage is more severe. In Table 2, Panel E, we report that the board removes the executive from his primary firm position at the disclosure 36% of the time. Not surprisingly, turnover is less for executives in a secondary role. Table 5 reports that executive turnover is 27% (or 89 of 325) of the full sample of primary and secondary firm observations. The wealth losses associated with these turnovers are statistically comparable to those cases in which the executive is retained (−2.32% versus −1.35%, difference  $p$ -value = .294). In both subsets, however, the wealth losses are significantly negative.

When stratifying by indiscretion type in Table 5, the three-day CARs are significantly negative for three of the four categories of alleged indiscretions. The magnitudes of losses, however, differ markedly across the categories. Sexual misadventure is associated with losses of 0.63%, and violence and dishonesty are associated with losses of 1.67% and 2.84%, respectively. The abnormal returns associated with substance abuse are not statistically significant. If trust in economic exchange is an important factor of production (Triole, 1996; Erhard et al., 2014), then cases of violence and dishonesty are perhaps the most damaging to the firm. In fact, dishonesty, the indiscretion category that arguably reflects the most upon the reputation of the executive, is associated with the most negative returns.

Finally, we bifurcate the sample according to whether the indiscretion is announced in a shady industry. The shady firm-shady manager conjecture suggests that announcements in these industries are muted to the extent that disreputable behavior is anticipated. Consistent with this argument, using the noncompliance measure of shady industry, the 161 disclosures in shady industries are associated with mean (median) losses of −1.11% (−0.34%), and the 164 observations in the non-shady industries experience sharper losses of −2.12% (−1.1%). The abnormal returns are significantly different from zero (but insignificantly different) for both shady and non-shady industries. In addition, the announcement returns are similar in mag-

<sup>19</sup> The authors identify deviant organizations (as opposed to deviant managers) as those with a history of noncompliance and enforcement activities from the Food and Drug Administration (FDA), Department of Justice, Federal Trade Commission (FTC), Mine Safety and Health Administration, Occupational Safety and Health Administration, Office of Federal Contract Compliance Program, Wage and Hour Division, and Environmental Protection Agency. They illustrate that deviant organizations exhibit a propensity for financial misreporting.

<sup>20</sup> We thank Kedia et al. (2016), who graciously provided their data.

<sup>21</sup> Although the results are consistent with both measures, we have some concern for using either the noncompliance or BPI measures as the sole method of identifying shady industries. We take comfort that such differing methodologies for classifying shady industries, which each likely identify some facet of shadiness, yield similar results.

<sup>22</sup> The shady industry indicator is negative and significant when including company disclosed indiscretions, consistent with our concern of nondisclosure.



**Table 5**

Managerial indiscretions and firm value.

This table presents the impact of 325 managerial indiscretions on firm value as indicated by the three-day and five-day cumulative abnormal returns (CARs) at disclosure using standard event study methods (Brown and Warner, 1985). Investor reactions are presented for the full sample, split by the investor reactions at the executive's primary firm and secondary firm, by executive title, and by turnover. *CEO* indicates whether the executive committing the indiscretion is the firm's chief executive officer, and *non-CEO* denotes some other executive or director at the firm. *Turnover* indicates the executive leaves within 30 days of the announcement, and *executive retained* indicates that the executive remains at the firm. Announcement returns are further disaggregated by *sexual misadventure*, *substance abuse*, *violence*, and *dishonesty*, which are described in Table 2 and the text. *Shady industry (noncompliance)* indicates the firm resides in an industry with a degree of regulatory noncompliance greater than the median for all industries (Kedia et al., 2016), while *Shady industry (BPI)* denotes firms in sectors with grand bribery scores less than the median value of the Transparency International 2011 Bribe Payers Index (BPI) (Karpoff et al., 2015). *p*-values using Student's *t* tests and nonparametric Wilcoxon signed-rank tests are reported in parentheses.

Category	N	(-1, +1) CAR		(-2, +2) CAR	
		Mean	Median	Mean	Median
Full sample	325	-1.62% (.00)	-0.58% (.00)	-1.73% (.00)	-0.68% (.00)
Announcement returns by primary versus secondary firm:					
Primary firm	219	-2.34% (.00)	-1.12% (.00)	-2.27% (.00)	-0.97% (.00)
Secondary firm	106	-0.13% (.78)	-0.34% (.26)	-0.61% (.58)	-0.40% (.19)
Announcement returns by title:					
CEO	113	-4.06% (.00)	-1.84% (.00)	-3.80% (.00)	-2.28% (.00)
Non-CEO	212	-0.32% (.48)	-0.37% (.30)	-0.62% (.23)	-0.42% (.14)
Announcement returns by turnover:					
Turnover	89	-2.32% (.02)	-0.89% (.01)	-1.97% (.03)	-0.55% (.03)
Executive retained	236	-1.35% (.00)	-0.54% (.00)	-1.63% (.01)	-0.77% (.01)
Announcement returns by indiscretion type:					
Sexual misadventure	153	-0.63% (.05)	-0.40% (.11)	-0.45% (.27)	-0.49% (.28)
Substance abuse	35	-0.69% (.25)	-0.37% (.54)	-0.49% (.94)	0.05% (.87)
Violence	29	-1.67% (.04)	-1.95% (.06)	-2.62% (.00)	-2.71% (.00)
Dishonesty	108	-2.84% (.00)	-1.19% (.00)	-2.49% (.00)	-0.89% (.00)
Announcement returns by shady industry:					
Shady industry (noncompliance)	161	-1.11% (.06)	-0.34% (.07)	-0.71% (.29)	0.00% (.57)
Non-shady industry (noncompliance)	164	-2.12% (.00)	-1.05% (.00)	-2.73% (.00)	-1.40% (.00)
Shady industry (BPI)	146	-1.74% (.03)	-0.57% (.03)	-2.20% (.02)	-0.72% (.03)
Non-shady industry (BPI)	179	-1.52% (.00)	-0.58% (.00)	-1.34% (.01)	-0.62% (.01)

nitude to each other using the BPI-based measure. Although this insignificance between categories does support the shady firm–shady manager conjecture, it demonstrates that our primary conclusions from the announcement returns are not driven by these observations.

Table 6 contains a regression analysis linking characteristics of indiscretions and types of executives with abnormal announcement returns. Consistent with our univariate results, abnormal returns are significantly more negative for indiscretions involving the CEO and for public dishonesty. In the first model, CEO indiscretions are associated with returns that are 3.6% lower than those for non-CEO indiscretions, and those involving dishonesty experience returns that are 3.9% lower than the other indiscretions.

As under the integrated affairs hypothesis, the decline in firm value reported in the univariate CARs could be related to the executive getting caught or the strength

of the integrity signal from the indiscretion, or both. To distinguish between these two potential effects, we examine the relative importance of direct and reputational costs as components of the total abnormal return. By construction, reputational costs are measured as abnormal returns minus the direct costs. Consequently, the sensitivity of the total announcement return to the direct costs of the indiscretion demonstrates the relative importance of the direct disruptive costs versus reputational costs.

The coefficient on direct disruption costs is insignificantly related to the returns around the announcement of an indiscretion for the overall sample in Model 1. This suggests that the direct costs associated with the distraction are not a primary predictor of the total loss in firm value. Instead, the resulting implication is that the primary cost

**Table 6**

Managerial indiscretions and firm value regressions.

