The Agency Costs of Managerial Indiscretions[*]

Sex, Lies, and Firm Value

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Abstract – This paper asks if there are agency costs to managerial indiscretions. It investigates whether the personal lives of top management influence returns to shareholders or if their extracurricular activities are separable from their responsibilities at the firm. To answer these questions, we assemble a unique sample of executives who have allegedly engaged in ethically questionable, but non-business-related behavior which potentially compromises the integrity of their personal, professional, or legal environments. The sample events are distinguished from other forms of malfeasance studied in the literature in that they are, by construction, unrelated to the business activities of the firm and reflect personally upon the character of top management. The evidence indicates that personal managerial indiscretions negatively impact firm value and performance. On average, there is an immediate 1.5% loss in shareholder value at the disclosure of an indiscretion. Conditional on the indiscretion originating for the CEO, firm value declines by 4%. Moreover, operating performance for firms with CEO indiscretions suffers an abnormal decline of 3.26% in the same fiscal year. These losses are mostly attributable to cases of dishonesty by top management from. ,as shareholder experience losses of 3.2% compared to a a significant -0.78% for all high distraction events. This suggests that investors are concerned with the integrity of top management as well. Executives accused of committing an indiscretion significantly manage their reported earnings upward during the year in which the indiscretion is disclosed, further supporting the notion that these events signal an impairment of managerial character. The evidence indicates that better governance structures might decrease the likelihood of an indiscretion occurring.

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1. Introduction

The subject of managerial integrity is an oft-discussed issue in the financial and academic press as well as in the classroom. Despite that ethics are frequently placed at the forefront of company policy and even congressional legislation,[1] the headlines remain littered with cases of executives whose personal life choices have disrupted the firms they lead. Boeing's Harry Stonecipher, RadioShack's David Edmonson, Staples' Martin Hanika, and Raytheon's William Swanson were all placed under the spotlight for engaging in alleged extramarital affairs, substance abuse, domestic violence, or public displays of dishonesty. Many of today's chief executives recognize that these activities might put the corporation at risk. Shelly Lazarus, CEO of multibillion dollar marketing firm Ogilvy & Mather Worldwide, says that in a 24/7 news world, "everything a C.E.O. says and does is no longer personal. It is attributed to the company" [Gordon (2007)].

Although some executives' extracurricular activities are quite sensational, other cases suggest that management's personal behavior does not translate into poor performance for the firm. Oracle's CEO, Larry Ellison, is purported to have had strings of senior-subordinate romances and a hard-charging lifestyle, but the Silicon Valley software-maker remains one of the market darlings. Microsoft's CEO Steve Ballmer, aka 'Bad Boy Ballmer,' has successfully executed his strategic plan and maintained the firm's considerable market power during his tenure. This is in spite of accusations of poor self-control which reference a violent outburst against an employee who left for rival firm, Google. Virgin Group's Richard Branson and billionaire entrepreneur Mark Cuban have both cultivated successful empires despite well-known reputations as perennial rebels.

This paper investigates the issue of whether a manager's personal and professional lives are separable or if acts of questionable integrity in one's private affairs signal a greater problem brewing at the firm. That is, do those managers who engage in personal improprieties represent a greater moral hazard when executing the duties of their office? While almost universally revered as a desirable quality,

[1] Section 406 of the Sarbanes-Oxley Act requires that all companies subject to the act adopt a code of ethics policy or explain why they have chosen not to.

the issue of managerial integrity has received scant attention in the finance and economics literatures. While integrity is difficult to measure, allegations of personal misconduct might provide useful insight to the character of an executive. To investigate this issue, we assemble a unique sample of personal misconduct on the part of the top management team. The managerial indiscretions analyzed in this paper include incidences of sexual misadventure, substance abuse, violence, and public dishonesty. These events, which might arguably present a distraction to the executive, could also provide a relative proxy for the integrity of the top management team.

In this paper, we present four competing, but non-mutually exclusive hypotheses that address how managerial indiscretions might affect shareholders. The *pure skills* hypothesis states that these tangential activities do not impact firm value or operating performance and that only management's raw abilities are relevant for creating value. The *managerial risk aversion* hypothesis advances the notion that firms run by indiscretion executives, due to an increased appetite for risk, face lower agency costs associated with inducing the top management team to undertake risky, value-maximizing projects. Challenging the pure skills and managerial risk aversion hypotheses, the *distraction* hypothesis contends that managerial indiscretions adversely impact firm value from either the physical distraction of top management while they partake in these activities or from the disruption created at the firm when the consequences of their extracurricular activities force their removal from the company. Alternatively, the *managerial character* hypothesis argues that managerial indiscretions impair the trust and confidence that investors, subordinates, and customers have with management. As a result, this engenders an environment with excessive contracting costs and greater perceived information asymmetries.

The evidence provided herein does not appear to support the *pure skills* or the *managerial risk aversion* hypotheses since firm value and operating performance decrease significantly around the disclosure of an indiscretion. There is an immediate 1.55% loss in shareholder value at the revelation of an indiscretion, which translates to an average loss of $304 million in market capitalization. When committed by the CEO, the loss in shareholder value reaches 4.08% and these firms are associated with a significant abnormal decline of -3.26% in ROA the fiscal year in which indiscretion is disclosed. The results are consistent with the *distraction* hypothesis, although we find evidence that indicates that investors are concerned with the character and values of top management as well. Firm value remains adversely affected even for those indiscretions that offer a low potential for distraction. Further, the evidence indicates that executives accused of an indiscretion significantly manage their reported earnings for the year in which the indiscretion is disclosed. These last results provide the most support for the *managerial character* hypothesis.

This paper is related to two strands of literature. The first is the literature that examines the importance of top management as a factor of production. Existing work documents the role that the top management team plays to either create or destroy shareholder value [Fama and Jensen (1983), Lang, Stulz, and Walkling (1989)]. However, much of the extant literature on managerial quality focuses on the technical skills and experience of an executive when investigating their importance as an input factor of production [Bertrand and Schoar (2003)]. Some authors have considered how certain behavioral biases might affect economic decisions by the top management team [Camerer and Lovallo (1999), Malmendier and Tate (2005)]. Nonetheless, the available literature on managerial traits and behavior is limited in scope to the realm of normal firm activities (ex. agency costs associated empire building during M&A activity, overconfidence and executive compensation, etc). This paper contributes to the literature by documenting the importance of non-business related activities that consume top executives to firm value and how a manager's personal life may influence the firm's production function.

The second strand of literature related to this paper studies the importance of reputation and trust in economic exchange [Blau (1964), Tirole (1996)]. Recently, Erhard, Jensen, and Zaffron (2008) have argued that the integrity of the top management team is a factor of production. This notion has precedent in the literature. Mutual trust between two economic agents may serve as a substitute for excessive contracting which affords the opportunity to forgo the transaction costs imposed by these controls [Williamson (1975)]. These frictions are especially relevant in the market for corporate control. Investors face a market for lemons when allocating capital [Akerlof (1970)]. Since not all outcomes are contractible, the costs of agency and information asymmetries between managers and investors can be substantial [Jensen and Meckling (1976), Myers and Majluf (1984)]. When the trust among economic agents is breached, the offending agent's reputation is damaged. Most interestingly though, the repercussions resulting from the damaged reputation are often many times the actual harm associated with the offending event. For example, Karpoff, Lee, and Martin (2006) show that, while the legal penalties for corporate fraud average only $24 M, investors punish the firm's market capitalization by over seven times that amount. This holds even for lesser breaches of expectations between shareholders and managers. Yermack (2006) shows that when CEOs unexpectedly implement lavish corporate jet programs, the stock price drops by 1% at the announcement and then underperforms similar risk firms by 4% per year thereafter. Again, the loss of shareholder value is many times that the actual cost of the corporate jet program itself. A common characteristic of the existing work on managerial excess and malfeasance is that the events studied are intertwined with the business itself. Thus, each offending action could have been undertaken by corporate managers attempting, in their own best business judgment, to increase shareholder value. This study extends the existing literature by analyzing activities which are, by construction, explicitly tangential to the operations of the firm, but still reflect personally upon character and quality of the executives in question.

