The Agency Costs of Managerial Indiscretions*

Sex, Lies, and Firm Value

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Abstract – We examine a sample of executives accused of indiscretions in their personal lives for actions explicitly unrelated to the operations of their firm. These include accusations of violence, substance abuse, dishonesty, and sexual misadventure. While these actions are personal in nature, we find that they signal significant agency costs for the firm. Companies of accused executives experience significant short-term and long-term wealth losses, and reduced operating performance in the period surrounding the alleged indiscretion. These firms are also more likely to be involved in shareholder-initiated lawsuits, DOJ/SEC investigations, and are significantly more likely to manage their earnings.

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1. Introduction

An important literature examines the incidence and outcome of corporate misdeeds, focusing on allegations of fraud, shareholder lawsuits, and earnings management.[1] All of these situations are explicitly linked to the operations of the firm. Correspondingly, the firms accused often justify the actions behind these events as consistent with the intent to maximize shareholder welfare.[2] In contrast to these firm related actions are the alleged personal indiscretions of individual executives. These personal indiscretions involve allegations of dishonesty, substance abuse, sexual misadventure, or violence in the executive's private life. The actions associated with these allegations are distinct from operations of the firm and have been unexplored in the literature. Nevertheless, they offer the possibility of unique insights into managerial character and its importance to the firm. The objective of our research is to examine the corporate agency costs associated with alleged indiscretions in executive's personal life.

It has often been stated that, without the appropriate 'tone at the top,' even the best-designed controls will be ineffective. Recognizing this, ethics and codes of conduct are frequently placed at the forefront of company policy. Nevertheless, many executives face ethical charges in their personal lives unrelated to the firm's financial or operating decisions. 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.

The existence of alleged improprieties in an executive's personal life raises important questions for corporate governance. First, what is the impact of these allegations (if any) on the valuation and operations of the firm? While the allegations are purposefully selected to be distinct from operations of the firm, they have the potential to signal important managerial qualities to the market. In addition, they could distract the executive from the important task of running the business. Second, what is the

[1] For example, Karpoff, Lee, and Martin (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, Malatesta, and Sefcik (2004) and Teoh, Welch, and Wong (1998) examine the impact of earnings management on shareholder wealth. A discussion of these and other findings are discussed in the next section.

[2] See Becker (1968), Posner (1986), Bartov, Givoly, and Hayn (2002), and Murphy, Shrieves, and Tibbs (2010) for the ex-ante shareholder wealth motivations for earnings management or malfeasance.

frequency and nature of the allegations, and what is the board response to allegations of personal managerial indiscretions? A third set of questions asks whether an executive's alleged personal indiscretions relate to *subsequent* questionable or even illegal activities at the firm level including earnings management, actions provoking shareholder lawsuits, or fraud. In essence, are signals suggested by personal indiscretions borne out by successive duplicitous actions in the corporate setting? These questions are important, offering unique insights into managerial character and 'tone at the top' in settings removed from the operational or financial decisions of the firm.

Anecdotal and theoretical evidence can be found to support and refute arguments that personal indiscretions are related to the firm's performance.[3] First, many of today's chief executives recognize that their personal 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)]. Other cases suggest that management's personal behavior does not impact firm performance. Oracle's CEO, Larry Ellison, is known for leading a hard-charging lifestyle and purported to have had strings of senior-subordinate romances, but the Silicon Valley software-maker remains a market favorite. Virgin Group's Richard Branson and billionaire entrepreneur Mark Cuban have both cultivated successful empires despite well-known reputations as perennial rebels. Arguably, Elliot Spitzer's effectiveness as a district attorney or Tiger Woods' competitiveness on the golf course was not affected by indiscretions in their personal lives until their respective indiscretions were announced.[4]

While almost universally revered as a desirable quality, the issue of managerial integrity has received scant attention in the empirical finance and economics literatures, undoubtedly because of the difficulties in detection and measurement. Allegations of personal misconduct provide useful insight into the utility functions of top executives. An indiscretion may further credibly signal the relative value an executive places on their reputation which has implications for trust among economic agents. However, it

[3] We discuss related empirical evidence in the next section of this paper.

[4] Additional support for the notion that personal indiscretions might not affect an executive's company might be inferred from the actions of the boards of these executives. In our sample, the turnover rate is about 25% for first offenders and only slightly higher (27%) for repeat offenders.

is important to note that unless otherwise specified, when we mention indiscretions we are dealing with allegations, not proof of guilt. Nevertheless, the allegations and possibly the alleged behavior itself present a distraction to the executive; they also provide a measurable, if imperfect, proxy for the integrity of the top management team.

We present three 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. Two competing hypotheses (mutually exclusive with the pure skills hypothesis) are the distraction and managerial character hypotheses. The *distraction* hypothesis contends that managerial indiscretions adversely impact firm value from either the physical distraction of top management while they partake in the indiscretions or from the disruption created when the allegations are revealed. Finally, the *managerial character* hypothesis argues that personal managerial indiscretions signal flaws in character that impact corporate actions. This could impair the trust and confidence that investors, the board, subordinates, and customers have with management, and result in greater perceived information asymmetries and excessive contracting costs. Engaging in improprieties could also be associated with overconfident executives; higher agency costs might arise from increased monitoring to insure that excessive risks are not taken.[5] Any of the situations associated with the distraction or managerial character hypotheses are likely to be associated with reduced market valuation.

Note, while the pure skills hypothesis is mutually exclusive of the distraction and managerial character hypotheses, the latter two are more difficult to disentangle and are not mutually exclusive. We will attempt to differentiate managerial character from distraction by focusing on subsequent actions at

[5] An alternate hypothesis is that firms run by executives charged with indiscretions are more likely to take bold value-maximizing projects avoided by executives with excessive risk aversion. (Virgin group's Richard Branson comes to mind.) Investors might be more forgiving of indiscretions by executives associated with superior long-run performance. 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. In a study linking CEO personal risk-taking to corporate policies, Cain and McKeon (2012) find that CEOs with small aircraft pilot licenses lead firms with higher leverage and greater stock return volatility. If the typical executive is too 'risk averse' [Smith and Stulz (1985)], a CEO associated with managerial indiscretions might be willing to take more appropriate risks, increasing firm value over time. Thus, a record of superior performance may mitigate shareholder's reaction to managerial indiscretions. In contrast, excessive risk taking would decrease firm value.

the corporate level: earnings manipulation and allegations of fraud. Specific managerial decisions are necessary to impact earnings manipulation if not allegations of fraud.

Our evidence does not support the *pure skills* hypothesis*:* firm value and operating performance decrease significantly around the disclosure of an indiscretion. We find that there is an immediate 1.8% loss in shareholder value at the revelation of an indiscretion. This translates to an average loss of $176 million in market capitalization. When committed by the CEO, the loss in shareholder value reaches 3.8% or $320 million in market capitalization. The effect appears to be more than just a transitory negative shareholder reaction. Sample firms also experience a long-run decline in value of 9% to 12% during the year in which an indiscretion is announced as measured by either buy-and-hold abnormal returns or the change in Tobin's Q, respectively. We also find a significant abnormal decline of 1.5% in operating performance (ROA) in the fiscal year in which an indiscretion implicating the CEO is disclosed. The results are consistent with both the *distraction* and *managerial character* hypotheses. Further, the evidence indicates that executives accused of an indiscretion significantly manage reported earnings for the year in which the indiscretion is disclosed. Their firms are also more likely to be targeted by shareholder class-action lawsuits as well as be targeted by DOJ or SEC enforcement actions for fraud. These latter results provide the most support for the *managerial character* hypothesis.

This paper is related to two streams of literature. The first is the literature examining the importance of top management as a factor of production. Existing work documents the role top management teams play to either create or destroy shareholder value [e.g., Fama and Jensen (1983); Lang, Stulz, and Walkling (1989); Moeller, Schlingemann, and Stulz (2005)]. 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 focuses on normal firm activities (ex. agency costs

associated with empire building during M&A activity, overconfidence and executive compensation, etc). This paper contributes to this literature by documenting the link between non-business related activities, firm value, and the firm's production function.

The second stream of literature related to this paper studies the importance of reputation and trust in economic exchange [Blau (1964), Tirole (1996)]. Recently, Erhard and Jensen (2012) and Erhard, Jensen, and Zaffron (2009) 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 can reduce transactions costs if it mitigates the need for excessive contracting [Williamson (1975)]. 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. The penalties resulting from the damaged reputation are often a multiple of the actual harm associated with the offending event. For example, Karpoff, Lee, and Martin (2008) show that, while the legal penalties for corporate fraud average only $24 million, investors punish the firm's market capitalization by over seven times that amount. This also holds for smaller 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 the firm subsequently underperforms by 4% per year. 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, it is important to recognize that each of these offending actions could have been undertaken by corporate managers attempting, in their own best business judgment, to increase shareholder value [Posner (1986)]. A recent exception to this is the work of Davidson, Dey, and Smith (2011) who explore the link between criminal charges against an executive, their ownership of luxury goods, and the incidence of accounting fraud. Our study extends the existing literature by analyzing activities that are, by construction, explicitly tangential to the financial and

operational decisions of the firm, but still reflect personally upon the 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 discusses the sample selection process and describes the sample observations. Determinants of managerial indiscretions and the impact on firm performance are presented in Section 4. Section 5 examines the association between indiscretions and other agency costs such as class action lawsuits, fraud, and earnings management; Section 6 concludes.

2. Literature Review and Hypothesis Development

There is an extensive literature documenting 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 that exploit these opportunities. The market for corporate control punishes those firms in which management a) does not develop available opportunities either because of self-dealing [Jensen and Meckling (1976), Lang, Stulz, and Walkling (1989), Yermack (2006)] or a lack of ability [Hayes and Schaefer (1999), Fich (2005)] or b) pursues the wrong opportunities [Mitchell and Lehn (1990)]. However, by its very nature, the market for control is a corrective measure that works only after the damage is done and the opportunities are missed. Therefore, highly qualified effective managers are essential for preserving shareholder wealth.

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 technical skills and experience are the only relevant factors, then pure managerial talent is the dominating force when attributing an executive's contribution to firm value. Viewed this way, managers are able to completely separate their personal and professional lives and only their raw abilities matter.

Kaplan, Klebanov, and Sorensen (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 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 on this issue 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 those not explicitly linked to the company's operations or financial decisions have no bearing on firm value or performance.

While the pure skills hypothesis suggests market indifference to alleged executive improprieties, there are at least two 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 labor for productive outcomes with the rewards from private life activities. Bennedsen, Pérez-González, and Wolfenzon (2007) examine a sample of limited liability companies in Denmark and find that the sudden death of one of the CEO's immediate family members negatively impacts firm performance. While the sudden loss of a family member does not reflect personally on the manager in the same way as an allegation of impropriety, the results suggest that private affairs might also affect firm performance if the consequences of these activities distract

the executive either because of legal complications or disciplinary action. 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 re-allocates time to these private life activities and away from more productive endeavors at the firm, or if the sudden loss of the executive disrupts the firm's ongoing operations.[6]

Hypothesis 2a: 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.