This table presents regressions of the  $(-1, +1)$  cumulative abnormal returns (CARs) at the indiscretion announcement for our sample of 325 managerial indiscretions Model 1. Models 2–5 are run on subsets stratified by the indiscretion category. *Sexual misadventure*, *violence*, and *dishonesty* denote the category of indiscretion and are described in Table 2 and the text. Models 6 and 7 bifurcate this sample on the basis of whether the firm is in a *shady industry* or *non-shady industry*, respectively, where shady industry is identified by noncompliance with federal regulations (Kedia et al., 2016) or by the Transparency International's Bribe Payers Index (Karpoff et al., 2015). *Disruption costs* are the direct disruption costs defined in Table 2 normalized by sales. *Turnover* indicates the executive left the firm at the time of the announcement. *With subordinate* indicates that the indiscretion involved another employee of the firm. *Founding family exec* indicates the executive is a member of the founding family. *Confounding event* indicates that the firm announces some other event that is generally regarded as influencing stock returns (e.g., earnings guidance, mergers, new product announcements, etc.). *Firm size* is the natural log of net sales. *Market-adjusted return* is the firm's net-of-market stock return for the 250 trading days preceding the indiscretion. All other variables are defined in Tables 2 and 3.

Variable	(-1, +1) cumulative abnormal return (CAR)																	
	Model 1		Model 2		Model 3		Model 4		Model 5		Model 6		Model 7		Model 8		Model 9	
	Estimate	p-value	Estimate	p-value	Estimate	p-value	Estimate	p-value	Estimate	p-value	Estimate	p-value	Estimate	p-value	Estimate	p-value	Estimate	p-value
Intercept	-0.013	.61	-0.009	.61	-0.094	.11	-0.034	.38	-0.035	.38	0.007	.85	-0.021	.55	-0.085	.26	-0.004	.87
CEO	-0.036	.00	-0.029	.00	-0.012	.48	-0.015	.44	-0.077	.00	-0.026	.04	-0.046	.00	-0.020	.46	-0.036	.00
Disruption costs	0.002	.76	-4.946	.02	-0.016	.69	8.787	.16	0.368	.62	-1.913	.00	0.004	.58	-8.930	.00	0.001	.90
Sexual misadventure	-0.006	.74									0.030	.24	-0.034	.18	-0.019	.72	-0.003	.87
Violence	-0.012	.55									0.011	.67	-0.030	.30	-0.029	.63	-0.006	.76
Dishonesty	-0.039	.03									0.004	.86	-0.064	.01	-0.056	.30	-0.035	.06
With subordinate	0.000	.00									0.003	.87	-0.006	.74	0.009	.78	-0.001	.91
Turnover	-0.003	.75	0.024	.01	0.016	.52	0.022	.36	-0.037	.11	-0.010	.45	0.006	.65	0.015	.55	-0.009	.37
Arrest	-0.019	.16	0.003	.89	0.012	.48	-0.018	.40	-0.054	.10	0.014	.43	-0.043	.03	-0.082	.02	-0.009	.53
Repeat offender	0.007	.49	0.006	.54	0.019	.24	-0.022	.37	0.052	.16	0.005	.71	0.004	.77	0.029	.26	0.003	.79
Founding family exec	-0.002	.87	0.007	.59	0.025	.26	0.002	.95	-0.032	.41	-0.019	.27	0.024	.16	-0.016	.64	0.006	.65
Confounding event	0.023	.03	0.034	.00	0.021	.25	0.059	.01	-0.005	.85	-0.004	.78	0.046	.00	0.007	.79	0.021	.07
Poor monitoring index	-0.002	.75	0.005	.26	0.009	.27	0.004	.63	-0.006	.69	-0.003	.69	0.007	.29	0.005	.69	0.001	.84
Firm size	0.004	.08	-0.001	.78	0.006	.19	0.000	.94	0.007	.21	-0.001	.85	0.004	.17	0.011	.05	0.001	.57
ROA	-0.025	.04	-0.020	.21	-0.088	.56	0.105	.01	-0.040	.10	-0.024	.18	-0.011	.52	-0.058	.00	-0.019	.14
Tobin's q	0.000	.97	0.000	.89	0.002	.87	0.002	.54	0.000	.96	-0.003	.04	0.003	.01	0.003	.21	0.002	.13
Market-adjusted return	0.011	.25	0.001	.91	0.030	.16	0.027	.18	0.020	.42	0.024	.06	0.003	.82	0.013	.61	0.013	.16
Sample	All indiscretions		Sexual misadventure		Substance abuse		Violence		Dishonesty		Shady industry (noncompliance)		Non-shady industry (noncompliance)		Shady industry (BPI)		Non-shady industry (BPI)	
F-statistic	3.60	.00	3.59	.00	1.30	.28	2.97	.02	2.22	.02	4.07	.00	3.36	.00	4.27	.00	2.50	.00
R <sup>2</sup>	0.1574		0.2353		0.4153		0.6900		0.2186		0.3115		0.2680		0.3461		0.1981	
N	325		153		35		29		108		161		164		146		179	

associated with the decline in firm value is attributable to reputational capital lost.<sup>23</sup>

Although all of our indiscretions probably impose some reputational damage, reputational costs are likely to vary according to the indiscretion type. For example, cases of dishonesty are more likely to tarnish the firm's reputation for honest dealing. Sexual misadventure could entail more direct costs associated with the indiscretion. In Models 2 through 5, we estimate separate models for each indiscretion category to examine the impact according to indiscretion type and the conditional effect of the direct versus reputational costs on firm value as both types of costs could be at play depending on the nature of the indiscretion.

We find that disruption costs are a significant predictor for the returns around the announcement of cases of alleged sexual misadventure. The coefficient on disruption costs in Model 2 suggests that a 1% increase (approximately a one standard deviation move) in the ratio of direct costs to sales for sexual misadventure is associated with an announcement return that is lower by 4.9%. Thus, a significant portion of the returns for this category is explained by direct costs. However, disruption costs are insignificant for substance abuse, violence, and dishonesty. Overall, these results indicate that both costs are at play, but, for the majority of indiscretion types (substance abuse, violence, and dishonesty), reputational costs are the dominant factor.

As discussed in Section 2.3, the market could anticipate that in some industries hiring managers with less integrity can be optimal. Some managers could be hired with the expectation of cutting corners. In these industries, the reputational impact of an indiscretion could be less severe because indiscretions are partially anticipated by shareholders. In this situation, direct costs would play a larger role in explaining the market reaction to an indiscretion in shady industries.

Models 6 through 9 examine indiscretions in shady and non-shady industries. Using the noncompliance measure, CEO indiscretions for each sample are negatively and significantly related to the announcement CARs. However, point estimates on CEO indiscretions indicate that the impact of an indiscretion committed by a CEO in a non-shady industry is 2% larger than one committed by a CEO in a shady industry. This is consistent with market anticipation of shady behavior in industries associated with non-compliance. The coefficient on disruption costs is insignificantly related to the returns around the announcement of an indiscretion for firms operating in the non-shady industry environment. However, the direct disruption costs are a significant negative component of the returns for firms operating in shady industries. For these shady industry firms, a 1% increase in direct cost is associated with an announcement return that is lower by 1.9%. Perhaps most compelling, dishonesty is insignificant for the shady industry sample, but it remains negative and significant for the non-shady industry firms. The results are similar bifurcat-

ing by the BPI version of shady industry. Thus, investors react more negatively to indiscretion announcements in industries in which having an impeccable reputation is more likely to be expected. In contrast, investors of firms in industries associated with bending the rules react more to the direct costs of the indiscretion instead of the signal of managerial integrity.

The announcements of our indiscretions are primarily driven by external events (e.g., arrests). Our sample also contains 63 confounding announcements (e.g., earnings guidance, new product announcements, etc.) released during the announcement period in which the indiscretions are disclosed.<sup>24</sup> The results are qualitatively unaffected if the confounding events are removed.<sup>25</sup> However, in these tests, we choose not to exclude potentially confounding events. Instead, we identify these instances with an additional control variable labeled *confounding event*. Because the indiscretions we measure are personal in nature, a structural connection to confounding corporate events seems unlikely. However, we retain these observations due to the possibility that firms manage the grouping of news events, and this sample provides additional insight into the motives of top management.