The remainder of this paper is organized as follows. Section 2 discusses the related literature and develops testable hypotheses. Section 3 describes the sample selection process and describe the sample observations. Section 4 presents the empirical evidence while Section 5 concludes.

2. Literature Review and Hypothesis Development

There is an extensive literature that documents the importance of top management to shareholder value. Successful firms capitalize on the growth opportunities that others either cannot or choose not to capture [Zingales (2000)]. Fama and Jensen (1983) charge senior management with the responsibility of initiating and implementing the strategies which exploit these opportunities. The market for corporate control punishes those firms in which management does not develop available opportunities either because of self-dealing [Jensen and Meckling (1976), Lang, Stulz, and Walkling (1989), Yermack (2006)] or from a lack of ability [Hayes and Schaefer (1999), Fich (2005)].

Much of the extant literature on managerial quality focuses on the technical skills and experience of the executive when investigating their importance as an input factor of production [Rosen (1981), Bertrand and Schoar (2003)]. If these are the only relevant factors, then pure managerial talent is the dominating force when attributing an executive's contribution to firm value. In this view, managers are able to completely separate their personal and professional lives and only their raw abilities matter.

Kaplan, Klebanov, and Sorensen (2007) 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 their VC and LBO 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 may even negatively affect outcomes. Frank and Goyal (2007) provide additional evidence for publicly traded companies using a vector of CEO personal characteristics including: age, gender, education, career experience, and tenure at the firm. The authors find that, while compensation packages and education significantly explain the firm's capital structure, other personal traits exhibit no relation. These results imply that the value of corporate management is dependent largely on the skills and talents each executive brings to the firm and that education and career experience are the key personal characteristics that matter.

Hypothesis 1: Pure Skills – Only the pure skills of senior executives affect shareholders. Managerial indiscretions that occur while an executive is away from the job and are explicitly linked to the company's operations have no bearing on firm value or performance.

It is often argued that executives are too risk-averse and may pass up risky, albeit value-maximizing investment opportunities if they threaten their job security [Smith and Stulz (1985)]. To the extent to which engaging in risky personal behavior in one's external affairs signals a greater appetite for risk for a particular executive, managers engaging in indiscretions may be more willing to take risks that lead to enhanced shareholder value. Indeed, Lane, Cherek, and Tcheremissine (2004, 2005) document that when users of recreational drugs and alcohol are faced with two financial gambles, they preferred the riskier of the two options. The typical solution for inducing managers to utilize firm resources in shareholders' interests is to design compensation contracts which are convex in their payoffs with firm performance, but these plans are not without an added cost [Habib and Ljungqvist (2005)]. If individuals who engage in perilous personal behavior are, in fact, less risk-averse, then firms led by indiscretion-executives would also enjoy lower explicit contracting costs associated with ensuring their executives have proper incentive alignment.

Hypothesis 2: Managerial Risk Aversion – Managerial indiscretions are associated with higher firm value and performance, since these organizations are led by management teams with greater appetites for risk and are more inclined to undertake risky, value-maximizing projects.

There are reasons to believe that management's private life could have a detrimental influence on their professional affairs. Some authors have argued that other factors, such as behavioral biases, might affect firm performance rather than just the pure skills of top management [Malmendier and Tate (2005)]. In Becker's (1965) model, managers allocate time in a utility-maximizing manner in which they trade-off the rewards from private life activities and labor for productive outcomes.

Bennedsen, Pérez-González, and Wolfenzon (2007) provide evidence of executives faced with this choice using a sample of limited liability companies in Denmark. They find that the sudden death of one of the CEO's immediate family members negatively impacts performance as time is taken out to address the personal crisis. Managers' private affairs might also affect firm performance if the consequences of these activities force the removal of the executive either from legal complications or disciplinary turnover. In this event, the sudden loss of a top executive could have a disruptive effect on firm operations. Johnson, Magee, Nagarajan, and Newman (1985) and Bennedenson *et al.* (2007) document that the sudden death of a senior executive is associated with negative stock price reactions. Other authors have found a negative effect for disciplinary turnovers as well [Khanna and Poulsen (1995)]. Thus, managerial indiscretions might adversely affect firm performance if the executive allocates time to these private life activities away from more productive endeavors at the firm or if the sudden loss of the executives disrupts the firm's ongoing operations.

Hypothesis 3a: Distraction – Managerial indiscretions negatively impact firm value and performance because they distract from the executive's obligations or because of the disruption caused by the sudden loss of the executive due to legal complications or disciplinary turnover.

Unlike the observations in Bennedenson *et al.* (2007), managerial indiscretions also reflect personally upon the quality and character of the executive in question. Previous work has shown the importance of reputation and trust in economic exchange [Blau (1964), Tirole (1996)]. Erhard, Jensen, and Zaffron (2008) argue that managerial integrity is a factor of production which is necessary, but not sufficient, for success. As the integrity of management becomes impaired, the organization no longer functions properly or to its potential.[2] In this environment, contracts and controls become substitutes for trust and additional transaction costs are incurred [Williamson (1975)]. The result is a reduction in

[2] 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 where top management does not maintain integrity, i.e. keep its word, does 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.

the opportunity set and the restricted ability to capitalize on the growth options described by Zingales (2000).

Prior research documents a relation between the character of top management and firm value. Chemmanur and Paeglis (2005) examine executive credibility surrounding initial public offerings and find that firms with more reputable management enjoy higher post-IPO stock price performance, higher operating performance, and lower underpricing at the issuance. Further, investor reactions to signals of impaired managerial integrity are often substantially larger than the cash flow impact of the events themselves [Karpoff, Lee, and Martin (2006), Yermack (2006), Bernile and Jarrell (2008)]. Although each of the abovementioned studies examine business-related activities, the implication is that negative signals regarding the character and integrity of management adversely affect firm value. In this view, managerial character and integrity are inseparable from the organization and are intimately linked to future performance.

> *Hypothesis 3b: Managerial Character – Managerial indiscretions negatively impact firm value and performance since managerial character and integrity are factors of production. Executives who are visibly out of integrity in their personal lives engender a professional environment with excessive contracting costs.*

3. Data

3.1 Sample Selection

To test the hypotheses presented in Section 2, we assemble a unique sample of executives who have engaged in questionable ethical behavior that potentially compromise the integrity of their personal, professional, or legal environments. The cases are identified using targeted search strings in the *Factiva*, *LexisNexis*, and *ProQuest* news retrieval services.[3] The sample is arranged along four broad categories:

[3] The following is an example *LexisNexis* search string which searches for *dishonesty*: (CEO OR COO OR CFO OR executive OR president OR chairman) w/p (lied OR lie OR credentials OR resume OR dishonest OR plagiarism OR falsification OR falsified OR padded resume OR lied on resume).

sexual misadventure, *substance abuse*, *violence*, and *dishonesty*. S*exual misadventure* refers to extra-marital affairs, senior-subordinate inter-office romances, accusations of sexual harassment, and the like. *Substance abuse* cases are reported DUIs, illicit drug arrests, etc. *Violence* refers to instances of domestic violence, sexual battery, rape, or assault.[4] *Dishonesty* cases include falsifying credentials, perjury, and plagiarism. *Sexual misadventure* and *dishonesty* cases represent the breaking of explicit or implicit agreements in the executive's personal or professional environment while *substance abuse* and *violence* cases are violations of the executive's legal obligations. These observations are chosen such that the activities are explicitly tangential to the operations of the firm or the normal business-related activities of the executive. Other questionable activities, such as fraud, embezzlement, or securities violations, which might also signal the integrity of the executive are specifically excluded since these could potentially be undertaken to further the goals of the organization and may have an ambiguous impact on future performance.[5]