Unlike the observations in Johnson *et al.* (1985) and Bennedenson *et al.* (2007), managerial indiscretions also reflect personally upon the quality and character of the executive in question. It is important to also recognize that while the indiscretions themselves might prove distracting, the executives *chose* to place themselves in the potentially distracting situation and this choice reflects upon their character as well. Previous work has shown the importance of reputation and trust in economic exchange [Blau (1964), Tirole (1996)]. If we assume that indiscretions impair the reputation of the offending executive, then the commission of these activities provides a unique insight into the utility function of the manager. Indiscretions may credibly signal that the executive does not highly value their reputation, which might have implications for future economic activity. Erhard and Jensen (2012) and Erhard, Jensen, and Zaffron (2009) 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's performance suffers.[7] In this environment, contracts and controls become substitutes for trust and additional transaction costs are incurred [Williamson (1975)]. The result is a reduction in

[6] The loss of the executive could occur because of legal complications taking them away from the firm or because of disciplinary turnover.

[7] 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, 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.

the opportunity set and restricted ability to capitalize on the firm's growth opportunities [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. In contrast, Atanasov, Ivanov, and Litvak (2012) find that VC firms whose reputations are tarnished by litigation suffer declines in future business relative to their peers. Further, investor reactions to signals of impaired managerial integrity with regard to corporate actions are often substantially larger than the cash flow impact of the events themselves [Yermack (2006), Karpoff, Lee, and Martin (2008), Bernile and Jarrell (2009)]. Although each of the above mentioned studies examines 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 2b: Managerial Character – Managerial indiscretions negatively impact firm value and performance since managerial character and integrity are factors of production. Executives who are alleged to be out of integrity in their personal lives engender a professional environment with excessive contracting costs.

Both the distraction and managerial character hypotheses suggest a negative market reaction to the announcement of an alleged impropriety. Admittedly, it is difficult to empirically separate these hypotheses. However, we attempt to disentangle the two by observing other executive actions separate from the alleged improprieties. In particular, while even a person with impeccable character can face false allegations, we would not expect the executive to be systematically associated with earnings manipulation or fraud. Moreover, an announcement of an allegation occurs at a point in time and to the extent it signals managerial character, it will impact stock price. A finding relating allegations to (inferior) prior operating performance is more likely to be associated with distraction.

3. Data

3.1 Sample Selection

To test the hypotheses presented in Section 2, we assemble a unique sample of executives who have allegedly engaged in questionable ethical behavior that potentially compromises 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.[8] The announcement is recorded as the date of the first news article mentioning the event. The sample is arranged along four broad categories: *sexual misadventure*, *substance abuse*, *violence*, and *dishonesty*.[9] *Sexual 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.[10] *Dishonesty* cases include falsifying credentials, perjury, and plagiarism. *Sexual misadventure* and *dishonesty* allegations 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 operating and financial decisions of the firm and to the normal business-related activities of the executive. Other questionable activities, such as fraud, embezzlement, or securities violations at the firm, 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.[11] Concentrating on personal indiscretions and testing their relation to corporate performance is an important aspect of our work.

[TABLE 1]

[8] 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).

[9] Note: Indiscretions are categorized according to the primary offending action, but some instances involve multiple indiscretion types (ex. violence resulting from substance abuse). There are 24 indiscretions that involve two categories and 3 that involve three categories.

[10] 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.

[11] For a discussion of the costs and benefits of fraud to the organization, see Becker (1968), Posner (1986), or Murphy, Shrieves, and Tibbs (2010).

To test our hypotheses, we develop two samples. The first is a set of identifiable alleged indiscretions from 1978 to 2011. We identify 405 potential indiscretion observations involving C-level executives (CEO, COO, CFO), division heads, or board members from 1978 to 2011. Table 1 shows that, after screening for COMPUSTAT and CRSP data, there is a final sample of 301 indiscretions.[12] About 48% of the indiscretions (144 of 301) involve sexual misadventure. Dishonesty accounts for 31% of the observations, with substance abuse and violence accounting for 12% and 10%, respectively. There is a noticeable increase in indiscretions during 2007 and 2008. The sharp increase is primarily associated with dishonesty (and in 2007, sexual misadventure). We are careful to include calendar year effects into our tests to account for the time-varying nature of our sample.

We note that, in all likelihood, there are far more 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 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.

To investigate the characteristics and impact of managerial indiscretions relative to the population of publicly traded firms, we assemble a second sample of observations from the universe of firms listed in the COMPUSTAT/EXECUCOMP merged database. This database consists of all firms listed in the S&P 500 Large Cap, S&P 400 Mid Cap, and S&P 600 Small Cap indices as well as any company which has left that index, but remains publicly traded. Since we will require data on the governance structure of the firm as well as biographical data on the top management team from RiskMetrics (IRRC)[13], we restrict this sample to 1996-2011. For each observation in this database, we require that each have all of the data used

[12] Forty-nine 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). Eighteen 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). 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 17 were excluded because they had insufficient information on CRSP and COMPUSTAT to conduct our primary tests.

[13] RiskMetrics' directors coverage begins in 1996.

in our tests for the current and prior fiscal years. After imposing these restrictions we have a total of 12,827 firm-year-observations.

[TABLE 2]

3.2 Sample Characteristics

Table 2 reveals that 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 ($3.8B), $28.2B ($2.7B), and $24.0B ($2.5B), respectively. Comparing these figures to those in other studies of managerial reputation, they are similar to those in Yermack (2006), but substantially larger than those in Chemmanur and Paeglis (2005). The average (median) Tobin's Q ratio of 2.20 (1.47) is also comparable to that found in other corporate work [Yermack (1996, 2006); Coles, Daniel, and Naveen (2008)]. The typical firm in our sample is profitable on an operating basis, with a mean (median) OROA of 8.18% (11.2%). Strikingly, 49% of the sample observations are classified as having occurred at either a family or founder managed firm. This is significantly higher than the incidence of family or founder managed firms found in a typical study of U.S. industrial firms [Fahlenbrach (2009)].[14]

[TABLE 3]

3.3 Indiscretion Characteristics and Outcomes

Table 3 documents the participants, characteristics, and outcomes of the sample indiscretions. In some cases data on characteristics and outcomes is unavailable. Obviously, this will limit some forms of multivariate tests. For the sake of completeness, however, we show all available data in the univariate information of Panels B and C. In the paragraphs below, we highlight a few characteristics.

[14] We identify family firms in several ways. First, we identify family firms using the data collected by Anderson and Reeb (2004) and made publicly available on their website. 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. Finally, we review each news story to see whether the firm itself is founder managed or family controlled.

Nineteen percent of the executives accused of indiscretions in the sample are members of the founding family. Seventy-five percent of the indiscretion executives sit on the company's board (this is their only role at the firm for nearly 38% of the sample), 34% hold the title of CEO, while 28% of the executives are subordinate to the CEO holding titles such as President, CFO, COO, or division manager.

The average indiscretion lasts for approximately 2.5 years (899 days) prior to disclosure, and a significant proportion result in some form of legal action against the executive, the firm, or both.[15,16] About 29% of all indiscretions involve repeat offenders; the percentage rises to 61% for substance abuse. The executive is arrested about 19% of the time and the indiscretion results in personal or corporate legal action in 44% and 27% of the cases, respectively.

It appears that the corporate boards are not convinced that indiscretions impair firm value or future performance (or at least not in an amount exceeding the perceived value of the executive) since only 25% of executives are terminated for committing an indiscretion despite the fact that 29% of our observations are repeat offenders. The rate of turnover falls precipitously (13.9%) for substance abuse cases even as the incidence of repeat offenses rises substantially (61%). 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)]. In unreported tests we find that the turnover rate for first time offenders (25.7%) is almost identical to that of repeat offenders, (25.3%).

[15] For specific categories of indiscretions the averages are 629 days (substance abuse), 906 days (sexual misadventure) to 921 days (violence). The length of time over which dishonesty occurs is indeterminate. For example, we don't know the first time an executive lied on his resume. This points to the fact that these time periods must be interpreted with caution. First, we don't know the frequency of various indiscretions over these time periods – only the time since the first alleged offense. Also, we don't know the degree to which various indiscretions actually impact a particular executive. Some individuals can be better at compartmentalizing personal problems; others may continually worry about inappropriate actions. Finally, it is important to remember that these are alleged indiscretions. Some allegations lead to convictions or even admissions of guilt, but most allegations remain unproven, even in cases of financial settlements. The net impact of the indiscretions and the length of time involved are empirical issues to be resolved by the data.

[16] We have made the point that these alleged indiscretions are personal to the executive and do not involve the company. Admittedly, when lawsuits are filed against the company, the plaintiffs are taking the positions that the indiscretions are company related. Defending lawsuits against the company will require use of corporate resources. However, it is difficult to argue that an executive's act of violence or personal dishonesty or drug use benefit the company. In contrast, indiscretions at the corporate level could be associated with actions that directly impact shareholder wealth. For example, an executive accused of violating the Foreign Corrupt Practices Act might argue that it was necessary to do so to compete in a particular foreign market. This focus on 'personal' allegations is a distinguishing feature of our work.

4. Determinants of Managerial Indiscretions and Firm Performance

4.1 Determinants of Managerial Indiscretions

Before investigating our hypotheses, we examine whether certain firm or individual characteristics might predispose an executive to committing an indiscretion and if there are governance structures that might serve to prevent them.

Prior research provides insight regarding which factors might bias executives to commit various forms of malfeasance. In particular, agency problems at the corporate level often manifest as a result of poor board oversight. Yermack (1996) argues that large boards are weak monitors due to free rider problems and that crowded boardrooms are associated with weaker CEO performance incentives and lower valuations. Weisbach (1988) shows that non-independent boards are less likely to dismiss poorly performing CEOs. Borokhovich, Parrino, and Trapani (1996) and Dahya and McConnell (2005) find that the quality of CEO selection is inversely related to board independence. The nature of the independent directors on the board is also of import. Core, Holthausen, and Larcker (1999) and Fich and Shivdasani (2006) find that directors with multiple outside board seats tend to be poor monitors. They find that these 'busy boards' are associated with excess CEO pay and poor performance. Bebchuk and Fried (2006), among others, argue that an overly collegial board may be complicit in rent-seeking behavior. Shivdasani and Yermack (1999) argue that the CEO's involvement in the selection of the outside directors contributes to the overly collegial environment. Coles, Daniel, and Naveen (2010) find that these "hand-picked" directors are less likely to fire the CEO following stock price declines and they award pay packages that are less sensitive to shareholder wealth.

Accordingly, we construct an index of poor monitoring to test whether poor board oversight might facilitate managerial indiscretions. The poor monitoring index is a (0,4) measure constructed as:

$$\begin{aligned} \textit{Poor Monitoring Index (0,4)} \;=\; & \textit{Non-Independent Board (0,1)} + \textit{Large Board (0,1)} \\ & + \textit{Busy Board (0,1)} + \textit{Hand-Picked Board (0,1)} \end{aligned} \qquad (1)$$

where *Non-Independent Board (0,1)* takes a '1' if more than 50% of the outside directors are not classified as independent, *Large Board (0,1)* is set to '1' if the board is larger than the median board in RiskMetrics (IRRC) in the year, *Busy Board (0,1)* takes a '1' if more than 50% of the outside directors hold three or more board seats, and *Hand-Picked Board (0,1)* is set to '1' if more than 50% of the outside directors have tenures less than that of the CEO.

Founder status might also be an important contributor to the propensity of an indiscretion. Anderson, Duru, and Reeb (2009) document that founder-led firms are associated with greater information asymmetry, larger agency costs, and lower firm performance. Arguably, given their substantial personal investment in the company, corporate founders make less of a distinction between themselves and their firms. Consequently, founders might be especially prone to engage in indiscretions or have boards that are more likely to overlook transgressions.