In Model 1 of Table 6, the full sample model shows a positive bias to the confounding observations of around 2%. Provided that positive shocks do not systematically arrive at firms disclosing indiscretions more often than negative ones, this evidence is consistent with purposely releasing positive information at the time the indiscretion is announced, suggesting further support for the integrated affairs hypothesis. However, because we do not have a benchmark for the typical market reaction to similar confounding events, the result should be interpreted with caution.

Overall, the evidence presented in Tables 5 and 6 suggests that on average the market response to a managerial indiscretion is significantly negative.<sup>26</sup> Table 6 further reveals that for the full sample, and most indiscretion categories, the market response is not significantly related to the direct cost of getting caught. The implication is that a significant portion of the loss in firm value is due to the reputational capital lost when an indiscretion is announced. To the extent that investor reactions contain expectations of lost business, this is consistent with prior work finding that the financial markets anticipate product market discipline following managerial

<sup>24</sup> The 63 confounding events in our sample are as follows: four analyst opinion changes, five announcements about dividends or share repurchases, 11 earnings releases, six disclosures about an FDA or patent approval or the lifting of FTC restrictions, nine announcements or updates to pending litigation (all unrelated to the indiscretion), 17 announced takeovers, four new product announcements, one announced proxy contest, one S&P index addition, and five instances of unscheduled management guidance.

<sup>25</sup> Test results excluding the confounding events are reported in Online Appendix Tables OA3 and OA4. Not surprisingly, the univariate results are marginally stronger with the confounding events removed.

<sup>26</sup> We obtain similar results when examining long-run buy-and-hold stock returns (not reported, available upon request) and the change in Tobin's *q* following the announcement (Online Appendix Table OA5).

<sup>23</sup> In the remaining tables of the paper, because our models are not predicting CARs, we include both the direct disruption costs and the reputational costs associated with a managerial indiscretion.

misconduct (Karpoff and Lott, 1993; Karpoff et al., 2008; Murphy et al., 2009). This evidence lends support to the integrated affairs hypothesis.

#### 4.2. Counterparty response to managerial indiscretions

The integrated affairs hypothesis predicts a decline in counterparty trust and a deterioration in counterparty relationships, as other firms are less willing to conduct business with an indiscretion firm. To test this hypothesis, we examine whether the firm initiates or maintains new strategic alliances with major customers or joint venture partners. We collect data on meaningful counterparty relationships using two sources: the Compustat customer segment database and the Thomson Reuters Joint Ventures and Strategic Alliances database on Securities Data Company (SDC) Platinum. If a firm is not listed in either of these two sources, we assume it does not have such relationships. Under SFAS 14 and 131, public companies must disclose the identity of any single customer representing 10% or more of total sales. We track whether the indiscretion firm obtains a new major customer representing at least 10% of sales in the year following the indiscretion and the change in the number of major customers in the years surrounding the indiscretion announcement. As a second measure, we pull the entirety of the SDC Joint Ventures database and match it to our sample. We note the existence of a new joint venture (JV) partner and the change in the number JV partnerships surrounding the indiscretion announcement.

Table 7 reports tests on the impact that indiscretions have on counterparty trust. The results suggest that CEO indiscretions significantly decrease the likelihood of obtaining new major customers (Model 1) and negatively impact the change in the number of major customers (Model 3). The marginal effects imply that a CEO indiscretion is associated with a 2.1% lower likelihood of obtaining an additional major customer in the fiscal year following the indiscretion announcement and a loss of 0.29 major customers from year  $(t - 1)$  to year  $(t + 1)$ .<sup>27</sup> CEO indiscretions are associated with a 5.1% lower likelihood of initiating a new joint venture (Model 4) and a loss of 0.22 venture partners (Model 6). Given that the ex ante probabilities for obtaining a new customer or JV partner are 11.6% and 10.6%, respectively, these economic effects are meaningful.

The sample of major customers contains only business counterparties. Some venture partnerships, however, are with governmental entities that could be less concerned about reputation given their enhanced control rights inherent in the legal system. Consequently, we bifurcate venture partnerships into private industry partnerships and those with governmental entities (Models 7 and 8). The results for joint ventures are concentrated among business coun-

terparties. CEO indiscretions are insignificantly related to the change in the total number of government venture partners (Model 8). These findings indicate that counterparty relationships in general, and industry relationships in particular, suffer in the presence of a managerial indiscretion, lending further evidence to the integrated affairs hypothesis.

Consistent with the results for direct disruption costs on CARs around the announcement of all indiscretions reported in Table 6, Model 2 of Table 7 suggests that CEO reputational costs are significantly negatively related to the likelihood of obtaining a new major customer. Parameter estimates on CEO reputational costs imply that a one standard deviation increase in the reputational costs of a CEO indiscretion decreases the likelihood of obtaining a major customer by 3.81%.<sup>28</sup> Again, compared with the likelihood of obtaining a new customer (11%), the economic effect is meaningful. Model 5 of Table 7 suggests that the reputational costs are insignificantly related to the likelihood of initiating a new joint venture. CEO disruption costs, however, are insignificant in both models. The insignificance of the estimate suggests that, similar to penalties from environmental violations, direct disruption costs from getting caught have little effect on measurable counterparty relationships.

#### 4.3. Managerial indiscretions and firm operating performance

The integrated affairs hypothesis predicts a loss of strategic relationships, which could force the firm into lower margin businesses in which reputation is less important (Shapiro, 1983). To quantify the impact of an indiscretion on operating performance, we first define operating return on assets as earnings before interest, taxes, depreciation, and amortization (EBITDA) to average total assets. To compute *Abnormal OROA*, we follow the Barber and Lyon (1996) matching firm methods and measure abnormal operating performance as the difference between the observed operating performance of the identified firm and that of the pre-event performance-adjusted industry benchmark. This adjustment removes biases in OROA resulting from industry norms or historical firm performance. In our primary operating performance tests, we further compute the change in this measure (*Abnormal  $\Delta$  OROA*) to eliminate any time-invariant unobservable firm-specific biases in performance. We compute the change in the return on sales (*Abnormal  $\Delta$  Profit Margin*) in a similar fashion.

Results of these tests are shown in Table 8. The firms in our indiscretion sample exhibit significantly lower operating performance than their industry- and performance-matched peers in the year of the indiscretion. Model 1 reports that, on average, sample firms demonstrate a marginally significant abnormal change in OROA of  $-0.8\%$  over the fiscal year when an indiscretion is disclosed. These results are primarily driven by the indiscretions of CEOs (Model 2), the individuals with the most impact

<sup>27</sup> We acknowledge the possibility that the firm does not lose the customer, but rather the customer's sales simply fall below the 10% threshold for mandatory reporting. Provided the measurement error induced by this reporting choice is uncorrelated with our explanatory variables, ordinary least square is unbiased but the estimates suffer from larger standard errors (Wooldridge, 2002, pp. 71–72).

<sup>28</sup> The marginal effect is  $-0.2104$  and a one standard deviation move is  $0.4424$ , resulting in a decrease of  $-0.03805$ .





**Table 8**

Margin response to the product market discipline for managerial indiscretions.