[TABLE 1]

We identify 372 potential indiscretion observations involving C-level executives (CEO, COO, CFO), division heads, or board members from 1978 to 2009. Table 1 shows that, after screening for COMPUSTAT and CRSP data, there is a final sample of 252 indiscretions.[6] It is likely that there are many other instances of indiscretions than we are able to identify. These types of events are often summarily swept under the rug and never reported as neither the firm nor the executive have a vested interest in disclosing them [Murray (2007)]. Since the sample construction is dependent on the media reporting the indiscretions, the identified incidents likely understate the prevalence of these sorts of

[4] Some *violence* acts, such as sexual battery or rape, might also be classified as *sexual misadventure*. The distinction is made here since these cases are criminal in nature as opposed to the strictly personal or civil complaints involved in the misadventure category.
[5] For a discussion of the costs and benefits of fraud to the organization, see Murphy, Shrieves, and Tibbs (2008).
[6] Seventy-six observations were excluded because there was not sufficient information to substantiate the alleged indiscretion for our analysis (ex. no specific date from the news stories, details of the case are unclear, etc). Ten were excluded because the executive was no longer at the firm when the event was reported (ex. Thrifty Payless was spun-off from K-Mart in the midst of an alleged affair involving Thrifty's CEO). Three observations were excluded because they were not completely unrelated to company business. Twelve were eliminated because they were not yet publicly traded at the time of the announcement. The remaining 19 were excluded because they had insufficient information on CRSP/COMPUSTAT to conduct our primary tests.

events. To the extent that these unidentified events remain hidden in any sort of matched control group, this should bias against finding a difference in relative performance.

[TABLE 2]

3.2 Sample Characteristics

As shown in Table 2, there is substantial skewness in the size of the firms in the sample as they range from very small to rather large capitalization firms. The mean (median) level of assets, sales, and market capitalization are $63.4B ($10.6B), $19.5B ($2.2B), and $19.6B ($2.3B), respectively. Comparing these figures to those in other studies of managerial reputation, they are somewhat smaller than those in Yermack (2006), but substantially larger than those in Chemmanur and Paeglis (2005). The average (median) market-to-book ratio of 6.43(2.25) is also somewhat higher than in other corporate work, indicating that the sample firms are more growth oriented. Consistent with the growth firm characterization, the mean firm in the sample exhibits a negative return on assets during the year in which the indiscretion is disclosed, although the median firm is profitable.

[TABLE 3]

Table 3 documents participants, characteristics, and outcomes of the sample indiscretions. The proportion of founding families in the sample, 18%%, is significantly higher than that found in a typical study of U.S. industrial firms [Fahlenbrach (2006)]. Roughly 40% of the sample indiscretions involve either the Chairman or the CEO. Eighty-one percent of the sample involves the Chairman, a C-level executive, or the President. The remaining 19% of executives are either division CEOs in multi-line corporations or senior vice-presidents (not reported). The average indiscretion lasts for approximately 2.5 years prior to disclosure and a significant proportion result in some form of legal action against the executive, the firm, or both.

It appears that the board of directors is not convinced that these activities impair firm value or future performance since only 23% of executives are terminated for committing an indiscretion despite the fact that 31% are repeat offenders. For example, in January 2007 U.S. Airways CEO Doug Parker was arrested for driving under the influence and served a 24-hour jail sentence before returning to run the airline. Although the 45-year-old executive denied that the arrest pointed to a pattern of behavior, court records document that he has two prior DUI convictions [Martin (2007)].

4. Empirical Analysis

4.1 Managerial Indiscretions and Firm Value

Standard event-study methodology [Brown and Warner (1985)] is employed to test whether managerial indiscretions affect firm value, as predicted by Hypothesis 2, 3a and 3b, or whether only professional characteristics matter, as predicted by Hypotheses 1. Fama, Fisher, Jensen, and Roll (1969) demonstrate that the market quickly processes and incorporates new information regarding the firm almost immediately into the price of the stock. Thus, the sign and significance of the stock returns at the announcement of an executive indiscretion should provide an unbiased forecast of how management's personal behavior impacts the value of the firm. The disclosure date for each managerial indiscretion from the first news article mentioning the event is recorded as the announcement date. Daily market-adjusted abnormal returns are defined as the difference between the continuously compounded firm stock return and that of the CRSP value-weighted index (including distributions). Cumulative abnormal returns are defined as the three-day (-1,+1) and five-day (-2,+2) summations of the daily abnormal returns surrounding the announcement date. The multi-day windows should take into account any information leakage prior to the announcement or any delays in processing the information.

[TABLE 4]

Under the assumed hypothesis of an efficient market, the sign and significance of the stock returns at the announcement suggests that management's personal indiscretions negatively impact current and future performance. As shown in Table 4 Panel A for the full sample of 252 observations, the mean (median) three-day cumulative abnormal returns at the announcement of an indiscretion are -1.55% (-

0.43%). The results are similar when we examine the longer 5-day windows. These values are both significant at better than the 1% level. In dollar terms, this translates into an average of $304 M in market capitalization evaporating at the disclosure of the indiscretion. The losses associated with managerial indiscretions can be especially severe in some cases, with losses totaling as much as $7.1 B in shareholder value destroyed. Considering that only a minority of the cases involve some form of corporate settlement (see Table 3, Panel C), it is clear that investors are reacting to more than the legal consequences presented by an executive's alleged elicit behavior.

In Panel B, the announcement returns are segmented by executive title. The negative announcement returns are significantly larger in magnitude when the executive in question is the CEO. The mean (median) 3-day CARs for the 88 CEO observations are -4.08% (-2.39%), while the 164 other executive and director CARs are -0.19% (-0.01%). The mean and median CARs are significantly lower for the CEO group at conventional levels (not reported).

4.2 Managerial Indiscretions, Distraction, and Managerial Character

While the evidence in Section 4.1 is supportive of both hypotheses 3a and 3b, it is unable to distinguish between the two. The managerial indiscretions investigated here could reflect negatively upon the character of top management, but they might also provide a distraction. This section will attempt to utilize the characteristics of each of the managerial indiscretion categories and their outcomes to distinguish between the two sub-hypotheses.

Everything else being equal, the sudden loss of an executive as a result of the indiscretion should present a more severe distraction as the replacement is made. While a turnover at the announcement has little interpretation for the character of the executive, a significant effect would be consistent with the idea that these events provide a distraction and would provide support for the *distraction* hypothesis. While it is difficult to state which one is the most distracting, arguably the *sexual misadventure, substance abuse, violence* indiscretions have the greatest potential to occupy the time of the manager. In contrast, it is unlikely that the *dishonesty* indiscretions cause an ongoing distraction and are instead reflective of the character of the executive in question. While an observed effect in the high distraction subsample would be consistent with both sub-hypothesis, an effect in the low distraction subsample would be consistent with only the *managerial character* hypothesis.

In Table 4, Panels C and D we bifurcate the sample by whether the executive leaves the firm at the disclosure of the indiscretion and by whether the event presents the potential for a low or high distraction to the firm. Panel C shows that both when the executive is either retained or fired at the announcement there is a significant negative reaction. There is an average decline of 3.6% when the executive is fired and a decline of 0.94% when they are not. As shown in Panel D, there are significant negative investor reactions to both broad indiscretion categories. The mean (median) reaction to the low distraction disclosures is -3.99% (-1.69%) while the reaction to the high distraction disclosures is -0.78% (-0.35%). The differences are significant at conventional levels.