Our models include other governance characteristics such as CEO and director ownership, CEO age and tenure, and the incidence of women on the board. We also add standard firm controls such as *firm size* (log of total sales), *firm age* (number of years listed on CRSP or COMPUSTAT), *ROA* (net income to assets), *Tobin's Q* (market value of equity plus the book value of assets less the book value of common equity all over the book value of assets), *stock return*, and *leverage* (total debt to assets). Firm size is a standard variable likely to be correlated with other variables of interest (e.g., founder firms, board size, etc.). Part of our analysis tests whether performance (measured by ROA, Tobin's Q, or stock return) is impacted during the period of an indiscretion. We return to this analysis in a latter section. A priori, we do not expect leverage to be related to the probability of an indiscretion, although a case could be made for a relation between highly levered firms and the risk tolerance of a firm's executives. Similarly, a firm that is highly levered is more prone to financial distress, a factor that could be correlated with personal indiscretions.[17] All control variables are computed as of the most recent fiscal year-end immediately

[17] We discuss the possibility of reverse causality below.

preceding the indiscretion. Each model includes industry and year fixed-effects and the reported p-values are computed using robust [Rogers (1993)] firm-clustered standard errors.

[TABLE 4]

Table 4 presents our results using the 12,827 panel data observations from COMPUSTAT/EXECUCOMP over the 1996-2011 period. Separate logistic regressions analyze variables related to the probability of an indiscretion by type of executive position and by type of indiscretion. In Panel A, the dependent variable in each model is a (0,1) indicator of whether any indiscretion, a CEO indiscretion, or a non-CEO indiscretion occurs, respectively. 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.

The results appear in line with prior research on agency problems and malfeasance. Most notably, our poor monitoring index is positively related to the propensity for a managerial indiscretion in each of our models. The marginal effects imply that incrementing the index by one provision magnifies the unconditional probability of an indiscretion occurring by 9.3%.[18] Disaggregating this index into its constituent parts reveals that large boards, busy boards, and hand-picked boards are each positively associated with observing an indiscretion. The non-independent board variable is not significant at conventional levels. Consistent with founders intertwining their personal and professional lives, family managed firms are significantly more likely to produce indiscretions in all models and the economic impact is large. The marginal effects imply a 35.9% increase in the unconditional probability of an indiscretion.[19] In several of our models, we also find indiscretions are more likely to occur at younger, larger firms, and those managed by new CEOs. These results are consistent with the argument that some governance structures increase the likelihood of a managerial indiscretion occurring. (Some of our

[18] The marginal effect at sample means is 0.14%. Given that the unconditional probability of an indiscretion is 1.52%, this represents a 0.14%/1.52% = 9.3% increase.
[19] Similarly, the marginal effect of 0.546% implies a 0.546%/1.52% = 35.9% increase in the unconditional probability of an indiscretion.

variables, like age, tenure and ownership, are correlated. However, unless noted, our main results are unaffected by the inclusion or exclusion of other variables.)

It is certainly possible that causality could run from corporate problems to personal indiscretions. In particular, a harried executive might be inclined to relieve stress through intoxication or other indiscretions. In our sample, we are only aware of one such incident: Doug Parker, CEO of USAIR, was arrested for DUI following the failed Delta merger. The possibility remains that other such incidents exist and are unreported. We caution the reader to keep this possibility in mind while interpreting our results. Nevertheless, in Panel A of Table 4 we find that measures of prior performance (ROA, Tobin's Q, and stock returns) are insignificantly related to the probability of an indiscretion. In Panel B, we examine the determinants of specific types of indiscretions. Here, results for ROA produce inconsistent results, being significantly negatively related to sexual misadventure or dishonesty, but significantly positively related to violence. We view these results as unreliable and implausible. Moreover, prior performance is unrelated to the area where a connection seems most likely: substance abuse. In Panel B, the significance of any one performance variable is also sensitive on the inclusion of the other performance variable.

4.2 Managerial Indiscretions and Firm Value

We employ standard event study methodology to test whether managerial indiscretions impact firm value, as predicted by Hypotheses 2a and 2b, or whether only professional characteristics matter, as predicted by Hypothesis 1. As we previously discussed, the announcement date for each managerial indiscretion is defined as the disclosure date of the first news article mentioning the event. 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 5]

Panel A of Table 5 reveals the abnormal returns at the announcement of the allegations. Disclosures of management's personal indiscretions are associated with significantly negative abnormal returns for their firms. For the full sample of 301 observations, the mean (median) three-day cumulative abnormal return at the announcement of an indiscretion are -1.79% (-0.67%) which translates into an average (median) $176 M ($3 M) evaporation in market capitalization at the disclosure of the indiscretion.[20] The results are similar when we examine the longer 5-day windows. These values are both significant beyond the 1% level. The losses associated with managerial indiscretions are especially severe in some cases. For example, the value of Hewlett-Packard declined by as much as $9.7 B at the announcement of Mark Hurd's alleged affair with Jodie Fisher. Considering that only a minority of the cases involve some form of corporate settlement (see Table 3, Panel C), this suggests that investors react to more than the legal risks directly associated with an executive's alleged illicit behavior. We've noted before that our events are alleged indiscretions and do not necessarily imply guilt. We add that a firm's market value could drop, not because of an indiscretion, but because the alleged event makes in more likely that a good executive would be removed. However, in subsequent multivariate tests we do not find a significant relation between prior performance measures and the change in market value.

4.3 Firm value, type of indiscretion and board action

If executive behavior sends a signal about firm performance, we might expect the signal to be stronger for the CEO than for other executives. Panel B reveals announcement returns 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 CAR for the 103 CEO observations is -3.84% (-1.82%), while the CAR for the 198 other executives and directors is a marginally significant -0.72% (-0.40%). Overall, these results suggest that more than just the pure skills matter in regards to firm value as the decline in value is more severe for the executive most closely tied to the firm's performance. The evidence seems to most strongly support both the distraction and managerial character hypotheses.

[20] This is the net-of-market change in market value. The raw mean loss in market capitalization is $129 M. It is interesting to note that the difference in raw and net-of-market dollar returns implies that firms may prefer to reveal indiscretions in the face of a positive market.

Indiscretions by the CEO could also reflect more broadly on a culture throughout the company as they set the 'tone at the top.'

Dramatic wealth changes could precipitate or be caused by executive turnover at the announcement of the indiscretion. Large wealth losses at the announcement of an indiscretion could increase the probability of board dismissal of an executive. Alternatively, board dismissal might signal to the market that the problems were more serious. In slightly less than 25% (75 of 301) of the alleged indiscretions, the board removes the executive from their position at the disclosure of the event. Panel C reveals that the wealth losses associated with this turnover are significantly greater than cases where the executive is retained (-3.41% v. -1.23%, difference p-value = 0.015). In both subsets, however, the wealth losses are significantly different from zero.

In Panel D we examine wealth losses by type of indiscretion. Three day abnormal returns at the announcement are significantly negative for three of the four categories of alleged indiscretions. The abnormal returns associated with substance abuse are not significant. The magnitudes of losses differ markedly across the categories. Sexual misadventure is associated with losses of about 0.8% while violence and dishonesty are associated with losses of 2.2% and 3.7%, respectively. We note that dishonesty, the indiscretion category that arguably reflects the most upon the character of the executive (and potentially the most damaging to the firm), is associated the most negative returns.

Table 6 contains a multivariate analysis of the variables associated with announcement period returns. Consistent with our univariate results, we find that abnormal returns are significantly more negative for indiscretions by the CEO, public dishonesty, and those involving executive turnover. In the first model, CEO indiscretions are associated with returns that are 2.9% lower than the typical indiscretion. Indiscretions that result in executive turnover at the announcement generate returns that are lower by 1.6%.

Since investors seem particularly concerned when the indiscretion is allegedly committed by the CEO, we investigate the interaction of CEO allegations with turnover and with the incidence of public

dishonesty. The results, shown in the second and third models suggest an even more severe wealth loss when it involves the CEO. While the interaction of CEO indiscretion and turnover at announcement does not make the investor reaction significantly more negative at conventional levels, the joint effect does remain significantly negative. In contrast, the reaction is significantly more negative by 5.8% when the CEO is involved in a case of public dishonesty. The joint effect of -6.9% indicates that investors are particularly concerned when the CEO is involved in an allegation that impairs the perception of his character. This provides strong support for the importance of the allegations in signaling managerial character.

It should be noted that throughout these tests, we *chose not* to exclude potentially confounding events (ex. earnings guidance, new product announcements, etc).[21] Rather, we identify these instances with an additional control variable labeled *confounding event*. We retain these observations because of the possibility that firms manage the grouping of news events and this provides additional insight into the potential motives of top management. It is well known that firms have some discretion over the disclosure of information and often delay the release of bad news [Dye (1990), Rajan (1994), Genotte and Trueman (1996), and Miller (2002)]. If the firm was concerned about potential negative reactions to the disclosure of an indiscretion, they could choose to disclose other positive information to soften the blow. Alternatively, they may choose to disclose other impending bad information and just 'take a bath' in the news cycle. Acharya, DeMarzo, and Kremer (2011) provide a dynamic model of strategic disclosure of negative firm news and find that bad news regarding the economy prompts the immediate disclosure of negative firm news; good economic news on the other hand slows the release of negative firm news. Other supporting evidence is provided by Tse and Tucker (2010) who document industry clustering of earnings warnings and that firms disclose these warnings quicker under poor market conditions. Confounding events can contain positive or negative information. Absent a connection between the

[21] The 59 confounding events in our sample are as follows: 4 analyst opinion changes, 5 announcements about dividends or share repurchases, 10 earnings releases, 5 disclosures about an FDA / patent approval or the lifting of FTC restrictions, 9 announcements of or updates to pending litigation (all unrelated to the indiscretion), 16 announced takeovers, 4 new product announcements, 1 announced proxy contest, 1 S&P index addition, and 4 instances of management guidance. Our results are qualitatively unaffected if the confounding events are removed.

confounding events and the managerial indiscretions, there is no reason for their influence to be systematically significantly positive or negative. Since the indiscretions we measure are personal in nature, such a structural connection to confounding corporate events seems unlikely. Thus, a significant coefficient for the existence of a confounding event is suggestive of an ulterior motive in purposefully influencing the information flow.

The models in Table 6 uniformly document a positive bias to the confounding observations of around 3.4%. Provided that positive shocks do not systematically arrive at firms disclosing indiscretions more often than negative ones (a supposition supported in Table 4), this evidence is consistent with purposely releasing positive information at the time the indiscretion is announced. This provides further support for the managerial character hypothesis. Overall, the results appear to support both the importance of *distraction* and *managerial character*.

4.4 Managerial Indiscretions and Firm Operating Performance

The previous section demonstrates that investors react negatively to the disclosure of an indiscretion. In this section, we investigate the link between the alleged indiscretion and the firm's operating performance. In particular, we test for declines in a firm's operating performance during the fiscal period when the alleged offenses are disclosed. A significant decline in operating performance would be consistent with the alleged offense distracting the executive from adequately performing their duties. The degree to which indiscretions distract an executive from their work is an empirical issue to be resolved by data. Absent distractions related to the improprieties, there is no reason to expect the industry-adjusted performance of an executive's firm to be significantly affected surrounding the period of an alleged impropriety. We hasten to add that even false allegations can cause meaningful distractions to performance. Our analysis cannot ascertain guilt.