This table presents the impact of managerial indiscretions upon firm operating performance during the fiscal year the indiscretion is disclosed using the universe of firms listed in EXECUCOMP from 1996 to 2012. The dependent variable in Models 1–3, *Abnormal  $\Delta$  OROA ( $t - (t - 1)$ )*, is the abnormal change in operating return on assets (OROA) using the procedure outlined in Barber and Lyon (1996, model 8). The dependent variable in Models 4–6, *Abnormal  $\Delta$  profit margin ( $t - (t - 1)$ )* is the abnormal change in operating return on sales (OROS) using the same procedure. The key independent variable of interest, *CEO indiscretion*, is a (0, 1) indicator variable that takes on the value of one if a chief executive officer indiscretion is disclosed during the fiscal year and zero otherwise. *CEO reputation costs* and *CEO disruption costs* are the reputational and disruption costs normalized by sales described in Table 2 for CEO indiscretions, where the direct costs are rescaled by multiplying by one thousand. Firm Size is the natural log of net sales. All other variables are defined in Table 3. Each model includes industry and year fixed effects. All *p*-values are computed using robust Rogers (1993) firm-clustered standard errors.

Variable	Abnormal $\Delta$ OROA ( $t - (t - 1)$ )						Abnormal $\Delta$ profit margin ( $t - (t - 1)$ )					
	Model 1		Model 2		Model 3		Model 4		Model 5		Model 6	
	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value
Intercept	−2.329	.00	−1.391	.11	−2.863	.00	11.257	.00	14.490	.00	9.715	.00
Indiscretion	−0.822	.10					−1.815	.16				
CEO indiscretion			−1.734	.02					−5.004	.04		
CEO reputational costs					−7.430	.00					−27.102	.00
CEO disruption costs					−0.081	.17					−0.114	.26
Firm size	0.319	.00	0.317	.00	0.353	.00	0.740	.00	0.735	.00	0.719	.00
Firm age	−0.001	.67	−0.001	.68	0.001	.78	0.005	.30	0.005	.30	0.005	.28
Family-managed firm	0.204	.05	0.202	.05	0.212	.04	−0.059	.80	−0.057	.80	−0.076	.74
CAPX	−2.013	.00	−2.014	.00	−1.969	.00	−2.332	.07	−2.334	.07	−2.365	.07
Leverage	−1.908	.00	−1.904	.00	−1.825	.00	−5.882	.00	−5.868	.00	−5.792	.00
CEO ownership	−0.004	.64	−0.004	.67	−0.009	.31	0.002	.89	0.004	.81	0.005	.74
Outside director ownership	0.036	.02	0.037	.02	0.041	.01	0.027	.32	0.027	.30	0.027	.31
Diversification	−0.049	.04	−0.049	.04	−0.100	.00	−0.074	.14	−0.074	.14	−0.077	.12
Poor monitoring index	−0.139	.02	−0.139	.02	−0.041	.09	−0.119	.32	−0.116	.33	−0.112	.34
<i>F</i> -statistic	99.6	.00	99.39	.00	100.10	.00	769.7518	.00	766.887	.00	749.01	.00
<i>R</i> <sup>2</sup>	0.0128		0.0129		0.0143		0.0173		0.0177		0.0190	
<i>N</i>	15,950		15,950		15,950		15,950		15,950		15,950	

on firm performance. When a CEO indiscretion is disclosed, the indiscretion group experiences an industry- and performance-adjusted decline of 1.7% in operating performance, which is both statistically and economically significant. In contrast to our results on economic value for CEOs, untabulated analysis reveals no evidence of significant abnormal operating under-performance for the non-CEO subgroup. This is not surprising given the relatively smaller influence these other executives often have on the formation of strategic partnerships or customer relationships.

To better understand the effect of managerial indiscretions on ROA and product market discipline, we examine the change in profit margin. Model 4 of Table 8 indicates that on average the full sample of indiscretion firms demonstrates a negative but insignificant abnormal change in profit margin when an indiscretion is disclosed. However, in the fiscal year when a CEO indiscretion is disclosed (Model 5), the firm experiences an industry- and performance-adjusted decline of 5% in operating profit margin, which is both statistically and economically significant. For both profit margin and OROA, the reputation costs play the dominant role in explaining the performance declines.

## 5. Managerial indiscretions and other firm consequences

Someone who is duplicitous in his or her private life could be more willing to mislead professionally. If indiscretions are signals of poor character in an executive's personal affairs, they could also indicate a willingness to falsify the financials. Evidence suggesting a correlation

between personal misconduct and firm-level malfeasance would indicate a broader culture of misconduct at the firm. Thus, fraudulent activity can demonstrate that a manager and the firm are willing to abrogate contracts with their counterparties (Karpoff et al., 2008). Alternatively, the misconduct could be concentrated with the manager and not indicative of firm behavior and culture. In addition, the evidence in Section 4 indicates under-performance during the period of the alleged indiscretion. Executives of an underperforming firm face additional pressure from the financial press, shareholders, and their boards. Evidence of explicit earnings management or legal action against the firm would be supportive of the integrated affairs hypothesis. In this section, we test the propensity for firms led by executives associated with indiscretions to be involved in corporate class action lawsuits, a DOJ or SEC enforcement action, and earnings management. In each case, we add dummy variables for CEO and non-CEO indiscretions along with estimates of direct and reputational costs to models established in the literature.

### 5.1. Managerial indiscretions, shareholder class action lawsuits, and fraud

The typical securities class action lawsuit alleges that managers violate Rule 10b-5 of the Securities Exchange Act of 1934 by fraudulently withholding negative information or publicizing false or misleading information (Niehaus and Roth, 1999). In Panel A of Table 9, we estimate the propensity of a class period violation (when the wrongdoing allegedly is taking place) as defined by a shareholder class action lawsuit in the year of the indiscretion an-

**Table 9**

Managerial indiscretions, shareholder class action lawsuits, and fraud.

This table presents logistic regressions that estimate the propensity for malfeasance using the universe of firms listed in EXECUCOMP from 1996 to 2012. In Panel A, the dependent variable in each logistic regression model, *violation period class action lawsuit*, is a (0, 1) indicator denoting that the firm commits a violation in the year of the indiscretion or in the 2 years following the announcement that becomes the target of a class action lawsuit. In Panel B, the dependent variable in each logistic regression model, *violation period fraud*, is a (0, 1) indicator of whether the firm allegedly commits fraud in the year of the indiscretion or in the 2 years following the announcement that becomes the subject of a Department of Justice or Securities and Exchange Commission investigation. The key independent variable of interest, *indiscretion*, is a (0, 1) indicator variable that takes on the value of one if a managerial indiscretion is disclosed during the fiscal year and zero otherwise. *CEO indiscretion* and *non-CEO indiscretion* indicate whether the event is perpetrated by the firm's chief executive officer, a junior executive, or director, respectively. *Reputation costs* and *disruption costs* are the reputational and disruption costs normalized by sales described in Table 2, in which the direct costs are rescaled by multi plying by one thousand. *Industry legal exposure* is an indicator variable of whether the firm's industry is targeted by greater than the median number of class action lawsuits during the sample period. *Retail firm*, *technology firm*, and *regulated firm* are indicator variables of whether the firm is in retail, technology, or regulated industries as defined by Field et al. (2005). *Firm size* is the natural log of net sales. *Market-adjusted stock return* is the annual return on the firm's common stock for the period ending with the fiscal year-end, net of the Center for Research in Security Prices value-weighted index. *Average volume* is the average daily trading volume in millions of shares for the firm's common stock during the fiscal year. *Discretionary accruals* is the discretionary portion of total current accruals as defined in Teoh et al. (1998). All other variables are defined in Table 3. Each model includes year fixed effects (Panel B models also include industry fixed effects); *p*-values are computed using robust Rogers (1993) firm-clustered standard errors.