[TABLE 5]

Since each of the subsamples studied above may have overlapping characteristics, in Table 5 we explore our hypotheses in a regression setting. We continue to find that when the indiscretion is undertaken by the CEO, signals public dishonesty, or results in the immediate turnover of the executive it garners a more severe negative reaction. In the first model, CEO indiscretions are associated with returns that are 3.68% lower. Less distracting dishonesty cases are associated with 2.09% lower returns while turnover at the announcement generates returns that are lower by 1.87%. Since investors seem particularly concerned when the indiscretion is allegedly done by the CEO, in the second and third model we investigate the effect of when either the CEO is fired at the announcement or the CEO engages in public dishonesty by interacting these variables and examining their joint effect. These models suggest an even more severe reaction when it occurs with the CEO.

It should be noted that, throughout these tests, we *did not* exclude those events in which many researchers might consider a confounding event (ex. earnings guidance, new product announcements, etc). Rather, we identify these instances with an additional control, *confounding event*. In event studies, we assume that the market has priced relevant information and that news, on average, arrives to the market in an unbiased manner with some news events being positive and others negative, but generally mean zero [Fama *et al*. (1969)]. However, if the firm were concerned about potential negative reactions to the disclosure of an indiscretion, they may choose to disclose positive information to soften the blow. They certainly wouldn't choose to disclose negative information. Thus, if we were to find that the confounding events in our sample were significantly positively biased, this might be suggestive of an ulterior motive to announcing the confounding event and thus supportive of the managerial character hypothesis. The models in Table 5 uniformly document a positive bias to the confounding observations of around 5%. Provided that positive shocks do not systematically arrive at firms disclosing indiscretions more often than negative ones, this evidence might be interpreted as supportive of the managerial character hypothesis.

Overall, the results appear to support both the *distraction* and *managerial character* hypotheses. The results show that, for high distraction events, there is a significant detrimental impact to firm value. However, there is also evidence to support the notion that investors are concerned with the character and quality of top management as well.

4.3 Managerial Indiscretions and Firm Operating Performance

The above section demonstrates that investors react negatively to the disclosure of an indiscretion. In this section we attempt to uncover one potential motivation for the reaction, namely changes in firm operating performance. The results here should also serve to further distinguish our hypotheses. Barber and Lyon's (1996) methodology is employed to detect abnormal operating performance. Each sample firm is assigned to an industry and pre-event performance matched control group which is defined as all firms having the same 2-digit SIC code and an ROA within 90%-110% of that of the sample firm. Since the typical indiscretion begins two years prior to disclosure, the matching algorithm is performed at this point and abnormal operating performance is observed from the start of the indiscretion until one year after the disclosure. Abnormal operating performance is defined as the difference between the observed operating performance of the sample firm and that of the industry control group.

[TABLE 6]

Overall, the firms in our indiscretion sample do not perform differently than their industry- and performance-matched peers. Panel A shows that, on average, the sample firms demonstrate an insignificant abnormal ROA of -0.66% in the year in which an indiscretion is disclosed. However, the story is a bit different if we restrict our attention to the CEO, the individual with the most impact on firm performance. Consistent with the event study evidence in Section 4.1 and 4.2, Table 6 Panel B indicates that CEO indiscretions negatively impact the firm's operations in addition to shareholder value. For the fiscal year in which an indiscretion is disclosed, this group experiences a mean abnormal decline of -3.26% which is both statistically and economically significant. Unlike the above results for firm value, there is no evidence of significant abnormal operating underperformance for the 'other executive or director' subgroup. This might be expected given their relatively smaller influence over the strategic direction of the firm. Splitting the CEO sample into high and low distraction subgroups in Panel C reveals that both of these indiscretion types experience significantly negative abnormal operating performance.

Overall, the results in Sections 4.1, 4.2, and 4.3 do not support either the *pure skills* or *managerial risk aversion* hypotheses, since it appears that managerial indiscretions adversely affect both shareholder value and firm operations. The data tends to support both the *distraction* and *managerial character* hypotheses.

[TABLE 6]

Panel B documents the results for abnormal operating performance. Although there is evidence of significant negative abnormal performance for the high distraction subgroup, we fail to uncover evidence of abnormal performance for the low distraction subgroup.

4.4 Managerial Indiscretions and Earnings Management

Another potential approach to distinguishing among our hypotheses is to examine the quality of the company's earnings disclosures. Healy and Wahlen (1999, p. 6) 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). The firm's financials are some of the only indications available to outside investors as to the health of the company. In a market for potential lemons, shareholders are forced to rely on management's word for the veracity of the firm's reported earnings.

Thus, trust in management to accurately portray the firm's financials is crucial to the efficient allocation of capital in the economy. Stephen McClellan, a 32-year Wall Street veteran and 19-year *Institutional Investor* All-American analyst was quoted, "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)]." If indiscretions are signals of poor character due to deceit in an executive's personal affairs, they may also be indicative of deception in how a manager portrays the firm's financials. Consequently, searching for evidence of earnings management presents a fruitful avenue to disentangle the *distraction* and *managerial character* hypotheses. While it is unclear how distractions associated with one's personal affairs might lead to a manipulation of reported corporate profits, someone who is duplicitous in their private life is increasingly likely to be so professionally. Thus, evidence of explicit earnings management would be supportive of the *managerial character* hypothesis.

To detect the presence of earnings management, we focus on the manipulation of discretionary accruals that can be used to manage reported income upwards or downwards. We compute total accruals as:

$$TA_{i,t} = \left(\Delta CA_{i,t} - \Delta CL_{i,t} - \Delta Cash_{i,t} - \Delta STD_{i,t} - Dep_{i,t}\right)/(A_{i,t-1})$$

where $TA_{i,t}$ is total accruals, $\Delta CA_{i,t}$ is the change in current assets, $\Delta CL_{i,t}$ is the change in current liabilities, $\Delta Cash_{i,t}$ is the change in cash and marketable securities, $\Delta STD_{i,t}$ is the change in short-term debt, $Dep_{i,t}$ is depreciation and amortization, and $A_{i,t-1}$ is beginning of period total assets.

While the total change in accruals is immediately observable, it is not obvious to investors what portion of accruals vary involuntarily due the daily business operations of the firm and the portion of which that have been altered in an attempt to manage earnings. Consequently, one must first estimate the level of non-discretionary accruals that arise from the day-to-day operations at the company using an assumed model for the benchmark level of accruals. In this paper, non-discretionary accruals are computed using the modified Jones (1991) model as the benchmark level of accruals. This approach, which mirrors the that taken by Dechow, Sloan, and Sweeney (1995) and Dechow, Richardson, and Tuna (2003), involves estimating the typical level of total accruals by running annual cross-sectional regressions upon each two-digit industry in the COMPUSTAT universe with available data. The assumed model used for determining non-discretionary total accruals takes the following form:

$$NDA_t = \alpha_1(1/A_{i,t-1}) + \alpha_2(\Delta REV_{i,t} - \Delta REC_{i,t}) + \alpha_3(PPE_{i,t})$$

where NDA_t (the estimated level of non-discretionary accruals for each two-digit industry at time t) is level of total accruals for each benchmark firm, $A_{i,t-1}$ is beginning of period total assets, $\Delta REV_{i,t}$ is the change in revenues, $\Delta REC_{i,t}$ is the change in accounts receivables, $PPE_{i,t}$ is the level of property, plant, and equipment. Discretionary accruals are defined as the residual of the difference between total accruals and the predicted level of non-discretionary accruals.