We follow Barber and Lyon's (1996) matching firm methodology to measure abnormal operating performance. Each of our 12,827 firm-year indiscretion and control observations from the universe of firms in COMPUSTAT, EXECUCOMP and RiskMetrics (IRRC) is assigned to an industry and (pre-

event) performance matched benchmark. This is defined as all firms having the same 2-digit SIC code reported in COMPUSTAT and an OROA within 90%-110% of that of the sample firm as of the prior fiscal year.[22] Abnormal operating performance is defined as the difference between the observed operating performance (EBITDA to average total assets) of the identified firm and that of the industry benchmark.

$$Abnormal\ OROA_{i,t} \quad = \quad OROA_{i,t} - OROA_{Industry,t} \qquad (2)$$

where $Abnormal\ OROA_{i,t}$ is the abnormal operating ROA for firm i at time t, $OROA_{i,t}$ is the operating ROA for firm i at time t, and $OROA_{Industry,t}$ is the operating ROA for the industry and pre-event performance matched benchmark for firm i at time t.

However, Barber and Lyon (1996) identify that a potential problem with the above model is that it ignores the history that a sample firm has in terms of performance relative to its benchmark. For example, a highly profitable firm with a single bad year would get matched to a poorly performing benchmark and would then subsequently show outperformance the next year as the firm mean reverts to its long-term average. Therefore, they propose modeling the expected operating performance in terms of changes.

$$Abnormal\ \Delta OROA_{i,t} \quad = \quad \Delta OROA_{i,t} - \Delta OROA_{Industry,t} \qquad (3)$$

where $Abnormal\ \Delta OROA_{i,t}$ is the abnormal change in operating ROA for firm i at time t, $\Delta OROA_{i,t}$ is the change in operating ROA ($OROA_{i,t} - OROA_{i,t-1}$), and $\Delta OROA_{Industry,t}$ is the change in the benchmark operating ROA ($OROA_{Industry,t} - OROA_{Industry,t-1}$). The resultant calculation is comparable to the change in industry-adjusted OROA. We construct the two measures in equations 2 and 3 for all 12,827 firm-year observations in our sample.

[TABLE 7]

[22] We recognize that many of our observed indiscretions begin earlier than the prior fiscal year and may adversely affect performance in prior periods. To the extent to which that occurs, the effect of an indiscretion on operating performance will be controlled away by the pre-event performance matching; thus, this test is biased against finding a result for these cases.

Our results are shown in Table 7. Overall, the firms in our indiscretion sample do not perform differently than their industry- and performance-matched peers in the year of the indiscretion. Panel A shows that, on average, the sample firms demonstrate an insignificant abnormal OROA of -0.7% in the year in which an indiscretion is disclosed. However, if we restrict our attention to indiscretions by the CEO, the individual with the most impact on firm performance, we find a different story. Consistent with the event study evidence in Section 4.2 and 4.3, our results indicate that in addition to the impact on shareholder value, CEO indiscretions negatively impact the firm's operations. For the fiscal year in which an indiscretion is disclosed, the indiscretion group experiences an industry/performance-adjusted decline of -1.5% in operating performance which is both statistically and economically significant. In contrast to our results on economic value for CEOs, there is no evidence of significant abnormal operating underperformance for the 'non-CEO' subgroup. This might be expected given the relatively smaller influence of these other executives on the strategic direction of the firm. A similar story emerges from Panel B where the dependent variable is the change in abnormal OROA. The results are consistent with the distraction hypothesis. If indiscretions engender frictions or lost sales from excessive contracting or perceived liabilities, it would also be consistent with the character hypothesis.

Overall, the results in Sections 4.2, 4.3, and 4.4 do not support the *pure skills* hypothesis, since it appears that managerial indiscretions adversely affect both shareholder value and firm operations. The data is more consistent with both the *distraction* and *managerial character* hypotheses.

4.5 Managerial Indiscretions and Long-Run Firm Value

It is possible that the negative shareholder reactions reported in sections 4.2 and 4.3 represent transitory shocks to firm value as investors exhibit a knee-jerk reaction to the announcement. In this section we examine whether the reactions are permanently capitalized into the stock price or if there are reversals following an indiscretion. In doing so, we test the the relation between managerial indiscretions and long-run firm value by analyzing the change in Tobin's Q around the indiscretion disclosure as well

as by computing the buy-and-hold abnormal returns for up to one year (250 trading days) following the announcement.

According to theory [Tobin (1969)], Q capitalizes all that is relevant with respect to firm value in current and future periods. Consequently, we use the time *t-1* to time *t* (where *t* is defined as the fiscal year-end immediately following the indiscretion announcement) change in Q surrounding the announcement of the indiscretion to provide a better indication of a long-term value change. Secondly, it will also account for any issues we might have with misidentifying the announcement date, problems with confounding events, slow leakage of information about the indiscretion, etc.

[Table 8]

Panel A of Table 8 reveals that the announcement of an alleged indiscretion is significantly negatively related to the change in Tobin's Q during the year it is disclosed. On average, firms demonstrate a 0.231 reduction in Q from *t-1* to *t*. At sample means, this implies an 11.5% loss in firm value. When the CEO is involved in an indiscretion the average decline in Q is a significant 0.253 or a 12.6% loss in firm value. Thus, consistent with the evidence reported in the operating performance section, our results here indicate that, in addition to their impact on firm operations, managerial indiscretions are associated with a more permanent deterioration in shareholder wealth. These findings are significant for the combined set of all executives, as well as for individual samples of CEO and non-CEO indiscretions.

[Figure 1]

While Q represents the valuation awarded to a firm, it does not present a strategy that can be replicated by investors. We therefore compute the buy-and-hold abnormal returns (BHAR) for the 301 observations in our indiscretion sample. These returns are calculated as the difference between the buy-and-hold returns for our sample firms and that of the benchmark over 250 trading days as:

$$BHAR_i = [\prod_{t=0...+249}(1+RET_{i,t}) - 1] - [\prod_{t=0...+249}(1+Benchmark\ RET_{i,t}) - 1] \quad (4)$$

where $RET_{i,t}$ is the daily holding period return of sample firm i at time t and $Benchmark\ RET_{i,t}$ is the return of the benchmark portfolio. Following Barber, Lyon, and Tsai (1999), each sample firm is assigned to one of 140 equally-weighted size and book-to-market benchmark portfolios. The 140 portfolios are formed from the 10 size deciles of the NYSE as of June 30 of each year, where the smallest decile is further broken into 5 subdeciles. This provides a total of 14 size rankings. The 10 book-to-market deciles are formed from NYSE firms as of December of the prior year. In the event that a sample firm is delisted, the delisting value is reinvested into the benchmark.

Median values are reported in Panel B of Table 8 with p-values computed from non-parametric Wilcoxon rank-sign test statistics.[23] Results are also graphed in Figure 1. The buy-and-hold tests are consistent in both sign and magnitude with those for changes in Tobin's Q. The median shareholder in an indiscretion firm significantly underperforms the benchmark return by as much 9% over the next year. It is notable that much of this loss does not simply occur immediately after the announcement, but instead throughout the year as the losses at one month (20 trading days) amount to around only 1.4%. Further, the tests reveal a substantially greater loss for indiscretions involving the CEO with median losses exceeding 14%. These results imply that the announcement of an indiscretion may forebode greater problems brewing at the firm. We explore these potential problems in the next section.

5. Managerial Indiscretions and Other Agency Costs

The ability to 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 has noted, "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

[23] The mean returns, which are more subject to skewness, are also negative and qualitatively similar to the medians reported here.

clubs, [or] heavy drinking [McClellan (2008), emphasis added]." If indiscretions are signals of poor character due to deceit in an executive's personal affairs, they may also be indicative of a willingness to deceive in the manager's portrayal of the firm's financials. Consequently, searching for evidence of impaired disclosure or malfeasance 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 or fraud, one could argue that someone who is duplicitous in their private life is also more likely to mislead professionally.[24] In addition, the evidence in the previous section indicated underperformance during the period of the alleged indiscretion. Executives in a firm that is underperforming face additional pressures from the financial press, shareholders and their board. Evidence of explicit earnings management or legal action against the firm would be supportive of the *managerial character* hypothesis. In the sections that follow, we test the propensity for firms retaining executives with poor signals of integrity to be involved in corporate class action lawsuits, a DOJ or SEC enforcement action, and earnings management.

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 regarding the firm during a class period [Niehaus and Roth (1999)]. If employing and retaining individuals with less integrity signals a poor ethical environment at the corporate level, then we would expect our indiscretion variable to be positively related to being involved in a lawsuit. Accordingly, we examine whether indiscretions are related to the propensity to take this next step and result in class action in the coming years.

[24] When Veritas Software Corp. disclosed that their CFO, Ken Lonchar, falsified his personal credentials there was immediate concern 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 (2002)]. Similarly, 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" [O'Donnell and Farrell (2004)].

In Panel A of Table 9, we estimate the propensity to be targeted by a shareholder class action lawsuit in the year of the indiscretion announcement or during the two years following. Of primary interest are the indiscretion indicator variables. Three models are estimated: the full sample of indiscretions, CEO indiscretion, and Non-CEO indiscretion. Several papers, including Gande and Lewis (2009), find lawsuits to be predictable events based on firm- and industry-level characteristics. Field, Lowry, and Shu (2005) find that larger firms are more likely to be sued due to their ample resources to settle. They also find that firms with heavy investor interest (as measured by share turnover) are also targeted more frequently. They note that certain industries, such retail and technology, are particularly litigious and that there is persistence in the legal exposure among industries. Regulation, on the other hand, is found to decrease the likelihood of a suit. Others find that firms with poor accounting and stock returns are more likely to be sued [Jones and Weingram (1996)]. Governance also appears to matter as Fich and Shivdasani (2007) find that firms where the CEO is also chairman, the board is large, or the directors are not independent are also frequently targeted. In keeping with this literature, we include controls for firm size (log of sales), share turnover (average daily volume), firm performance (ROA, stock returns, and Q), governance characteristics (CEO-Chairman duality, board size, and percent independent), whether the company is a retail or technology firm, whether the firm is highly regulated, and whether the firm is in a high litigation risk industry.[25] We also include controls for other firm characteristics such as firm age and leverage.

[Table 9]

The results in Panel A suggest that firms with executives committing managerial indiscretions are significantly more likely to be targeted in shareholder class action suits when an alleged managerial indiscretion has occurred. The marginal effects imply that an indiscretion increases the unconditional probability of being sued by 15.3%.[26] The coefficients are again driven by allegations against the CEO;

[25] Following Field et al (2005), we classify Retail firms as those residing in SIC codes 5200-5961. Technology firms reside in SIC codes 2833–2836, 3570–3577, 3600–3674, 7371–7379 or 8731–8734. Regulated firms are those in SIC codes 4812–4813, 4833, 4841, 4811–4899, 4922–4924, 4931, 4941, 6021–6023, 6035–6036, 6141, 6311, 6321, or 6331. High litigation risk industries are those where the number of lawsuits observed in a given industry is greater than the overall median number of suits per industry.

[26] 0.0138/ 0.0903 = 0.1528

allegations against non-CEO executives are not statistically significant (p-value = 0.13). Consistent with the existing literature, we also find that large or poorly performing firms, companies with heavy investor interest, firms in litigious industries, and those with either large boards or those where the CEO is also Chairman are more likely to be sued.