Panel A: Shareholder class action lawsuits

Variable	Violation period class action lawsuit							
	Model 1		Model 2		Model 3		Model 4	
	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value
Intercept	−6.737	.00	−6.758	.00	−6.763	.00	−6.715	.00
Indiscretion	0.393	.10						
CEO indiscretion			0.757	.04	0.762	.04		
Non-CEO indiscretion					0.198	.51		
Reputational costs							0.656	.10
Disruption costs							0.042	.77
Industry legal exposure	0.584	.04	0.584	.04	0.584	.04	0.584	.04
Retail firm	−0.213	.38	−0.211	.38	−0.211	.38	−0.214	.37
Technology firm	0.439	.01	0.437	.01	0.438	.01	0.437	.01
Regulated firm	−0.232	.37	−0.231	.37	−0.232	.37	−0.231	.37
Firm size	0.269	.00	0.272	.00	0.271	.00	0.272	.00
Firm age	−0.015	.00	−0.015	.00	−0.015	.00	−0.015	.00
Leverage	0.626	.11	0.631	.11	0.628	.11	0.635	.11
Market-adjusted stock return	0.217	.00	0.217	.00	0.217	.00	0.216	.00
Average volume	0.000	.00	0.000	.00	0.000	.00	0.000	.00
CEO-chairman	0.199	.06	0.197	.06	0.198	.06	0.195	.06
Poor monitoring index	−0.006	.93	−0.007	.91	−0.007	.91	−0.005	.94
Likelihood ratio	594.52	.00	595.60	.00	596.09	.00	592.14	.00
Pseudo <i>R</i> <sup>2</sup>	0.0599		0.0488		0.0470		0.0290	
<i>N</i>	15,950		15,950		15,950		15,950	

Panel B: Fraud

Variable	Violation period fraud							
	Model 1		Model 2		Model 3		Model 4	
	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value
Intercept	−6.725	.00	−7.215	.00	−7.231	.00	−7.117	.00
Indiscretion	0.891	.00						
CEO indiscretion			1.211	.01	1.230	.01		
Non-CEO indiscretion					0.719	.06		
Reputational costs							2.118	.00
Disruption costs							−0.742	.20
Firm size	0.443	.00	0.465	.00	0.460	.00	0.472	.00
Firm age	−0.007	.15	−0.007	.20	−0.007	.21	−0.007	.20
Leverage	−0.196	.68	0.455	.34	0.447	.35	0.470	.33
Market-adjusted stock return	0.162	.00	0.134	.02	0.129	.03	0.132	.02
Average volume	−0.001	.88	−0.018	.21	0.000	.19	−0.018	.21
Discretionary accruals	0.062	.00	0.051	.00	0.052	.00	0.050	.01
CEO-chairman	0.160	.32	0.125	.44	0.128	.43	0.123	.45
CEO ownership	−0.019	.29	−0.013	.43	−0.013	.42	−0.012	.46
CEO age	−0.036	.00	−0.033	.01	−0.033	.01	−0.033	.01
CEO tenure	0.024	.11	0.024	.12	0.024	.11	0.024	.12
Poor monitoring index	−0.002	.98	0.020	.82	0.019	.83	0.019	.83
Likelihood ratio	799.15	.00	863.29	.00	867.18	.00	867.06	.00
Pseudo <i>R</i> <sup>2</sup>	0.0489		0.0256		0.0768		0.0107	
<i>N</i>	15,950		15,950		15,950		15,950	

nouncement or during the 2 years following. We control for known predictors of lawsuits (Gande and Lewis, 2009; Field et al., 2005; Fich and Shivdasani, 2007). The sample of securities class action lawsuits from 1996 through 2012 is collected from the Stanford Law School Securities Class Action Clearinghouse (SCAC) website.<sup>29</sup> Shareholder lawsuits can be an expected response when a personal managerial indiscretion is alleged. Consequently, we delete any class action suits that target the indiscretion.

The results in Models 1, 2, and 3 of Table 9 reveal that firms with executives committing managerial indiscretions are more likely to commit a violation that is targeted in shareholder class action suits. The marginal effects imply that an indiscretion increases the unconditional probability of wrongdoing by 5.5%.<sup>30</sup> As shown in Model 2, the effect is more powerful for the CEO (marginal effect = 12.8%,  $p$ -value = .04). In Model 3, where the CEO and non-CEO indicators are entered jointly, the coefficient is significant for CEO indiscretions ( $p$ -value = .04), but not for non-CEO indiscretions ( $p$ -value = .51). This suggests that, for class action lawsuits, we cannot rule out the interpretation that the CEOs are isolated bad apples. Although this could indicate that the indiscretions are a signal about the top manager rather than the culture at large, we cannot rule out the impact that CEOs have on the broader culture at the firm. In Model 4, only the reputational costs predict bad behavior.

We similarly focus on the violation periods for corporate fraud. Relative to class action lawsuits, one would imagine a higher threshold for the filing of a federal fraud investigation against the company. Thus, the violations predicted here are likely more severe forms of malfeasance than the lawsuits. In Models 1 through 4 of Table 9, Panel B, we estimate the propensity of fraud violations ultimately targeted by a DOJ or SEC enforcement action over the three-year period beginning with the indiscretion disclosure. We utilize two sources to identify the violation periods for corporate fraud. First, we use the fraud database assembled and maintained by Karpoff et al. (2008).<sup>31</sup> Second, we identify any instances of corporate fraud in the restatements file from Audit Analytics. As with shareholder class action lawsuits, prior research finds that the probability of fraud has observable predictors, which we are careful to include in our models (Brazel, Jones, and Zimbleman, 2009; Fich and Shivdasani, 2007).

Consistent with the results on shareholder initiated class action lawsuits, Models 1–3 in Table 9, Panel B, indicate that firms with executives committing indiscretions are more likely to be investigated for fraud at the federal level. As before, results are greater in magnitude and significance for CEOs but are now significant for both CEOs and non-CEOs. Also consistent with the findings for class action lawsuits in Model 4, reputational costs are significant and positively related to fraud violations and the indiscretion's direct disruption costs are unrelated to fraud

violations. As in other contexts, being targeted in a lawsuit does not indicate guilt any more than being accused of an indiscretion. However, this subsection does provide additional evidence on the linkage between alleged personal misconduct and alleged spillover effects at the firm as predicted by the integrated affairs hypothesis.

## 5.2. Managerial indiscretions and earnings management

Healy and Wahlen (1999, p. 368) define earnings management as what “occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers” (emphasis added). Because a firm's financials are often the only indications available to outside investors or other counterparties regarding the health of the company, managed earnings can substantially influence perception of the firm. In this subsection, we examine the link between earnings management and managerial indiscretions.

To detect the presence of earnings management, we follow Dechow et al. (1995) and focus on the manipulation of discretionary accruals. In Models 1 through 3, we compute discretionary current accruals, as defined by Teoh et al. (1998), for our panel data set of 15,950 firm-year observations and run cross-sectional ordinary least squares regressions to detect earnings management using our indiscretion indicator variables and a vector of controls guided by the literature. Some researchers argue that just meeting or beating analyst earnings forecasts suggests more pervasive earnings management. Consequently, we also follow Koh et al. (2008) and identify firms in which the discretionary accruals permitted the firm to meet or beat the annual analyst expectations for the fiscal year as reported in the Thomson Reuters Institutional Brokers' Estimate System (I/B/E/S) database. The (0, 1) indicator, manage to meet, is the dependent variable in Model 4. Finally, variations in operating performance among firms can lead to misspecification in estimating nondiscretionary accruals. We further acknowledge that total accruals could present a better measure of earnings management and repeat the tests in Models 5 and 6 using performance-adjusted total accruals as in Kothari et al. (2005).

The results presented in Table 10 suggest pervasive earnings management at firms in which a member of the top management team commits a personal indiscretion. In the first model, the coefficient on the indiscretion indicator variable is positive and significant, noting the presence of significant earnings management during the fiscal year in which a managerial indiscretion is disclosed. The point estimate on the indiscretion indicator implies that the magnitude of discretionary accruals is higher by as much as 2.7% of total assets relative to those at the typical company. Focusing on the identity of the executive committing the indiscretion reveals that the result is driven by the CEOs in our sample. Firms reporting a CEO indiscretion are associated with abnormal accruals amounting to 5.8% of assets in the fiscal year. For comparison, Teoh et al. (1998) find abnormal accruals of around 5–6% for firms

<sup>29</sup> <http://securities.stanford.edu/>.