$$DA_{i,t} = TA_{i,t} - NDA_t$$

To determine whether managerial indiscretions are associated with material levels of earnings management, we follow the experimental design presented in Dechow *et al.* (1995) for detecting earnings management. To conduct this test, we match our sample with the 12,717 firm-year observations from the universe of firms in COMPUSTAT, EXECUCOMP and RiskMetrics (IRRC) with available financial and governance data. Since the governance data begins in 1996, the panel runs from 1996-2009. We create a (0,1) *Indiscretion* indicator takes the value '1' for each firm-year in which a member of the top management team has committed an indiscretion. For those firm-years in which no indiscretion has been disclosed, the indicator takes on a '0' value. We also create indicators for whether the indiscretion is committed by the CEO, a subordinate executive, or a member of the board. Cross-sectional ordinary least squares regressions of the following form are estimated to detect earnings management:

$$DA_{i,t} = \beta_0 + \beta_1 Indiscretion\ (0,1)_{i,t} + \beta_2 Controls_{i,t} + \varepsilon_{i,t}$$

where $DA_{i,t}$ is the magnitude of the estimated level of discretionary accruals, *Indiscretion* is an indicator variable demarking a managerial indiscretion, *Controls* indicates a vector of firm, two-digit industry, and calendar year controls, and $\varepsilon_{i,t}$ is the error term. Our models include controls for *firm size* (total assets), *leverage* (total debt to assets), *return on assets* (net income to assets), and the *market to book* ratio (market value of common equity to its book value). We also account for the role that corporate governance plays by including *CEO-Chairman duality* (0,1), *CEO age, tenure, and ownership, board size*, *percent independent* directors, , and *Delaware incorporation* (0,1) as explanatory variables in the regression model. Each model includes both industry and year fixed effects.

[TABLE 7]

The results presented in Table 7 suggest pervasive earnings management at firms where a member of the top management team has committed a personal indiscretion. In the first model, the coefficient on the *Indiscretion* indicator variable is both positive and significant at the two-percent level, denoting the presence of significant earnings management during the fiscal year in which a managerial indiscretion is disclosed. The estimates are economically significant as well. Dechow *et al.* (1995) report that, for a typical firm, the average level of discretionary accruals amounts to 0.2% of total assets, with a standard deviation of 11.9%. The point estimate on the *Indiscretion* indicator implies that, for firms run by a top management team committing an indiscretion during the fiscal year, discretionary accruals are higher by as much as 7.6% of total assets relative to those at the typical company and is indicative of an aggressive management of reported earnings. Looking further at the identity of the executive committing the indiscretion reveals that the result is driven by the CEOs in our sample. We are unable to detect any abnormal accruals at firms where the indiscretion is committed by either a subordinate or a member of the board.

The results in this section show that managers committing indiscretions also appear willing to coerce the reported earnings in a manner in which makes their firms appear more favorable to outside investors. We interpret this evidence of the manipulation of the firm's financial statements by the top management team as supportive of the *managerial character* hypothesis. These results should be especially concerning to the shareholders of the indiscretion firms since several studies have documented that the upward management of corporate earnings is associated with long-run stock price underperformance [Teoh, Welch, and Wong (1998), Chou, Gombola, and Liu (2006)].

4.5 Determinants of Managerial Indiscretions

Sections 4.1through 4.4 document the adverse effects of managerial indiscretions upon firm value, operating performance, and the quality of reported earnings. This provided support for the *distraction* and *managerial character* hypotheses over the *pure skills* and *managerial risk aversion* hypotheses. Section 4.5 investigates whether certain firm or executive characteristics might predispose one to committing an indiscretion or if there are governance structures which might serve to prevent them.

Prior research has provided insights as to which factors might predispose executives to commit various forms of malfeasance. Anderson, Duru, and Reeb (2008) document that founder-led firms are associated with greater information asymmetry, larger agency costs, and lower firm performance. Further, corporate founders arguably make less of a distinction between themselves and their firms, given their substantial personal investment in the company. Consequently, founders might be especially prone to engage in these activities. Managerial power is another potential important element. For example, Grinstein and Hribar (2004) note that more powerful managers are associated with outsized M&A

bonuses. Others have shown that the size and composition of the board is an important marker for poor managerial oversight and increased agency costs [Yermack (1996), Coles, Daniel, and Naveen (2008)]. Fich and Shivdasani (2007) find that both of these factors are important determinants for malfeasance as founder firms and board size each increase the likelihood of fraud.

[TABLE 8]

We continue are analysis using the 12,717 panel data observations from Table 7. Table 8 presents eight logistic regression models which estimate the propensity for a managerial indiscretion to occur. In Panel A, the dependent variable in each model is a (0,1) indicator of whether any indiscretion, a CEO indiscretion, a subordinate indiscretion, or a director indiscretion occurs. In Panel B, we examine whether the effect of our explanatory variables differs by the type of indiscretion and use (0,1) indicator dependent variables for sexual misadventure, substance abuse, violence, and dishonesty.

We proxy for managerial power using the *managerial power* index developed by Grinstein and Hribar (2004). This is a (0,3) variable which is computed as the sum of indicators of whether the CEO is also the chairman, whether the firm has a large board, or whether the CEO is on the nominating committee. Managerial power might also manifest through family control or ownership, so we also control for *family managed firms* and *CEO ownership.* Bebchuk and Fried (2003), among others, argue that an overly collegial board may be complicit in rent-seeking behavior. Accordingly, we proxy for overly collegial boards with Coles, Daniel, and Naveen's (2008) *hand-picked board*. This is an indicator of whether more than 50% of the outside directors have tenures less than that of the CEO. Our models control for board size, ownership, and female composition. We also include standard firm controls such as *firm size*, *ROA*, *market to book*, and *stock return*.

The results appear consistent with prior research. Managerial power, founder status are significantly positively related to the likelihood of a managerial indiscretion occurring. Further, larger and hand-picked boards are also associated with a significantly greater likelihood of an indiscretion.. These results are consistent with the argument that poor governance structures increase the likelihood of a managerial indiscretion occurring.

5. Conclusions

This paper studies the importance of management's personal life to shareholder value and operating performance. It investigates whether questionable ethical behavior in one's non-business-related affairs represents a greater moral hazard or if these tangential activities are simply fodder for the popular press and irrelevant to the firm. A unique sample of personal managerial indiscretions, which include instances of *sexual misadventure*, *substance abuse*, *violence*, and *dishonesty*, is collected to examine this issue. These events are explicitly chosen such that they have no direct link to the business operations of the firm.

The data indicates that managerial indiscretions pose a significant risk to the company and impose substantial agency costs upon shareholders, particularly when it comes from the CEO. On average, there is an immediate 4.1% loss in shareholder value at the disclosure of a CEO indiscretion and operating performance suffers an abnormal decline of 3.3% during the same fiscal year. These losses may attributable to a distraction of top management from concentrating on their responsibilities governing the firm. However, shareholder value losses persist even for those indiscretions which present a low potential for distraction, indicating that investors are also concerned with the integrity of top management. Further, the evidence indicates that those firms whose executives commit a managerial indiscretion significantly manage their reported earnings upward for the year in which the indiscretion is disclosed.

It is especially troubling that only 23% of executives face disciplinary action for these offenses, despite the fact that a significant fraction these executives are repeat offenders. At best, this implies that the firm's monitors do not feel that this behavior poses a problem. At worst, it implies that these forces are ineffective at preventing these events or are simply apathetic to their consequences. The evidence suggests that, by improving the firm's governance structures, these indiscretions might be avoided. Future work should continue along these lines. As a policy implication, the evidence provided here should encourage executive selection committees to seriously consider the personal integrity of the managers in which they employ and not just their job-related skills.

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Table 1
Sample Counts by Disclosure Year and Transgression Type

This table presents the composition of 252 alleged sample observations by year and type. *Sexual misadventure* refers to non-criminal 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 are provided in the text.