Arguably, shareholder lawsuits are an expected response when even a personal managerial indiscretion is alleged. One would imagine a higher threshold for the filing of a federal suit against the company. To conduct this analysis, we merge the fraud database assembled and maintained by Karpoff, Lee, and Martin (2008) with our panel dataset.[27] In Panel B, we estimate the propensity of being targeted by a DOJ or SEC enforcement action over the three years beginning with the indiscretion disclosure. As with shareholder class-action lawsuits, prior research has shown that the probability of fraud has observable predictors. Notably, Brazel, Jones, and Zimbelman (2009) show that the manipulation of corporate earnings, as measured by accruals, is significantly related to the propensity to commit fraud. They also find that younger firms and poorly performing firms are more likely to engage in this sort of malfeasance. Erickson, Hanlon, and Maydew (2006) argue that highly levered firms are more likely to commit fraud in efforts to meet debt covenants. Accordingly, we model fraud as a function of discretionary accruals (formally discussed in the next section) and firm characteristics (firm size, age, leverage, and performance). We also include the governance controls from Fich and Shivdasani (2007) as the lawsuits in their sample allege fraud and Johnson, Ryan, and Tian (2009) show that governance is an important predictor for corporate fraud.

Consistent with the results on shareholder initiated class-action lawsuits, Panel B indicates 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 significant for CEOs. Larger firms, and firms with high discretionally accruals are also more likely to face a federal lawsuit; CEO age and the size of the board are significantly negatively related to DOJ or SEC enforcement action. As we have noted in other

[27] We are grateful to the authors for providing us with the data.

contexts, being targeted in a lawsuit does not indicate guilt any more than being accused of an indiscretion. However, this section does provide additional evidence on the linkage between alleged personal misconduct and spillover effects at the firm.

5.2 Managerial Indiscretions and Earnings Management

We continue our investigation of managerial indiscretions as a signal of character by examining 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 often the only indications available to outside investors regarding the health of the company. In a market for potential lemons [Akerlof (1970)], shareholders are forced to rely on management's word for the veracity of the firm's reported earnings.

To detect the presence of earnings management, we follow Teoh, Welch, and Wong (1998) and focus on the manipulation of discretionary accruals. Using their approach, we compute total current accruals as:

$$TCA_{i,t} = [\Delta(RECT_{i,t} + INVT_{i,t} + ACO_{i,t}) - \Delta (AP_{i,t} + TXP_{i,t} + LCO_{i,t})] / A_{i,t-1} \quad (5)$$

where $TCA_{i,t}$ is total current accruals, $RECT_{i,t}$ is accounts receivable, $INVT_{i,t}$ is inventories, $ACO_{i,t}$ is other current assets, $AP_{i,t}$ is accounts payable, $TXP_{i,t}$ is taxes payable, $LCO_{i,t}$ is other current liabilities, and $A_{i,t-1}$ is beginning of period total assets.

While the total change in accruals is immediately observable, it is not obvious what portion of accruals vary involuntarily due the daily business operations of the firm and what portion has 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. Non-discretionary accruals are modeled 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:

$$E[TCA_{i,t}] = \alpha_0 [1/ A_{i,t-1}] + \alpha_1 [\Delta SALE_{i,t} / A_{i,t-1}] + \varepsilon \quad (6)$$

where $E[TCA_t]$ (the estimated level of non-discretionary accruals for each two-digit industry at time t) is the level of total accruals for each benchmark firm, $A_{i,t-1}$ is beginning of period total assets, $\Delta SALE_{i,t}$ is the change in revenues. Non-discretionary accruals are then estimated for each firm as:

$$NDTCA_{i,t} = \alpha_0 [1/ A_{i,t-1}] + \alpha_1 [(\Delta SALE_{i,t} - \Delta RECTR_{i,t})/ A_{i,t-1}] \quad (7)$$

As in Teoh *et al.* (1998), we adjust for the change in trade receivables ($\Delta RECTR_{i,t}$) in this calculation. Discretionary accruals are defined as the residual of the difference between total accruals and the predicted level of non-discretionary accruals.

$$DTCA_{i,t} = TCA_{i,t} - NDTCA_{i,t} \quad (8)$$

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 again use the combined sample of managerial indiscretions with the 12,827 firm-year observations from the universe of firms in COMPUSTAT, EXECUCOMP and RiskMetrics (IRRC) with available financial and governance data. Cross-sectional ordinary least squares regressions are estimated to detect earnings management with the indiscretion indicator variables and a vector of controls. Our models include controls for *firm size* (log of total sales), *leverage* (total debt to assets), *return on assets* (net income to assets), and the *Tobin's Q* 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, the percentage of independent directors, and Delaware incorporation (0,1) as explanatory variables in the regression model. Each model includes industry and year fixed effects and the reported p-values are computed using robust [Rogers (1993)] firm-clustered standard errors.

[TABLE 10]

The results presented in Table 10 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 ten-percent level, 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, for firms run by a top management team committing an indiscretion during the fiscal year, the magnitude of discretionary accruals is higher by as much as 2.3% of total assets relative to those at the typical company. This is consistent with an aggressive management of reported earnings. Focusing on the identity of the executive committing the indiscretion reveals that the result is driven by the CEOs in our sample. Firms containing a CEO indiscretion are associated with abnormal accruals amounting to 4.9% of assets in the fiscal year. For comparison, Teoh et al (1998) find abnormal accruals of around 5-6% for firms conducting an IPO. We do not find significant abnormal accruals at firms where the indiscretion is committed by either a subordinate or a member of the board.

The results in sections 5.1 and 5.2 suggest that managers committing indiscretions appear willing to manage reported earnings to make their firms appear more favorable to outside investors. In addition, these firms are also more likely to be targeted by shareholder class action lawsuits and federal fraud investigations. We interpret this association between the manipulation of the firm's financial statements by the top management team and alleged malfeasance as supportive evidence of the *managerial character* hypothesis. These results should be of particular concern to the shareholders of the indiscretion firms since several studies have documented that the management of corporate earnings is associated with long-run stock price underperformance [Teoh, Welch, and Wong (1998), Chou, Gombola, and Liu (2006)]. Furthermore, the losses accruing to shareholders following class-action lawsuits [Bauer and Braun (2010)] and fraud allegations [Karpoff, Lee, and Martin (2008)] are quite severe.

6. Conclusions

This paper examines the relation between alleged indiscretions in management's personal life to shareholder value, operating performance, earnings management and allegations of fraud. The personal managerial indiscretions include allegations of *sexual misadventure, substance abuse, violence*, and *dishonesty*. These events are explicitly chosen such that they have no direct link to the business operations or financial decisions of the firm. We start by investigating whether questionable ethical behavior in one's non-business-related affairs are reflected in the financial and operating characteristics of the firm or if these tangential activities are simply fodder for the popular press and irrelevant to the firm. We then examine the relation between the alleged indiscretions and events symbolic of specific managerial actions at the firm level: earnings management and both shareholder and federal lawsuits.

The data indicates that managerial indiscretions pose a significant risk to the company and inflict substantial agency costs upon shareholders, particularly when the CEO is involved. On average, there is an immediate 3.8% loss in shareholder value at the disclosure of a CEO indiscretion and operating performance suffers an abnormal decline of 1.5% during the same fiscal year. In addition, the firm's of these executives experience a long-run abnormal decline in value of 9% to 12% during the year in which an indiscretion is announced as measured using either buy-and-hold abnormal returns or the change in Tobin's Q, respectively. These losses may be attributable to a distraction of top management from concentrating on their responsibilities to the firm or to signals to the market regarding questionable managerial integrity. Further, the evidence indicates that those firms whose executives commit a managerial indiscretion significantly manage their reported earnings during the year in which the indiscretion is disclosed. Finally, the firms of indiscretion executives are also more likely to be targeted in shareholder class-action lawsuits and DOJ/SEC fraud investigations.

Notably, only 25% of executives face disciplinary turnover for these offenses, despite the fact that a significant fraction of these executives are repeat offenders. In fact, the turnover rate for repeat offenders is almost identical to that of first time offenders. At best, this implies that the typical firm's

board does not feel that that management's behavior poses a problem. At worst, it implies that boards are ineffective at preventing these events or are simply apathetic to their consequences. Our evidence also suggests that improved governance structures might decrease the likelihood of managerial indiscretions. In particular, indiscretions are more likely in firms with larger, busier boards, as well as those where the CEO has had influence in selecting the independent directors. Indiscretions are also more likely in founder firms and those with newly hired CEOs.

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Figure 1
Buy-and-Hold Abnormal Returns (BHARs) following the Indiscretion Announcement

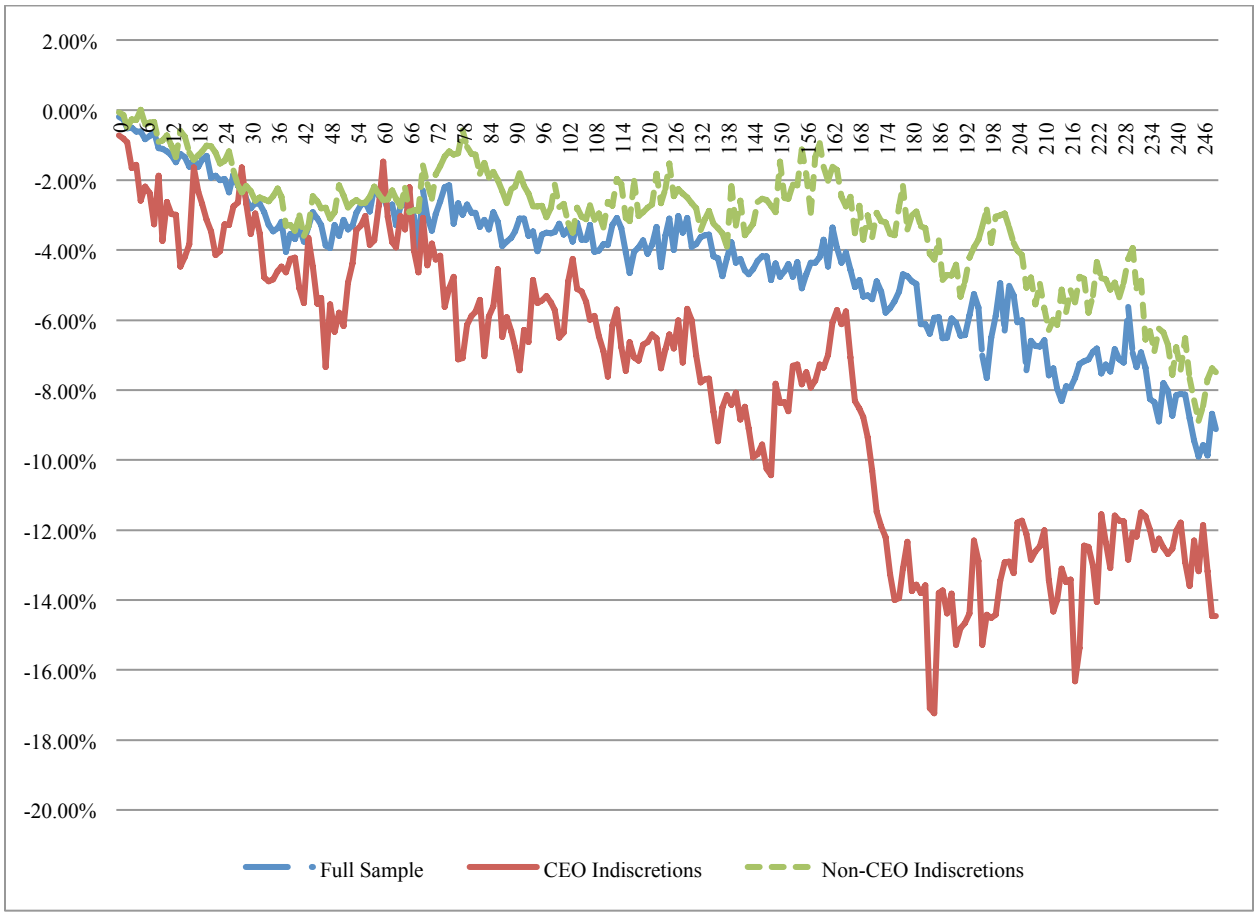

Table 1
Sample Counts by Announcement Year and Transgression Type

This table presents the composition of our 301 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 the indiscretion categories 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	6	0	0	1	7
1992	3	0	0	1	4
1993	6	0	3	0	9
1994	6	8	2	0	16
1995	10	0	0	0	10
1996	1	7	10	0	18
1997	11	0	3	3	17
1998	2	0	0	0	2
1999	7	1	2	1	11
2000	4	4	0	5	13
2001	2	1	0	1	4
2002	7	0	1	13	21
2003	13	0	0	3	16
2004	4	0	0	2	6
2005	7	2	2	3	14
2006	7	3	0	6	16
2007	13	3	2	11	29
2008	5	0	0	27	32
2009	6	0	0	8	14
2010	7	3	0	0	10
2011	3	1	3	3	10
Sample Total	**144**	**36**	**29**	**92**	**301**