<sup>30</sup> Given a marginal effect at sample means of 0.374% and an unconditional probability of lawsuit at 6.821%, the implied economic effect is  $0.00374/0.06821 = 0.0548$  or 5.5%.

<sup>31</sup> We are grateful to the authors for providing us with the data.

**Table 10**

Managerial indiscretions and earnings management.

This table presents evidence on the relation between managerial indiscretions and earnings management using the universe of firms listed in EXECUCOMP from 1996 to 2012. The dependent variable in ordinary least squares (OLS) Models 1–3 is the magnitude of *discretionary current accruals* as defined in Teoh et al. (1998). In OLS Model 5 it is the magnitude of *performance-adjusted discretionary total accruals* as in Kothari et al. (2005), where the first stage model used to estimate non-discretionary total accruals is augmented to include operating performance. The dependent variable in logistic regression Models 4 and 6 is a (0, 1) indicator of whether the discretionary current accruals in Models 1–3 or performance-adjusted discretionary total accruals in Model 5, were *managed to meet analyst expectations* following Koh et al. (2008). The key independent variable of interest, *indiscretion*, is a (0, 1) indicator variable that takes on the value of one if a managerial indiscretion is disclosed during the fiscal year and zero otherwise. *CEO indiscretion* indicates whether the event is perpetrated by the firm's chief executive officer. *Reputational costs* and *disruption costs* are the reputational and disruption costs normalized by sales described in Table 2, where the direct costs are rescaled by multiplying by one thousand. *Delaware incorporation* is an indicator variable of whether the firm is incorporated in Delaware. *Firm size* is the natural log of net sales. All other variables are defined in Table 3. Each model includes industry and year fixed effects; *p*-values are computed using robust Rogers (1993) firm-clustered standard errors.

Variable	Discretionary current accruals						Manage to meet using discretionary current accruals		Performance-adjusted discretionary total accruals		Manage to meet using performance-adjusted total accruals	
	Model 1		Model 2		Model 3		Model 4		Model 5		Model 6	
	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value
Intercept	0.121	.00	0.089	.02	0.146	.00	0.862	.00	0.045	.09	−0.649	.00
Indiscretion	0.027	.07										
CEO indiscretion			0.058	.03			0.448	.10	0.031	.08	0.594	.03
Reputational costs					0.1616	.00						
Disruption costs					−1.6196	.01						
CEO-chairman	0.005	.23	0.005	.23	0.005	.24	0.021	.56	0.005	.12	0.016	.68
CEO ownership	0.001	.03	0.001	.03	0.001	.03	−0.005	.11	0.001	.05	−0.007	.05
CEO age	−0.001	.00	−0.001	.00	−0.001	.00	0.002	.34	0.000	.31	0.003	.29
CEO tenure	0.000	.60	0.000	.58	0.000	.59	−0.006	.05	0.000	.18	−0.001	.85
Poor monitoring index	−0.001	.62	−0.001	.62	−0.001	.65	0.023	.29	−0.001	.59	0.013	.58
Delaware incorporation	0.015	.00	0.015	.00	0.015	.00	−0.011	.74	0.010	.00	0.005	.89
Firm size	−0.005	.01	−0.005	.01	−0.005	.01	−0.079	.00	−0.004	.01	−0.044	.01
ROA	−0.020	.56	−0.022	.53	−0.022	.53	1.025	.00	−0.044	.02	0.329	.14
Tobin's <i>q</i>	0.010	.00	0.010	.00	0.010	.00	0.023	.16	0.010	.00	−0.014	.42
Leverage	0.013	.42	0.012	.42	0.013	.40	0.161	.11	−0.008	.46	0.182	.11
<i>F</i> -statistic/likelihood ratio	138.46	.00	138.73	.00	136.11	.00	17.12	.00	162.69	.00	8.27	.00
<i>R</i> <sup>2</sup> /pseudo <i>R</i> <sup>2</sup>	0.1382		0.1383		0.1390		0.0134		0.1190		0.0166	
<i>N</i>	15,950		15,950		15,950		15,660		15,945		15,660	

conducting an initial public offering. In unreported tests, we do not find significant abnormal accruals at firms in which either a subordinate or a member of the board commits the indiscretion. Abnormal accruals are significantly increasing with the reputational costs of an indiscretion. Disruption costs are negatively related to earnings management. While it could be that the disruption created by an indiscretion disclosure inhibits the ability of a duplicitous manager to manage earnings (i.e., the spotlight of concurrent litigation discourages pushing the fiscal envelope), this result is not predicted by our hypotheses. We do find that CEO indiscretions are significantly positively related to the likelihood of managing to meet or beat analyst earnings forecasts. Similar results are obtained using performance-adjusted total accruals in Models 5 and 6.<sup>32</sup>

## 6. Labor market reaction to managerial indiscretions

In this section, we ask whether managerial labor markets discipline indiscretion executives. We explore three

forms of discipline for the executives involved in the indiscretions as well as for the board of directors at firms in which the personal indiscretions occurred: CEO turnover, reductions in CEO pay, and lower votes for directors in shareholder elections.

### 6.1. Managerial indiscretions and CEO discipline

Examining CEO turnover in our setting is particularly beneficial for understanding the labor market penalties for misconduct. With other forms of corporate misconduct, such as financial misreporting, the insiders (and perhaps the board) are frequently aware of the behavior before it is publicly announced and turnover often occurs prior to the information being released to the market. As a result, researchers studying whether managers suffer personal consequences for malfeasance are limited in the power of their tests because dismissals prior to fraud disclosure impair identification. In our setting, both insiders and investors (and the researcher) learn of the misconduct at about the same time, so the test is better specified.

The models in Table 11 explore the relation between managerial indiscretions and CEO discipline by estimating logistic regressions on forced CEO turnover using the combined sample of 15,950 indiscretion and control firm-year observations. Our model includes other relevant pre-

<sup>32</sup> The results presented in Tables 5 and 6 imply that reputational costs and the overall losses in firm value are larger for indiscretions involving dishonesty. In Online Appendix Table OA 8, we report tests comparing dishonesty and non-dishonesty indiscretions, which suggest that the results for lawsuits, fraud, and earnings management are positively related to cases of CEO dishonesty.

**Table 11**

Managerial indiscretions and chief executive officer discipline.

This table presents a logistic regression for the determinants for chief executive officer turnover and an ordinary least squares regression for the change in CEO pay using the universe of firms listed in EXECUCOMP from 1996 to 2012. The dependent variable in Models 1 and 2 is a (0, 1) indicator variable signifying *forced CEO turnover* during the fiscal year, where forced is defined as in [Parrino \(1997\)](#). The dependent variable in Models 3 and 4 is the *change in CEO pay* (salary and bonus). *CEO indiscretion* is a (0, 1) indicator variables which takes on the value of one if a CEO indiscretion is disclosed during the fiscal year and zero otherwise, *CEO reputation costs* and *CEO disruption costs* are the reputational and disruption costs normalized by sales described in [Table 2](#) for CEO indiscretions, where the direct costs are rescaled by multiplying by one thousand. *Stock return* is the firm's net-of market stock return during the fiscal year. *CEO age > 60* is a (0, 1) indicator of whether the CEO is older than 60 years. *Firm size* is the natural log of net sales. All variables are defined in [Table 3](#). Each model includes industry and year fixed-effects; *p*-values are computed using robust [Rogers \(1993\)](#) firm-clustered standard errors.