Year	Sexual Misadventure	Substance Abuse	Violence	Dishonesty	Full Sample
1978	1	0	0	0	1
1980	2	0	0	0	2
1981	0	0	0	1	1
1984	3	0	0	0	3
1985	2	1	1	1	5
1987	3	0	0	0	3
1988	2	0	0	2	4
1989	1	1	0	0	2
1990	0	1	0	0	1
1991	5	0	0	1	6
1992	3	0	0	1	4
1993	6	0	3	0	9
1994	5	8	2	0	15
1995	10	0	0	0	10
1996	1	7	8	0	16
1997	11	0	3	2	16
1998	2	0	0	0	2
1999	7	1	1	1	10
2000	4	4	0	5	13
2001	2	0	0	1	3
2002	7	0	1	15	23
2003	13	0	0	3	16
2004	4	0	0	2	6
2005	6	2	2	1	11
2006	5	3	0	6	14
2007	7	3	2	11	23
2008	3	0	0	22	25
2009	3	0	0	5	8
Sample Total	**118**	**31**	**23**	**80**	**252**

Table 2
Sample Statistics

Sample summary statistics for 252 managerial indiscretion observations. *Assets*, S*ales*, and M*arket Value* are the total assets, net revenues, and market value of common equity, respectively, in millions for the indiscretion firm. *Total Debt to Assets* is total liabilities divided by total assets, *ROA* is the return on average total assets, and *Market to Book* is the market value of common equity divided by the book value of common equity. *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 CEO, *CEO Age* and *CEO Tenure* are the age and job tenure of the primary CEO. *Female CEO* is a (0,1) indicator variable of whether the primary CEO is a female. *Board Size* is the number of directors on the board. *CEO-Chairman Duality* is an indicator of whether the CEO is also the chairman of the board. *Percent Independent Directors* is the percentage of the board which is comprised of outsiders as defined by RiskMetrics (IRRC). *Percent Female Directors* is the percentage of the board comprised of female directors. *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.

Variable	**N**	**Mean**	**Std Dev**	**Q1**	**Median**	**Q3**
Firm Characteristics (t)						
Assets ($M)	252	65,394.85	256,364.69	357.17	3,012.10	18,130.91
Sales ($M)	251	19,485.50	50,142.04	300.80	2,230.63	10,621.00
Market Value ($M)	252	19,584.91	44,845.26	327.53	2,306.39	13,305.34
Total Debt to Assets	251	0.68	0.61	0.43	0.63	0.82
Performance Characteristics (t)						
ROA	252	-2.27%	67.96%	0.03%	3.22%	8.36%
Market-to-Book Ratio	250	6.43	35.79	1.30	2.25	4.03
Stock Return	252	6.04%	68.42%	-29.32%	-1.03%	29.30%
CEO Characteristics (t-1)						
Founder Firm (0,1)	252	0.18	0.39	0.00	0.00	0.00
CEO Ownership	252	6.40%	13.97%	0.05%	0.41%	4.15%
CEO Age	252	54.39	8.62	49.00	54.00	59.00
CEO Tenure	252	7.41	7.64	2.08	4.96	9.96
Female CEO	252	0.01	0.11	0.00	0.00	0.00
Governance Characteristics (t-1)						
Board Size	252	10.34	4.16	7.00	10.00	13.00
CEO-Chairman Duality (0,1)	248	0.68	0.47	0.00	1.00	1.00
Percent Independent Directors	250	62.04%	21.76%	50.00%	66.67%	78.57%
Percent Female Directors	252	8.65%	9.20%	0.00%	8.33%	14.84%
Hand-Picked Board (0,1)	248	0.62	0.49	0.00	1.00	1.00
Busy Board (0,1)	249	0.30	0.46	0.00	0.00	1.00

Table 3
Sample Executives' Title, Characteristics, and Outcomes

This table describes the type of executives involved in the 252 sample indiscretions as well as the outcome of each event for the executive and the firm. *Founding Family* indicates the executive in question is a member of the founding family. *Director Only* indicates the executive's only role at the firm is that of a corporate director. *CEO or Chairman* indicates the executive serves as either the CEO or the Chairman of the Board and *Subordinate Executive* indicates the executive holds any other title at the company. Director Only, CEO or Chairman, and Subordinate Executive are all inclusive, summing to 100%. Further disaggregating the titles, *Chairman of the Board* and *Director* denote whether the executive is the Chairman of the Board or serves on the board, respectively. *CEO* indicates the executive is the CEO, *Other C-level Executive* denotes some other C-level title besides that of CEO, and *President* indicates the title of president. *Division Head* indicates the executive is the CEO of one of the company's division. *Other Exec* denotes the executive holds some other junior level title. *Bachelor's Degree, Master's Degree, MBA Degree, PhD Degree* indicate whether these academic titles have been awarded. *Financial* and *Technical* education and career experience follow the classification schema of Malmendier and Tate (2005). *Military Experience* indicates some form of armed service. *Indiscretion Length* is the number of days over which each applicable indiscretion occurs and repeat offender indicates whether the executive has committed the same offense in the prior to the current indiscretion. *Repeat Offender* indicates that the executive has been accused of another indiscretion at some point in the past. *Executive Turnover* indicates whether the executive leaves the firm within 90 days of the first disclosure of the indiscretion. *Arrest* indicates whether the executive was arrested for the offense. *Personal Legal Action* and *Corporate Legal Action* each indicate whether the executive or the firm face civil litigation or criminal prosecution as of a result of the indiscretion. *Corporate Settlement* and *Settlement Amount* describe whether the firm arranges a settlement with the aggrieved party and the amount of that settlement (if disclosed). The number of observations with available data is in listed in parentheses.

Panel A: Title Held by Executive

Founding Family	Director Only	CEO or Chairman	Subordinate Executive	Chairman of the Board	Director	CEO	Other C-level Executive	President	Division Head	Other Exec
18.25%	30.95%	41.27%	27.78%	30.16%	76.59%	34.92%	15.87%	19.84%	5.95%	12.70%
(252)	(252)	(252)	(252)	(252)	(252)	(252)	(252)	(252)	(252)	(252)

Panel B: Personal Characteristics

Male	Age	Bachelor's Degree	Master's Degree	M.B.A. Degree	Ph.D. Degree	Financial Education	Technical Education	Finance Career Exp.	Technical Career Exp.	Military Exp.
97.62%	55	80.60%	43.97%	33.19%	6.90%	55.22%	24.78%	33.20%	13.11%	15.06%
(252)	(240)	(232)	(232)	(232)	(232)	(230)	(230)	(244)	(244)	(239)

Panel C: Indiscretion Characteristics and Outcomes

Indiscretion Length (Days)	Repeat Offender	Executive Turnover	Arrest	Personal Legal Action	Corporate Legal Action	Corporate Settlement	Settlement Amount
907	30.56%	23.02%	19.44%	44.00%	28.00%	22.70%	$2,743,857
(96)	(252)	(252)	(252)	(250)	(200)	(141)	(14)

Panel D: Sexual Misadventure Characteristics and Outcomes										
Founding Family	CEO or Chairman	Affair	Harassment	Repeat Offender	Executive Turnover	Arrest	Personal Legal Action	Corporate Legal Action	Corporate Settlement	Settlement Amount
23.77%	47.54%	45.90%	47.54%	29.51%	19.67%	5.74%	52.46%	49.49%	33.33%	$764,909
(122)	(122)	(122)	(122)	(122)	(122)	(122)	(122)	(99)	(81)	(11)
Executive Married	Target Married	Marries Target	With Employee	With Executive	With Subordinate	Executive Divorce	Target Divorce			
75.21%	21.82%	8.04%	77.19%	14.91%	68.42%	23.33%	9.09%			
(117)	(110)	(112)	(114)	(114)	(114)	(120)	(110)			

Panel E: Substance Abuse Characteristics and Outcomes							
Founding Family	CEO or Chairman	Drugs	Alcohol	Repeat Offender	Executive Turnover	Arrest	Personal Legal Action
26.67%	37.78%	33.33%	64.44%	53.33%	8.89%	60.00%	63.64%
(45)	(45)	(45)	(45)	(45)	(45)	(45)	(44)

Panel F: Violence Characteristics and Outcomes						
Founding Family	CEO or Chairman	Repeat Offender	Executive Divorce	Executive Turnover	Arrest	Personal Legal Action
30.77%	42.31%	19.23%	46.15%	23.08%	38.46%	46.15%
(26)	(26)	(26)	(26)	(26)	(26)	(26)

Panel G: Dishonesty Characteristics and Outcomes			
Founding Family	CEO or Chairman	Repeat Offender	Executive Turnover
7.59%	30.38%	20.25%	35.44%
(79)	(79)	(79)	(79)

Table 4
Investor Reactions to Managerial Indiscretions

This table presents the impact of 252 *managerial indiscretions* on firm value as indicated by the 3-day and 5-day cumulative abnormal returns at disclosure using standard event study methodology [Brown and Warner (1985)]. *CEO* indicates whether the executive committing the *indiscretion* is the firm's CEO, or some *other executive or director* at the firm. *Turnover at Announcement* indicates the executive left at the time of the announcement. We define dishonesty indiscretions as *Low Distraction* and the remaining sexual misadventure, substance abuse, and violence indiscretions as *High Distraction.* P-values using parametric Student's t tests and non-parametric Wilcoxon signed-rank tests are reported in parentheses.