Table 2
Sample Statistics

Sample summary statistics for our 301 managerial indiscretion observations. *Assets*, *Sales,* and *Market 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, *OROA* is EBITDA to total assets, and *Market to Book* is the market value of common equity divided by the book value of common equity. *Tobin's Q* follows Smith and Watts (1992) and is computed as the market value of equity plus the book value of assets less the book value of common equity 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 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. *Family Managed Firm* is a (0,1) indicator of whether the company is a family held or managed firm (but does not necessarily indicate that the indiscretion executive is a member of this family). *Board Size* is the number of directors on the board. *CEO-Chairman Duality* is a (0,1) 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 a (0,1) indicator of whether 50% or more of the independent directors have a tenure shorter than that of the CEO. *Busy Board* is a (0,1) 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 ($M)	301	63,444	239,682	432	3,805	25,347
Sales ($M)	301	28,174	127,970	423	2,688	14,843
Market Value ($M)	301	23,960	49,438	407	2,453	17,106
Total Debt to Assets	301	0.64	0.37	0.44	0.61	0.81
Performance Characteristics (t)						
OROA	301	8.18%	32.56%	4.54%	11.23%	17.69%
Market-to-Book	301	4.06	6.25	1.32	2.25	3.78
Tobin's Q	301	2.20	2.07	1.09	1.47	2.29
Stock Return	301	2.60%	51.41%	-29.41%	0.00%	30.69%
CEO Characteristics (t-1)						
CEO Ownership	301	6.89%	14.23%	0.05%	0.37%	4.70%
CEO Age	301	54.60	8.61	49.00	54.00	59.00
CEO Tenure	301	7.68	7.92	2.08	5.00	10.51
Female CEO	301	0.01	0.10	0.00	0.00	0.00
Governance Characteristics (t-1)						
Family Managed Firm (0,1)	301	0.49	0.50	0.00	0.00	1.00
Board Size	301	10.37	3.90	8.00	10.00	13.00
CEO-Chairman Duality (0,1)	301	0.58	0.49	0.00	1.00	1.00
Percent Independent Directors	301	62.89%	21.43%	50.00%	66.67%	78.95%
Percent Female Directors	301	9.08%	8.95%	0.00%	9.09%	15.38%
Hand-Picked Board (0,1)	301	0.62	0.49	0.00	1.00	1.00
Busy Board (0,1)	301	0.35	0.48	0.00	0.00	1.00

Table 3
Sample Executives' Titles, Characteristics, and Outcomes

This table describes the type of executives involved in the 301 sample indiscretions as well as the outcome of each event for the executive and the firm. Panel A details the title held by the executive. *Chairman of the Board Only* and *Director Only* indicate the executive's only role at the firm is that of chairman of the board or of a corporate director, respectively. These titles are further disaggregated by whether the executive is either the company's *CEO* or a *Subordinate Executive* where he holds some other title at the company (President, CFO, COO, Division Head, etc) as well as whether the executive serves as a director on the company's board. *Founder of Firm* indicates the executive in question is a company founder or a member of the founding family. Panel B details the personal characteristics of the executive. *Age* and *Male* indicate the age and gender, respectively, of the executive. *Bachelor's Degree, Master's Degree, MBA Degree, PhD Degree* indicate whether these academic titles have been awarded. *Financial* and *Technical* training and career experience follow the classification scheme of Malmendier and Tate (2005). *Military Experience* indicates some form of armed service. Panel C details the specifics of the indiscretion itself. *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* and *Corporate Legal* each indicate whether the executive or the firm face civil litigation or criminal prosecution as of a direct result of the indiscretion. *Corporate Settlement* indicates whether the firm arranges a settlement with the aggrieved party. *Indiscretion Length* is the number of days over which each applicable indiscretion occurs. *Executive Married* denotes the marital status of the offending executive. *Target Married, Target is an Employee, Target is an Executive,* and *Target is a Subordinate* denotes the relationship status of the other party in the alleged indiscretion. *Executive Divorce, Target Divorce,* and *Executive Marries Target* indicate the personal consequences to the parties in the indiscretion. *Affair* denotes an alleged extramarital relationship, while *Harassment* indicates a sexual harassment case. *Drugs* indicates cases of reports of illegal use of controlled substances and *Alcohol* indicates DUIs or admissions to alcohol treatment programs.

Panel A: Title Held by Executive

	Sexual Misadventure	*Substance Abuse*	*Violence*	*Dishonesty*	*Full Sample*
Executive Title					
Chairman of the Board Only	5.6%	5.6%	17.2%	1.1%	5.3%
Director Only	32.5%	41.6%	27.7%	29.3%	32.2%
CEO and Chairman	28.5%	19.4%	13.8%	19.6%	23.3%
CEO and Director	8.3%	13.9%	10.3%	5.4%	8.3%
CEO Only	4.2%	0.0%	0.0%	2.2%	2.7%
Subordinate and Director	3.5%	5.6%	17.2%	7.6%	6.3%
Subordinate Executive Only	17.4%	13.9%	13.8%	34.8%	21.9%
Total	100.0%	100.0%	100.0%	100.0%	100.0%
Founder Status					
Founder of Firm	21.5%	25.0%	24.1%	10.9%	18.9%

Panel B: Personal Characteristics

	Sexual Misadventure		*Substance Abuse*		*Violence*		*Dishonesty*		*Full Sample*	
	N	Mean	N	Mean	N	Mean	N	Mean	N	Mean
Personal Data										
Age	135	54.4	36	55.2	29	53.0	87	54.7	287	54.4
Male	144	96.5%	36	97.2%	29	100.0%	92	94.6%	301	96.3%
Education										
Bachelor's Degree	130	86.2%	34	79.4%	27	96.3%	89	69.7%	280	81.1%
Master's Degree	130	54.6%	34	61.8%	27	55.6%	89	28.1%	280	47.1%
M.B.A. Degree	130	36.2%	34	61.8%	27	48.1%	89	14.6%	280	33.6%
Ph.D. Degree	130	12.3%	34	0.0%	27	0.0%	89	4.5%	280	7.1%
Financial Training	129	48.1%	33	72.7%	27	51.9%	89	52.8%	278	52.9%
Technical Training	129	41.9%	33	3.0%	27	37.0%	89	14.6%	278	28.1%
Career Experience										
Finance	139	28.1%	35	37.1%	29	48.3%	89	37.1%	292	33.9%
Technical	139	24.5%	35	0.0%	29	13.8%	89	11.2%	292	16.4%
Military	136	22.1%	34	5.9%	28	0.0%	89	13.5%	287	15.3%

Panel C: Indiscretion Characteristics and Outcomes

	Sexual Misadventure		*Substance Abuse*		*Violence*		*Dishonesty*		*Full Sample*	
	N	Mean	N	Mean	N	Mean	N	Mean	N	Mean
Executive Details										
Repeat Offender	144	31.3%	36	61.1%	29	17.2%	92	16.3%	301	28.9%
Executive Turnover	144	20.1%	36	13.9%	29	27.6%	92	35.9%	301	24.9%
Legal Action										
Arrest	144	3.5%	36	80.6%	29	41.4%	92	12.0%	301	18.9%
Personal Legal	144	47.9%	35	77.1%	29	44.8%	91	24.2%	299	43.8%
Corporate Legal	123	45.5%	33	3.0%	16	12.5%	85	10.6%	257	26.5%
Corporate Settlement	119	26.9%	23	0.0	16	6.3%	51	13.7%	209	19.6%
Indiscretion Details										
Length of Indiscretion	98	906	3	629	8	921	0	NA	109	899
Executive Married	139	76.3%	31	96.8%	29	89.7%	46	52.2%	245	75.9%
Target Married	126	23.0%			21	52.4%				
Target is an Employee	130	73.8%			22	13.6%				
Target is an Executive	130	15.4%			22	0.0%				
Target is a Subordinate	130	65.4%			22	13.6%				
Executive Divorce	142	27.5%								
Target Divorce	126	11.9%								
Executive Marries Target	131	6.9%								
Affair	144	45.8%								
Harassment	144	46.5%								
Drugs			36	27.8%						
Alcohol			36	75.0%						

Table 4
Determinants of Managerial Indiscretions

This table presents logistic regressions for the determinants for a *managerial indiscretion* to occur using the universe of firms listed in EXECUCOMP from 1996-2011. In Panel A, the dependent variable in each model is a (0,1) indicator variable signifying whether an *indiscretion*, *CEO indiscretion,* or a *Non-CEO 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. The *Poor Monitoring Index* is a (0,4) index defined as the sum of the four indicators non-independent board (0,1), large board (0,1), busy board (0,1), and hand-picked board (0,1). *Non-Independent Board* is an indicator of whether 50% or more of the firm's directors are classified as non-independent. *Large Board* is an indicator of whether the board size is greater than that of the median firm in RiskMetrics (IRRC) in a given year. *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. *Firm Size* is the natural log of net sales. *Firm Age* is the number of years the firm is listed on CRSP or COMPUSTAT. *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 (2003) or those where a member of the executive team holds the title of founder. *Leverage* is total debt to total assets. *ROA* is net income to total assets. *Tobin's Q* is computed as in Smith and Watts (1992). *Stock Return* is the raw stock return during the fiscal year. *CEO Age*, *CEO Tenure*, and *CEO Ownership*, are the age, years in office, and ownership of the common shares for the annual CEO, respectively. *Outside Dir Own* is the aggregate percentage ownership of the common shares held by all of the independent directors on the board. *% Female Directors* is the percentage of the board comprised of female directors. All variables are computed as of the most recent fiscal period immediately preceding the indiscretion. Each model includes industry and year fixed-effects and p-values are computed using robust Rogers (1993) firm-clustered standard errors.