Variable	Forced CEO turnover				Change in CEO pay			
	Model 1		Model 2		Model 3		Model 4	
	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value
Intercept	−0.864	.13	−0.043	.92	44.589	.42	41.892	.44
CEO indiscretion	3.495	.00			−388.477	.01		
CEO indiscretion × stock return	0.738	.30			347.429	.28		
CEO reputational costs			3.083	.01			−576.59	.05
CEO disruption costs			38.735	.18			−4752.46	.00
Poor monitoring index	0.044	.44	0.062	.27	4.246	.49	3.787	.53
Stock return × Poor monitoring index	0.233	.07	0.199	.12	13.478	.49	14.418	.46
Stock return	−0.958	.00	−0.920	.00	−66.972	.01	−65.611	.01
Firm size	−0.085	.02	−0.075	.04	−11.694	.00	−12.034	.00
Leverage	0.245	.31	0.275	.26	74.026	.00	74.271	.00
Family-managed firm	−0.160	.10	−0.112	.24	−5.611	.53	−6.552	.46
CEO age	−0.021	.01	−0.023	.00	0.409	.63	0.514	.54
CEO age > 60	−2.459	.00	−2.389	.00	7.131	.61	6.856	.63
CEO tenure	0.005	.57	0.003	.74	0.308	.67	0.297	.67
CEO ownership	−0.031	.04	−0.019	.18	−0.342	.60	−0.575	.39
Outside director ownership	0.021	.03	0.021	.03	−1.782	.05	−1.752	.06
Sample	All observations		All observations		No CEO turnover		No CEO turnover	
Likelihood ratio/ <i>F</i> -statistics	555.18	.00	447.97	.00	22.00	.00	24.81	.00
Pseudo $R^2/R^2$	0.0468		0.0340		0.0845		0.0833	
<i>N</i>	15,950		15,950		12,444		12,444	

dictors of turnover shown in the literature. We classify a turnover as forced using the procedure advocated by [Parrino \(1997\)](#).<sup>33</sup> Out of the 1848 turnover events in the panel (11.6% of our sample firm-years), we classify 639 as forced (4.0% of the sample). Because the [Parrino \(1997\)](#) definition classifies any CEO departure over the age of 60 as voluntary, we are careful to include an indicator for whether the CEO is 61 or older.<sup>34</sup> We arrive at similar conclusions if we conduct our analysis on all CEO turnovers, regardless of age, instead of just forced or if we run our regressions on only those CEOs who are 59 years old or younger.

[Hazarika et al. \(2012\)](#) show that boards are more likely to dismiss CEOs for unethical job-related behavior. Consistent with this, the disclosure of a personal indiscretion is hazardous to the career concerns of the CEO. The incidence of turnover for the entire sample is 36% of all indiscretion executives (regardless of title). An alleged CEO indiscretion significantly and substantially increases the conditional likelihood of forced turnover by 41.3% (from 4.0% to 45.3%). In untabulated results, non-CEO indiscretions do not significantly increase the likelihood of forced CEO

turnover. Those CEOs who are fired experience difficulty landing a similar position. As far as we can ascertain, only 24% of the dismissed indiscretion executives in our sample obtain another position as CEO. On average, it takes them 553 days to find their new post, and this position pays, on average, \$1.2 million less than their previous position.

Of particular interest among control variables is the role of governance. Our *Poor Monitoring Index* is a zero to four summation of dummy variables associated with poor governance (non-independence, hand-picked, large, and busy boards). The results of [Table 11](#) indicate that the monitoring index by itself is insignificant but that forced turnover increases with poor stock performance. Marginal effects imply that a one standard deviation decrease in stock price leads to a 6.9% increase in turnover. However, that effect is attenuated under lax board oversight. The marginal effect on the interaction of stock returns with *Poor Monitoring Index* is a significantly positive 0.6%, suggesting that incrementing the index by one unit decreases the performance-turnover sensitivity by about 9% (=0.6/6.9). Thus, disciplinary turnover is significantly less likely for poorly performing and poorly monitored CEOs.

If a firm's integrity is weakened due to a CEO's indiscretion, the firm could fire the CEO to signal that it takes the lack of integrity of its corporate leader as a serious matter. Thus, one implication of the integrated affairs hypothesis is that CEO dismissal should be more pronounced for indiscretions involving higher reputational costs. The

<sup>33</sup> Following [Parrino \(1997\)](#), we consider a change in the annual CEO as voluntary if the departing CEO is over the age of 60, leaves for reasons retired or deceased, leaves to become the CEO of another firm, or is considered an interim CEO. All other turnovers are classified as forced.

<sup>34</sup> We thank an anonymous referee for this suggestion.



**Table 12**

Managerial indiscretions and director election results.

This table presents firm and calendar year fixed effects regressions of the vote results for 86,836 director elections from 2108 unique firms in the Institutional Shareholder Services Shareholder (ISS) Voting database from 2003 to 2013. The dependent variable in each model is the *Percent "For" Votes* observed for each director in which the percentage "For" is defined as the votes "For" divided by the sum of the votes "For" and "Against." The key independent variable of interest, *Indiscretion*, is an indicator variable that takes on the value of one if a managerial indiscretion is disclosed during the fiscal year at that firm and zero otherwise. *Reputation costs* and *Disruption costs* are the reputational and disruption costs normalized by sales described in Table 2, where the direct costs are rescaled by multiplying by one thousand. *CEO indiscretion* indicates whether the event is perpetrated by the firm's chief executive officer and *board member indiscretion* indicates the offending executive is a member of the board of directors. *Board leadership indiscretion* indicates that whether the offending executive is a member of the standing nominating, compensation, audit, or governance committee. *Firm size* is the natural log of assets. *Industry-adjusted ROA* is the ROA reported by the company less the industry median ROA. *Classified board* and *poison pill* indicate the firm has a staggered board or poison pill (as reported by RiskMetrics), respectively. *Board holdings* is the aggregate percentage ownership of the common shares held by all of the directors on the board. *Litigation* indicates that the firm was the target of a shareholder class action lawsuit, and *accounting restatement* and *non-timely SEC filing* indicate the firm restated its financials or failed to file with the Securities and Exchange Commission in a timely manner as reported by Audit Analytics. *Residual of ISS rec.* is the residual of a linear probability model predicting a "For" recommendation by ISS for the director's election. *Vote-No campaign* indicates the existence of such a campaign at the firm during the year. *Unequal voting*, *confidential voting*, and *majority voting* indicate unequal voting rights, a firm policy that prevents management from knowing how shareholders vote, and a requirement that directors are elected by majority vote, not a plurality vote, respectively. Each model includes firm or year fixed-effects and *p*-values are computed using robust Rogers (1993) firm-clustered standard errors.