Panel A: Overall Announcement Returns

		(-1,+1) CAR		**(-2,+2) CAR**	
	N	**Mean**	**Median**	**Mean**	**Median**
Full Sample	252	-1.55%	-0.43%	-1.16%	-0.54%
		(0.00)	(0.00)	(0.02)	(0.02)

Panel B: Announcement Returns by Title

		(-1,+1) CAR		**(-2,+2) CAR**	
	N	**Mean**	**Median**	**Mean**	**Median**
CEO	88	-4.08%	-2.39%	-3.28%	-2.21%
		(0.00)	(0.00)	(0.00)	(0.00)
Other Executive or Director	164	-0.19%	-0.01%	-0.03%	-0.20%
		(0.65)	(0.99)	(0.96)	(0.50)

Panel C: Announcement Returns by Turnover

		(-1,+1) CAR		**(-2,+2) CAR**	
	N	**Mean**	**Median**	**Mean**	**Median**
Turnover at Announcement	58	-3.60%	-1.01%	-2.71%	-1.93%
		(0.00)	(0.00)	(0.02)	(0.01)
Executive Retained	194	-0.94%	-0.38%	-0.70%	-0.39%
		(0.02)	(0.07)	(0.21)	(0.19)

Panel D: Announcement Returns by Indiscretion Type

		(-1,+1) CAR		**(-2,+2) CAR**	
	N	**Mean**	**Median**	**Mean**	**Median**
Low Distraction	80	-3.20%	-0.63%	-3.06%	-1.49%
(Dishonesty)		(0.00)	(0.01)	(0.01)	(0.02)
High Distraction	172	-0.78%	-0.35%	-0.28%	-0.42%
(Sexual Misadventure, Substance		(0.03)	(0.07)	(0.53)	(0.24)
Abuse, and Violence)					

Table 5
Managerial Indiscretions and Firm Value

This table presents industry and calendar year fixed effects regressions of firm value upon indiscretion, executive and firm characteristics. The dependent variable in each model is the 3-day cumulative abnormal return centered on the disclosure of the indiscretion. *CEO* indicates that the executive in question is the company's CEO. *Low Distraction (Dishonesty)* is an indicator of whether the indiscretion was a public dishonesty case. *TO at Announcement* is an indicator of whether the executive left the firm at the announcement of the indiscretion. *Founding Family* indicates the executive was a member of the founding family. *Arrest* indicates the executive was arrested as a result of the indiscretion. *Confounding Event* indicates that the firm announced some other event that is generally regarded as influencing stock returns (ex. earnings guidance, mergers, new product announcements, etc). *Firm Size* and *ROA* are total assets and the return on assets reported by the company prior to the announcement. *CEO + Interaction* indicates the joint effect and significance of the estimates on 'CEO' and either CEO x TO at Announcement or CEO x Dishonesty. All models include industry and calendar year dummies.

	(-1,+1) CAR		(-1,+1) CAR		(-1,+1) CAR	
	Estimate	**Prob t**	**Estimate**	**Prob t**	**Estimate**	**Prob t**
Intercept	0.0010	0.88	-0.0009	0.90	-0.0052	0.45
CEO	-0.0368	0.00	-0.0306	0.00	-0.0187	0.07
Low Distraction (Dishonesty)	-0.0209	0.02	-0.0210	0.02	-0.0034	0.74
TO at Announcement	-0.0187	0.05	-0.0107	0.35	-0.0188	0.04
Founding Family	-0.0061	0.59	-0.0083	0.47	-0.0114	0.31
Arrest	-0.0050	0.62	-0.0041	0.68	-0.0022	0.82
Confounding Event	0.0499	0.00	0.0506	0.00	0.0486	0.00
Firm Size	0.0000	0.73	0.0000	0.75	0.0000	0.56
ROA	-0.0033	0.71	-0.0043	0.63	-0.0027	0.75
CEO x TO at Ann			-0.0237	0.22		
CEO x Dishonesty					-0.0601	0.00
CEO + Interaction			-0.0542	0.00	-0.0788	0.00
F-Statistic	7.81	0.00	8.46	0.00	7.13	0.00
N	252		252		252	

Table 6
Managerial Indiscretions and Operating Performance

This table presents the impact of the 220 managerial indiscretions with complete data on firm performance as evidenced by abnormal operating performance from two years prior to one year after disclosure using the procedure outlined in Barber and Lyon (1996). Panel A presents the results for the full sample, Panel B presents for only those observations where the executive is the firm's CEO. Panel C bifurcates the CEO results by whether the indiscretion is classified as low or high distraction. We define dishonesty indiscretions as *Low Distraction* and the remaining sexual misadventure, substance abuse, and violence indiscretions as *High Distraction.* P-values using parametric Student's t tests are reported in parentheses.

Panel A: Full Sample Abnormal Operating Performance

	Abnormal ROA (t-3)	Abnormal ROA (t-2)	Abnormal ROA (t-1)	Abnormal ROA (t)	Abnormal ROA (t+1)
N	220	219	213	207	184
Mean	0.02%	1.54%	0.99%	0.66%	1.02%
p-value	(0.09)	(0.00)	(0.07)	(0.30)	(0.19)

Panel B: Abnormal Operating Performance for CEOs

	Abnormal ROA (t-3)	Abnormal ROA (t-2)	Abnormal ROA (t-1)	Abnormal ROA (t)	Abnormal ROA (t+1)
N	76	76	75	74	64
Mean	0.01%	-0.39%	-0.44%	-3.26%	-5.63%
p-value	(0.61)	(0.71)	(0.70)	(0.00)	(0.01)

Panel C: Abnormal Operating Performance for CEOs by Indiscretion Type

	Abnormal ROA (t-3)	Abnormal ROA (t-2)	Abnormal ROA (t-1)	Abnormal ROA (t)	Abnormal ROA (t+1)
Low Distraction (Dishonesty)					
N	18	18	18	18	13
Mean	-0.06%	-3.53%	-1.51%	-12.72%	2.05%
p-value	(0.50)	(0.03)	(0.27)	(0.02)	(0.13)
High Distraction (Sexual Misadventure, Substance Abuse, and Violence)					
N	54	54	53	52	47
Mean	0.03%	-0.22%	-1.12%	-2.79%	-9.63%
p-value	(0.16)	(0.90)	(0.49)	(0.04)	(0.00)

Table 7
Managerial Indiscretions and Earnings Management

This table presents evidence on the relation between *managerial indiscretions* and earnings management. The dependent variable in each model is the magnitude of discretionary accruals as defined in Dechow, Sloan, and Sweeney (1995). The key independent variable of interest, *Indiscretion* (0,1), in an indicator variable which takes on the value of '1' if a managerial indiscretion is disclosed during the fiscal year and '0' otherwise. *CEO Indiscretion*, *Other Exec Indiscretion*, and *Director Indiscretion* indicate whether the event was perpetrated by the firm's CEO, a junior executive, or a director, respectively. *CEO-Chairman* is an indicator of CEO-Chairman duality. *CEO Age* and *CEO Tenure* indicate the age and the job tenure of the firm's CEO. *Board Size* is the total number of directors on the board, *Percent Independent* denotes the percentage of the board comprised of independent directors. *Deleware Incorp.* is an indicator of incorporation in the state of Delaware. *Firm Size* is total assets, *ROA* is net income to assets, *Market to* Book is the ratio of the market value of equity to the book value of equity. *Leverage* is total debt to assets.