Panel A: Determinants by Executive Title

	Indiscretion		Indiscretion		CEO Indiscretion		Non-CEO Indiscretion	
Variable	**Estimate**	**p-value**	**Estimate**	**p-value**	**Estimate**	**p-value**	**Estimate**	**p-value**
Intercept	-6.53	0.00	-6.25	0.00	-5.84	0.00	-7.80	0.00
Poor Monitoring Index	0.33	0.00			0.55	0.00	0.22	0.06
Non-Independent Board			-0.36	0.14				
Large Board			0.55	0.00				
Busy Board			0.29	0.10				
Hand-Picked Board			0.65	0.00				
Firm Size	0.38	0.00	0.36	0.00	0.16	0.22	0.46	0.00
Firm Age	-0.01	0.05	-0.01	0.05	-0.01	0.13	-0.01	0.13
Family Managed Firm	1.52	0.00	1.57	0.00	1.23	0.00	1.59	0.00
Leverage	0.22	0.70	0.12	0.83	0.60	0.51	0.07	0.92
ROA	-1.89	0.15	-1.89	0.16	-0.70	0.69	-2.14	0.18
Tobin's Q	0.07	0.35	0.07	0.37	-0.05	0.51	0.10	0.18
Stock Return	-0.22	0.27	-0.22	0.26	-0.60	0.10	-0.04	0.84
CEO Age	-0.02	0.12	-0.02	0.11	-0.03	0.12	-0.01	0.50
CEO Tenure	-0.08	0.00	-0.09	0.00	-0.04	0.05	-0.09	0.00
CEO Ownership	0.06	0.00	0.06	0.00	0.07	0.00	0.04	0.00
Outside Dir Own	0.00	0.86	0.00	0.95	0.00	0.86	0.00	0.91
% Female Directors	0.01	0.16	0.01	0.38	0.01	0.51	0.01	0.21
N	12,827		12,827		12,827		12,827	

Panel B: Determinants by Type of Indiscretion

	Sexual Misadventure		Substance Abuse		Violence		Dishonesty	
Variable	**Estimate**	**p-value**	**Estimate**	**p-value**	**Estimate**	**p-value**	**Estimate**	**p-value**
Intercept	-9.35	0.00	-12.37	0.00	-3.79	0.09	-6.58	0.00
Poor Monitoring Index	0.25	0.05	0.52	0.01	0.87	0.00	0.30	0.05
Firm Size	0.70	0.00	0.48	0.00	-0.21	0.47	0.22	0.08
Firm Age	-0.02	0.01	0.00	0.88	-0.08	0.03	-0.01	0.33
Family Managed Firm	1.57	0.00	1.48	0.00	1.24	0.00	1.53	0.00
Leverage	-1.25	0.10	-0.25	0.86	2.02	0.25	-0.21	0.81
ROA	-2.71	0.07	0.12	0.98	5.39	0.10	-3.18	0.07
Tobin's Q	0.03	0.66	-0.12	0.53	-0.06	0.65	0.11	0.10
Stock Return	-0.02	0.94	0.45	0.33	0.07	0.81	-0.45	0.18
CEO Age	-0.01	0.55	-0.01	0.65	-0.06	0.03	-0.03	0.11
CEO Tenure	-0.06	0.00	-0.03	0.17	-0.03	0.46	-0.09	0.00
CEO Ownership	0.05	0.00	0.05	0.03	-0.03	0.38	0.06	0.00
Outside Dir Own	0.01	0.68	0.03	0.25	0.04	0.07	-0.05	0.46
% Female Directors	0.03	0.01	0.02	0.39	0.00	1.00	0.00	0.85
N	12,827		12,827		12,827		12,827	

Table 5
Managerial Indiscretions and Firm Value

This table presents the impact of 301 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)]. Panel A presents the investor reactions for the full sample. In Panel B, we split the announcement returns by executive title. *CEO* indicates whether the executive committing the indiscretion is the firm's CEO, while *Non-CEO* denotes some other executive or director at the firm. In Panel C, *Turnover at Announcement* indicates the executive left at the time of the announcement while *Executive Retained* indicates that the executive remains at the firm. Announcement returns in Panel D are further disaggregated by *sexual misadventure, substance abuse, violence,* and *dishonesty* which are described in Table 1 and the text. P-values using parametric Student's t tests and non-parametric Wilcoxon signed-rank tests are reported in parentheses.

	N	Mean	Median	Mean	Median
Panel A: Overall Announcement Returns					
		(-1,+1) CAR		**(-2,+2) CAR**	
Full Sample	301	-1.79%	-0.67%	-1.40%	-0.77%
		(0.00)	(0.00)	(0.00)	(0.00)
Panel B: Announcement Returns by Title					
		(-1,+1) CAR		**(-2,+2) CAR**	
CEO	103	-3.84%	-1.82%	-3.04%	-1.97%
		(0.00)	(0.00)	(0.00)	(0.00)
Non-CEO	198	-0.72%	-0.40%	-0.72%	-0.48%
		(0.05)	(0.11)	(0.10)	(0.05)
Panel C: Announcement Returns by Turnover					
		(-1,+1) CAR		**(-2,+2) CAR**	
Turnover at Announcement	75	-3.41%	-1.17%	-2.41%	-1.54%
		(0.00)	(0.00)	(0.01)	(0.00)
Executive Retained	226	-1.23%	-0.54%	-1.05%	-0.69%
		(0.00)	(0.00)	(0.02)	(0.02)
Panel D: Announcement Returns by Indiscretion Type					
		(-1,+1) CAR		**(-2,+2) CAR**	
Sexual Misadventure	144	-0.76%	-0.52%	-0.19%	-0.47%
		(0.05)	(0.04)	(0.70)	(0.29)
Substance Abuse	36	-0.71%	-0.39%	-0.52%	-0.19%
		(0.19)	(0.72)	(0.49)	(0.71)
Violence	29	-2.15%	-1.95%	-2.53%	-2.70%
		(0.03)	(0.05)	(0.00)	(0.00)
Dishonesty	92	-3.69%	-1.24%	-3.28%	-1.73%
		(0.00)	(0.00)	(0.00)	(0.00)

Table 6
Managerial Indiscretions and Firm Value Regressions

This table presents industry and calendar year fixed-effects regressions of the (-1,+1) announcement CARs upon indiscretion, executive, and firm characteristics using our sample of 301 managerial indiscretions. 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. *Dishonesty* is an indicator of whether the indiscretion is 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 is a member of the founding family. *Arrest* indicates the executive is arrested as a result of the indiscretion. *Repeat Offender* indicates that the executive has committed any of the indiscretions tracked in our sample at some point in their past. *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 the natural log of net sales and the return on assets reported by the company prior to the announcement. *Tobin's Q* is the market value of assets to their book value as defined by Smith and Watts (1992) and *Stock Return* is the firm's stock return during the fiscal year. *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 variables are computed as of the most recent fiscal period immediately preceding the indiscretion. All models include industry and calendar year fixed-effects.

	(-1,+1) CAR		**(-1,+1) CAR**		**(-1,+1) CAR**	
	Estimate	**p-value**	**Estimate**	**p-value**	**Estimate**	**p-value**
Intercept	-0.027	0.06	-0.043	0.00	-0.031	0.03
CEO	-0.029	0.00	-0.011	0.21	-0.025	0.01
Dishonesty	-0.024	0.00	-0.004	0.67	-0.021	0.00
TO at Announcement	-0.016	0.03	-0.018	0.01	-0.013	0.15
Founding Family	-0.003	0.76	-0.007	0.48	-0.004	0.72
Arrest	-0.007	0.39	-0.002	0.77	-0.005	0.52
Repeat Offender	0.003	0.67	0.005	0.45	0.003	0.71
Confounding Event	0.034	0.00	0.033	0.00	0.034	0.00
Firm Size	0.003	0.04	0.004	0.01	0.003	0.02
ROA	-0.001	0.96	-0.002	0.83	-0.002	0.87
Tobin's Q	0.000	0.80	0.001	0.55	0.000	0.86
Stock Return	0.006	0.35	0.006	0.33	0.007	0.31
CEO x Dishonesty			-0.058	0.00		
CEO x TO at Ann					-0.012	0.44
CEO + Interaction			-0.069	0.00	-0.037	0.01
N	301		301		301	

Table 7
Managerial Indiscretions and Operating Performance

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 1996-2011. In Panel A, the dependent variable, *Abnormal OROA*, is the abnormal operating return on assets (EBITDA / average total assets) using the procedure outlined in Barber and Lyon (1996) [model 4]. In Panel B, the dependent variable, *Abnormal Δ OROA*, is the abnormal change in the operating return on assets [Barber and Lyon (1996), model 8] from the prior fiscal year to the one in which the indiscretion is disclosed. 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* and *Non-CEO Indiscretion* indicate whether the event was perpetrated by the firm's CEO or a junior executive / director, respectively. *Firm Size* is the natural log of net sales. *Firm Age* is the number of years the firm is listed on CRSP or COMPUSTAT. *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 (2003) or those where a member of the executive team holds the title of founder. *CAPX* is capital expenditures normalized by sales. *Leverage* is total debt to total assets. *CEO Ownership* is the ownership of the common shares for the annual CEO. *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. *# of Business Segments* is the total number of segments reported by the firm. All variables are computed as of the most recent fiscal period immediately preceding the indiscretion. Each model includes industry / year fixed-effects and p-values are computed using robust Rogers (1993) firm-clustered standard errors.

Panel A: Abnormal Operating Performance

	Abnormal OROA		**Abnormal OROA**		**Abnormal OROA**	
	Estimate	**p-value**	**Estimate**	**p-value**	**Estimate**	**p-value**
Intercept	-0.040	0.36	-0.040	0.31	-0.046	0.31
Indiscretion	-0.007	0.17				
CEO Indiscretion			-0.015	0.02		
Non-CEO Indiscretion					-0.003	0.69
Firm Size	0.005	0.00	0.005	0.00	0.005	0.00
Firm Age	0.000	0.51	0.000	0.52	0.000	0.54
Family Managed Firm	0.003	0.07	0.003	0.08	0.002	0.08
CAPX	-0.001	0.00	-0.001	0.00	-0.001	0.00
Leverage	-0.020	0.00	-0.020	0.00	-0.020	0.00
CEO Ownership	0.000	0.70	0.000	0.74	0.000	0.63
Outside Director Ownership	0.000	0.01	0.000	0.01	0.000	0.01
Board Size	-0.001	0.00	-0.001	0.00	-0.001	0.00
# Business Segments	0.000	0.20	0.000	0.20	0.000	0.19
N	12,827		12,827		12,827	

Panel B: Abnormal Change in Operating Performance						
	Abnormal Δ OROA		**Abnormal Δ OROA**		**Abnormal Δ OROA**	
	Estimate	**p-value**	**Estimate**	**p-value**	**Estimate**	**p-value**
Intercept	-0.099	0.00	-0.098	0.00	-0.104	0.00
Indiscretion	-0.007	0.20				
CEO Indiscretion			-0.015	0.03		
Non-CEO Indiscretion					-0.002	0.76
Firm Size	0.004	0.00	0.004	0.00	0.004	0.00
Firm Age	0.000	0.70	0.000	0.71	0.000	0.74
Founder Firm	0.003	0.05	0.003	0.06	0.003	0.06
CAPX	-0.001	0.00	-0.001	0.00	-0.001	0.00
Leverage	-0.018	0.00	-0.018	0.00	-0.018	0.00
CEO Ownership	0.000	0.46	0.000	0.49	0.000	0.41
Outside Director Ownership	0.000	0.01	0.000	0.01	0.000	0.01
Board Size	-0.001	0.00	-0.001	0.00	-0.001	0.00
# Business Segments	0.000	0.39	0.000	0.39	0.000	0.38
N	12,827		12,827		12,827	