Variable	Percent "For" votes									
	Model 1		Model 2		Model 3		Model 4		Model 5	
	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value	Estimate	<i>p</i> -value
Indiscretion	−1.152	.00								
Reputational costs			−7.329	.00						
Disruption costs			−0.160	.63						
CEO indiscretion					−1.283	.01				
Board member indiscretion							−1.168	.00		
Board leadership indiscretion									−1.784	.00
Firm size	−0.264	.00	−0.268	.00	−0.269	.00	−0.265	.00	−0.276	.00
Industry-adjusted ROA	2.047	.00	2.067	.00	2.063	.00	2.050	.00	2.053	.00
Classified board	−0.527	.00	−0.528	.00	−0.525	.00	−0.529	.00	−0.524	.00
Poison pill	−0.530	.00	−0.526	.00	−0.524	.00	−0.529	.00	−0.526	.00
Board size	0.012	.48	0.012	.49	0.012	.48	0.012	.47	0.011	.51
CEO-chairman	−0.018	.78	−0.012	.86	−0.013	.84	−0.014	.83	−0.012	.86
Percent independent directors	0.046	.00	0.046	.00	0.047	.00	0.046	.00	0.046	.00
Board holdings	−0.015	.00	−0.015	.00	−0.014	.00	−0.015	.00	−0.015	.00
Litigation	−1.123	.00	−1.118	.00	−1.114	.00	−1.126	.00	−1.129	.00
Accounting restatement	−0.365	.00	−0.364	.00	−0.363	.00	−0.365	.00	−0.360	.00
Non-timely SEC filing	−0.920	.00	−0.917	.00	−0.919	.00	−0.919	.00	−0.925	.00
Residual of ISS rec.	18.397	.00	18.392	.00	18.392	.00	18.394	.00	18.391	.00
Vote-No campaign	−2.306	.00	−2.248	.00	−2.246	.00	−2.285	.00	−2.268	.00
Unequal voting	−0.351	.10	−0.330	.12	−0.336	.12	−0.349	.10	−0.337	.12
Confidential voting	0.171	.11	0.167	.12	0.171	.11	0.175	.10	0.194	.07
Majority voting	1.243	.00	1.246	.00	1.246	.00	1.242	.00	1.245	.00
<i>F</i> -statistic	46.50	.00	46.46	.00	46.48	.00	46.50	.00	46.50	.00
<i>R</i> <sup>2</sup>	0.5395		0.5394		0.5394		0.5395		0.5395	
<i>N</i>	86,836		86,836		86,836		86,836		86,836	

results from Model 2 provide some evidence in support of this hypothesis as CEO reputational costs are significantly and positively associated with CEO turnover. This result is striking and suggests that the integrated affairs hypothesis drives board and shareholder behavior. The fact that CEO turnover is more likely following indiscretion-related declines in stock price supports the view that investors care about managerial indiscretions when they affect firm value and discipline the manager accordingly.

The question remains regarding what happens to those executives who are able to retain their jobs. Do they face some sort of discipline short of being fired? To shed light on this, we examine the change in the CEO's salary and bonus while restricting the sample to the 12,444 firm-year observations in which there no turnover occurs in the year prior and the year of the managerial indiscretion. Model 3 of Table 11 reveals a significant and substantial reduction in CEO pay in the year following the announcement of the indiscretion. Our estimates suggest that CEO pay

falls by \$388,000, indicating that boards assess a financial penalty for personal missteps. The change in CEO pay is also decreasing in CEO reputational costs and CEO disruption costs, indicating that when the costs of an indiscretion are greater for the firm, it enforces greater discipline on the individual charged with the indiscretion.

## 6.2. Managerial indiscretions and director elections

A related question is whether board members overseeing low integrity executives face repercussions from shareholders when they go up for election at the annual meeting. Few board members would suggest that they should be held responsible for monitoring the private extracurricular activities of their executives. To determine if shareholders reflect discontent with directors of indiscretion firms, we examine the shareholder vote totals of these boards. Table 12 presents firm and calendar year fixed effects regressions of the voting results for 86,836 director

elections from 2108 unique firms in the Institutional Shareholder Services (ISS) Shareholder Voting database from 2003 to 2013. The dependent variable is the *Percent “For” Votes* observed for each director, with the percentage “for” defined as the votes “for” divided by the sum of the votes “for” and “against.” The key independent variable of interest is an indicator that takes on the value of one if a managerial indiscretion is disclosed during the prior fiscal year and ‘0’ otherwise. *CEO Indiscretion* indicates an indiscretion by the firm’s CEO, and *Board Member Indiscretion* indicates that the offending executive was a member of the board of directors. *Board Leadership Indiscretion* indicates whether the offending executive is a member of the standing nominating, compensation, audit, or governance committees. Control variables include firm size, performance, standard governance measures, indications of litigation and accounting restatements, and other variables following Cai et al. (2009).

Results for all four main variables of interest indicate significantly lower votes for directors following the announcement of a personal indiscretion by an executive of their firm. Vote totals are significantly lower if an indiscretion occurred, if the CEO was involved in the indiscretion, if a board member was involved in the indiscretion, and if the executive associated with the indiscretion was a member of the nominating, compensation, audit, or governance committee.<sup>35</sup> The magnitude of the 1% to 2% lower vote total is comparable to the shareholder reaction to the firm being targeted by material litigation or under-performing its industry ROA benchmark by about 1%. Similar to Cai et al. (2009), the change in vote totals we observe is unlikely to deny any board member a seat. However, those authors also show that even small changes in votes are associated with significant changes in board behavior, including adjustments in executive pay and the removal of takeover defenses. Model 2 suggests that the impact on the “for” votes is significantly influenced by the reputational costs as opposed to the disruption costs of an indiscretion. This suggests that, consistent with the integrated affairs hypothesis, shareholders consider the board at least partially responsible for integrity concerns of those whom they monitor. The results here are particularly interesting because they apply to all board members at the firm and not just the offending executive. We find this governance association intriguing, as few would suggest that the role of board oversight extends into the CEO’s bedroom or extracurricular activities. These results are consistent with shareholder rejection of the separate affairs hypothesis in the voting patterns for the executives involved and for the directors associated with these executives.

## 7. Summary and conclusions

By the time a company’s ethical problems are apparent in the boardroom, they have resulted in a dramatic

loss of shareholder value. Many executives, however, are accused of indiscretions in their personal lives, including allegations of sexual misadventure, substance abuse, violence, and dishonesty. A priori, these incidents have no direct link to the business operations or financial decisions of the firm and, under the separate affairs hypothesis, they should have no impact on firm value. A leading auditing standard states that in auditing for non-compliance, auditors should ignore personal executive indiscretions. In contrast, the integrated affairs hypothesis suggests that these personal incidents will hurt shareholders. This hypothesis states that the personal indiscretion signals traits that influence financial reporting, corporate behavior, and the trust of shareholders and other stakeholders.

We test these hypotheses in several ways. We examine wealth effects associated with announcements of the indiscretions. On average, an immediate 4.1% loss in shareholder value occurs at the disclosure of a CEO indiscretion and operating performance suffers an abnormal decline in the same fiscal year. A decline in firm value, however, could simply indicate that it was not optimal for the executive to be caught. It does not necessarily indicate losses due to signals of low integrity. Consequently, we decompose the total cost into its reputational and direct components and examine associated impacts on counterparty business. We find significant reductions in counterparty relationships associated with indiscretions in general and reputational costs in particular. CEO indiscretions are associated with significant declines in the number of new major customers and joint venture partnerships. Customer losses are particularly severe for those indiscretions that damage the firm’s reputation the most.

The market could anticipate that some industries are more inclined to hire managers with low integrity. If questionable behavior is anticipated, the announcement of an indiscretion has less of a negative impact. Firms in industries with above median amounts of enforcement actions and noncompliance reports are associated with smaller market reactions to announced indiscretions.

Additional evidence suggests that these observable signals of poor managerial character provide investors a canary in the coal mine with regard to future malfeasance. We find that those firms whose executives commit a managerial indiscretion are significantly more likely to manage reported earnings and their firms are also more likely to engage in wrongdoing targeted by shareholder class action lawsuits and DOJ and SEC fraud investigations.

Finally, the managerial labor markets do not stand idle in light of these disclosures. CEO turnover increases dramatically in the wake of an indiscretion and compensation declines for CEOs who are retained. The collateral damage goes further. At least some shareholders seem to hold board members responsible for indiscretions associated with the firm’s executives. Board members receive significantly lower votes in the director election immediately following announcement of an indiscretion. Collectively, our results imply that the personal integrity of the top management team plays an important role in the valuation and business operations of the firm.

<sup>35</sup> Tests comparing the impact of dishonesty and non-dishonesty indiscretions indicate that voting outcomes are largely driven by indiscretions involving acts of dishonesty. These are reported Online Appendix Table OA 9.

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