	Discretionary Accruals		**Discretionary Accruals**		**Discretionary Accruals**		**Discretionary Accruals**	
	Estimate	**Prob t**	**Estimate**	**Prob t**	**Estimate**	**Prob t**	**Estimate**	**Prob t**
Intercept	1.1639	0.00	1.1628	0.00	1.1675	0.00	1.1677	0.00
Indiscretion	0.0759	0.02						
CEO Indiscretion			0.1185	0.03				
Other Exec Indiscretion					0.0681	0.25		
Director Indiscretion							0.0239	0.66
CEO-Chairman	-0.0027	0.74	-0.0025	0.76	-0.0023	0.78	-0.0024	0.77
CEO Ownership	0.0000	0.97	0.0000	0.96	0.0001	0.89	0.0001	0.83
CEO Age	-0.0012	0.03	-0.0012	0.03	-0.0012	0.03	-0.0012	0.03
CEO Tenure	0.0010	0.08	0.0010	0.09	0.0010	0.09	0.0010	0.09
Board Size	-0.0021	0.23	-0.0020	0.23	-0.0020	0.24	-0.0020	0.24
Percent Independent	0.0002	0.31	0.0002	0.31	0.0002	0.32	0.0002	0.32
Delaware Incorporation (0,1)	0.0163	0.03	0.0163	0.03	0.0160	0.03	0.0161	0.03
Firm Size	0.0000	0.07	0.0000	0.06	0.0000	0.05	0.0000	0.05
ROA	-0.3736	0.00	-0.3750	0.00	-0.3762	0.00	-0.3776	0.00
Market to Book	0.0073	0.00	0.0074	0.00	0.0074	0.00	0.0074	0.00
Leverage	-0.1108	0.00	-0.1116	0.00	-0.1113	0.00	-0.1117	0.00
F-Statistic	50.95	0.00	50.93	0.00	50.82	0.00	50.78	0.00
N	12,717		12,717		12,717		12,717	

Table 8
Determinants of CEO Indiscretions

This table presents evidence for the determinants for a *managerial indiscretion* to occur. In Panel A, the dependent variable in each model is a (0,1) indicator variable signifying whether an *indiscretion*, *CEO indiscretion*, *Subordinate indiscretion*, or a *Director indiscretion* occurred in the fiscal year. The dependent variables in Panel B are (0,1) indicator variables signifying a *sexual misadventure*, *substance abuse*, *violence*, or *dishonesty* indiscretion. *Managerial Power* is a (0,3) index defined by Grinstein and Hribar (2004) as the sum of the three indicators CEO-Chairman, large board, and CEO on the nominating committee. *Family Managed Firm* is an indicator of whether the firm is family run, which is defined as those firms indicated as so by Anderson and Reeb (2004) or those where the CEO owns over 5% of the outstanding stock. All other variables are defined in Table 2.

Panel A: Determinants by Executive Title

	Indiscretion		CEO Indiscretion		Subordinate Indiscretion		Director Indiscretion	
Variable	**Estimate**	**Prob Chi Sq**	**Estimate**	**Prob Chi Sq**	**Estimate**	**Prob Chi Sq**	**Estimate**	**Prob Chi Sq**
Intercept	-4.0308	0.00	-6.7156	0.00	-5.3588	0.00	-4.6875	0.00
Managerial Power	0.7842	0.00	0.6321	0.00	0.3407	0.15	1.3758	0.00
Family Managed Firm	1.7323	0.00	1.2425	0.00	2.2422	0.00	1.4471	0.00
CEO Age	-0.0424	0.00	-0.0256	0.16	-0.0341	0.09	-0.0556	0.01
CEO Tenure	-0.0766	0.00	-0.0391	0.09	-0.0811	0.01	-0.1040	0.01
CEO Ownership	0.0280	0.00	0.0457	0.00	0.0203	0.20	0.0104	0.61
Outside Director Ownership	-0.0376	0.27	0.0027	0.94	-0.2216	0.21	-0.0268	0.63
Board Size	0.1049	0.00	0.1504	0.01	0.1377	0.03	0.0340	0.61
Hand-picked Board	0.7620	0.00	0.9121	0.01	0.8476	0.03	0.4763	0.16
% Female Directors	-0.0064	0.52	-0.0208	0.24	0.0079	0.66	-0.0049	0.78
Firm Size	0.0000	0.00	0.0000	0.03	0.0000	0.00	0.0000	0.00
Leverage	-0.8981	0.05	-0.4508	0.56	-1.5941	0.06	-0.2655	0.76
ROA	-0.1382	0.83	-0.3144	0.74	-0.7381	0.16	2.6381	0.16
Market to Book	0.0005	0.70	-0.0070	0.81	0.0008	0.51	0.0000	1.00
Stock Return	0.0151	0.93	0.0944	0.72	0.0979	0.73	-0.0893	0.78
Likelihood Ratio	275.20	0.00	76.46	0.00	85.93	0.00	115.46	0.00
N	12,717		12,717		12,717		12,717	

Panel B: Determinants by Type of Indiscretion

	Sexual Misadventure		Substance Abuse		Violence		Dishonesty	
Variable	**Estimate**	**Prob Chi Sq**	**Estimate**	**Prob Chi Sq**	**Estimate**	**Prob Chi Sq**	**Estimate**	**Prob Chi Sq**
Intercept	-5.8805	0.00	-8.0542	0.00	-2.4022	0.31	-3.8743	0.00
Managerial Power	0.9832	0.00	1.2982	0.00	0.3275	0.47	0.5993	0.00
Founder Firm	2.4221	0.00	1.9766	0.00	2.1509	0.01	1.0917	0.00
CEO Age	-0.0318	0.09	-0.0276	0.27	-0.1175	0.00	-0.0442	0.01
CEO Tenure	-0.0620	0.02	-0.0430	0.21	-0.0314	0.60	-0.1037	0.00
CEO Ownership	-0.0192	0.37	0.0116	0.63	-0.0619	0.33	0.0503	0.00
Outside Director Ownership	-0.1311	0.22	0.0184	0.59	0.0285	0.52	-0.0671	0.31
Board Size	0.1648	0.00	0.0837	0.31	-0.0021	0.99	0.0241	0.70
Hand-picked Board	0.5197	0.10	0.3590	0.42	1.1930	0.12	1.1703	0.00
% Female Directors	0.0314	0.04	-0.0012	0.96	-0.0585	0.18	-0.0274	0.09
Firm Size	0.0000	0.00	0.0000	0.20	0.0000	0.34	0.0000	0.00
Leverage	-2.9824	0.00	0.5762	0.60	1.2609	0.44	-0.2177	0.75
ROA	-0.5707	0.38	-0.8652	0.33	4.9855	0.11	-0.2723	0.71
Market to Book	0.0004	0.93	-0.0156	0.71	-0.0183	0.75	0.0006	0.68
Stock Return	0.1526	0.57	0.1919	0.57	0.0983	0.85	-0.1670	0.52
F-statistic	179.51	0.00	62.08	0.00	23.66	0.05	100.73	0.00
N	12,717		12,717		12,717		12,717	