Table 8
Managerial Indiscretions and Long-Run Shareholder Wealth

This table presents the impact of managerial indiscretions upon long-run firm value during the fiscal year the indiscretion is disclosed using the universe of firms listed in EXECUCOMP from 1996-2011. The dependent variable in each model of Panel A is Δ *Tobin's Q* from the fiscal year-end immediately preceding (t-1) the indiscretion announcement to the one immediately succeeding it (t). *Tobin's Q* is computed as in Smith and Watts (1992). 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* and *Non-CEO Indiscretion* indicate whether the event was perpetrated by the firm's CEO or a junior executive / director, respectively. *Firm Size* is the natural log of net sales. *ROA* is the net income return on assets. *Leverage* is total debt to assets. *Increase in CAPX* is the change in capital expenditures to sales from (t-1) to (t). *Firm Age* is the natural log of firm age. *Increase in Diversification* is the change in the number of business segments from (t-1) to (t). *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 (2003) or those where a member of the executive team holds the title of founder. *CEO Age*, *CEO Tenure*, and *CEO Ownership*, are the age, years in office, and ownership of the common shares for the annual CEO, respectively. *Outside Director Ownership* is the aggregate percentage ownership of the common shares held by all of the independent directors on the board. *Increase in Board Size* is the change in the number of directors on the board. *Independent Board* is an indicator variable of whether 50% or more of the directors are classified as independent. Each model includes industry / year fixed-effects and p-values are computed using robust Rogers (1993) firm-clustered standard errors. Panel B presents median long-run buy-and-hold abnormal returns (BHARs) for up to one year from the indiscretion announcement for our 301 managerial indiscretions. *BHARs* are computed under the procedure outlined in Barber, Lyon, and Tsai (1999) where each sample firm is assigned to one of 140 size- and book-to-market matched benchmark equally-weighted portfolios. P-values computed from non-parametric Wilcoxon rank-sign test statistics are provided in parentheses.

Panel A: Managerial Indiscretions and the Change in Long-Run Firm Value

	Δ Tobin's Q		Δ Tobin's Q		Δ Tobin's Q	
	Estimate	**p-value**	**Estimate**	**p-value**	**Estimate**	**p-value**
Intercept	-0.345	0.39	-0.442	0.36	-0.475	0.15
Indiscretion	-0.231	0.00				
CEO Indiscretion			-0.253	0.01		
Non-CEO Indiscretion					-0.199	0.01
Firm Size	-0.002	0.56	-0.004	0.39	-0.003	0.47
ROA	0.159	0.10	0.159	0.10	0.165	0.09
ROA (t-1)	-0.682	0.00	-0.680	0.00	-0.683	0.00
Leverage	0.032	0.36	0.032	0.35	0.031	0.38
Increase in CAPX	0.013	0.00	0.013	0.00	0.013	0.00
Firm Age	0.034	0.00	0.036	0.00	0.035	0.00
Increase in Diversification	-0.021	0.00	-0.021	0.00	-0.021	0.00
Family Managed Firm	0.014	0.31	0.009	0.50	0.012	0.39
CEO Age	0.001	0.16	0.001	0.17	0.001	0.15
CEO Tenure	-0.001	0.24	-0.001	0.38	-0.001	0.29
CEO Ownership	-0.001	0.42	-0.001	0.34	-0.001	0.29
Outside Director Ownership	0.002	0.16	0.002	0.16	0.002	0.16
Increase in Board Size	-0.006	0.23	-0.006	0.23	-0.006	0.24
Independent Board	0.004	0.80	0.003	0.86	0.003	0.83
N	12,827		12,827		12,827	

Panel B: Managerial Indiscretions and Long-Run Stock Returns

	Median Size- and Book-to-Market matched BHARs		
	One Month [0,+19]	Three Months [0,+59]	One Year [0,+249]
Full Sample	-1.42%	-2.44%	-9.12%
	(0.00)	(0.00)	(0.00)
CEO Indiscretions	-2.67%	-2.74%	-14.46%
	(0.02)	(0.01)	(0.00)
Non-CEO Indiscretions	-1.17%	-2.41%	-7.49%
	(0.03)	(0.05)	(0.01)

Table 9
Managerial Indiscretions, Shareholder Class-Action Lawsuits, and Fraud

This table presents the logistic regression of the propensity for managerial indiscretions to impact the probability of being targeted in a shareholder class action lawsuit or to commit fraud using the universe of firms listed in EXECUCOMP from 1996-2011. In Panel A, the dependent variable in each logistic regression model is a (0,1) indicator of whether the firm is the target of a shareholder class-action lawsuit in the year of the indiscretion or in the two years following the announcement. In Panel B, the dependent variable in each logistic regression model is a (0,1) indicator of whether the firm allegedly commits fraud that becomes the subject of a DOJ or SEC fraud investigation in the year of the indiscretion or in the two years following the announcement. 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* and *Non-CEO Indiscretion* indicate whether the event was perpetrated by the firm's CEO or a junior executive / director, respectively. *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, Lowry, and Shu (2005). *Firm Size* is the natural log of net sales. *Firm Age* is the number of years the firm is listed on CRSP or COMPUSTAT. *Leverage* is total debt to assets. *ROA* is the net income return on assets. *Tobin's Q* is the market value of assets to their book value as computed as in Smith and Watts (1992). *Stock Return* is the annual return on the firm's common stock for the period ending with the fiscal year-end. *Average Volume* is the average daily trading volume in millions of shares for the firm's common stock during the fiscal year. *CEO-Chairman* is an indicator of whether the CEO is also the chairman of the board. *Board Size* is the number of directors on the board. *Percent Independent* is the percentage of the board which is comprised of outsiders as defined by RiskMetrics (IRRC). *Discretionary Accruals* is the discretionary portion of total current accruals as defined in Teoh, Welch, and Wong (1998). *CEO Age*, *CEO Tenure*, and *CEO Ownership*, are the age, years in office, and ownership of the common shares for the annual CEO, respectively. Each model includes year fixed-effects (panel B models also include industry fixed-effects) and p-values are computed using robust Rogers (1993) firm-clustered standard errors.

Panel A: Shareholder Class-Action Lawsuits

	Class-Action Lawsuit		Class-Action Lawsuit		Class-Action Lawsuit	
	Estimate	p-value	Estimate	p-value	Estimate	p-value
Intercept	-8.100	0.00	-8.065	0.00	-8.051	0.00
Indiscretion	0.555	0.02				
CEO Indiscretion			0.755	0.03		
Non-CEO Indiscretion					0.431	0.13
Industry Legal Exposure	0.994	0.00	0.995	0.00	0.993	0.00
Retail Firm	0.056	0.79	0.053	0.80	0.052	0.81
Technology Firm	0.438	0.00	0.433	0.00	0.436	0.00
Regulated Firm	-0.237	0.20	-0.237	0.20	-0.238	0.20
Firm Size	0.232	0.00	0.235	0.00	0.232	0.00
Firm Age	-0.012	0.00	-0.012	0.00	-0.012	0.00
Leverage	1.041	0.00	1.046	0.00	1.046	0.00
ROA	-1.494	0.00	-1.520	0.00	-1.498	0.00
Tobin's Q	0.225	0.00	0.226	0.00	0.225	0.00
Stock Return	-0.551	0.00	-0.550	0.00	-0.554	0.00
Average Volume	0.050	0.00	0.051	0.00	0.051	0.00
CEO-Chairman	0.204	0.04	0.200	0.04	0.203	0.04
Board Size	0.069	0.00	0.070	0.00	0.070	0.00
Percent Independent	0.000	0.88	0.000	0.89	0.000	0.90
N	12,827		12,827		12,827	

Panel B: Fraud						
	Fraud		**Fraud**		**Fraud**	
	Estimate	**p-value**	**Estimate**	**p-value**	**Estimate**	**p-value**
Intercept	-8.395	0.00	-8.611	0.00	-8.611	0.00
Indiscretion	0.815	0.01				
CEO Indiscretion			1.105	0.04		
Non-CEO Indiscretion					0.669	0.07
Firm Size	0.518	0.00	0.546	0.00	0.541	0.00
Firm Age	-0.008	0.17	-0.009	0.15	-0.009	0.15
Leverage	-0.119	0.82	0.398	0.46	0.388	0.46
ROA	-0.622	0.07	-0.447	0.20	-0.453	0.20
Tobin's Q	0.057	0.09	0.034	0.38	0.032	0.40
Stock Return	0.081	0.26	0.049	0.48	0.041	0.55
Average Volume	-0.006	0.66	-0.020	0.19	-0.019	0.20
Discretionary Accruals	0.089	0.00	0.086	0.00	0.086	0.00
CEO-Chairman	0.314	0.09	0.294	0.12	0.294	0.12
CEO Ownership	-0.050	0.03	-0.043	0.04	-0.042	0.04
CEO Age	-0.039	0.01	-0.038	0.01	-0.038	0.01
CEO Tenure	0.027	0.09	0.027	0.10	0.027	0.10
Board Size	-0.010	0.75	0.000	0.99	0.000	0.99
Percent Independent	-0.009	0.09	-0.011	0.05	-0.011	0.04
N	12,827		12,827		12,827	

Table 10
Managerial Indiscretions and Earnings Management

This table presents evidence on the relation between managerial indiscretions and earnings management. The dependent variable in each OLS model is the magnitude of *discretionary accruals* as defined in Teoh, Welch, and Wong (1998). 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* and *Non-CEO Indiscretion* indicate whether the event was perpetrated by the firm's CEO or a junior executive / director, respectively. *CEO-Chairman* is an indicator of whether the CEO is also the chairman of the board. *CEO Age*, *CEO Tenure*, and *CEO Ownership*, are the age, years in office, and ownership of the common shares for the annual CEO, respectively. *Board Size* is the number of directors on the board. *Percent Independent* is the percentage of the board which is comprised of outsiders as defined by RiskMetrics (IRRC). *Delaware Incorporation* is an indicator variable of whether the firm is incorporated in Delaware. *Firm Size* is the natural log of net sales. *ROA* is the net income return on assets. *Tobin's Q* is the market value of assets to their book value as computed as in Smith and Watts (1992). *Leverage* is total debt to assets. Each model includes industry and year fixed-effects and p-values are computed using robust Rogers (1993) firm-clustered standard errors.

	Discretionary Accruals		**Discretionary Accruals**		**Discretionary Accruals**	
	Estimate	**p-value**	**Estimate**	**p-value**	**Estimate**	**p-value**
Intercept	0.029	0.54	0.027	0.67	0.047	0.28
Indiscretion	0.023	0.10				
CEO Indiscretion			0.049	0.05		
Non-CEO Indiscretion					0.008	0.59
CEO-Chairman	0.000	0.91	0.000	0.92	0.000	0.91
CEO Ownership	0.001	0.07	0.001	0.07	0.001	0.06
CEO Age	-0.001	0.00	-0.001	0.00	-0.001	0.00
CEO Tenure	0.000	0.95	0.000	0.98	0.000	0.97
Board Size	-0.001	0.21	-0.001	0.22	-0.001	0.23
Percent Independent	0.000	0.90	0.000	0.90	0.000	0.91
Delaware Incorporation	0.014	0.00	0.014	0.00	0.014	0.00
Firm Size	-0.006	0.01	-0.006	0.01	-0.006	0.01
ROA	-0.024	0.49	-0.025	0.47	-0.025	0.47
Tobin's Q	0.008	0.00	0.008	0.00	0.008	0.00
Leverage	0.017	0.27	0.017	0.27	0.017	0.27
N	12,827		12,827		12,827	