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Executive indiscretions can hurt the bottom line

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In a new study, Adam Yore found that personal indiscretions made by executives can have multimillion dollar consequences for the companies that employ them. Credit: University of Missouri

A CEO outed for lying on a resume. An executive caught assaulting someone. A manager arrested for driving under the influence. These events certainly cast shadows on individuals, but a new study from Adam Yore, an assistant professor of finance in the Trulaske College of Business at the University of Missouri, shows that such indiscretions can have multimillion dollar consequences for the companies that employ them.

Yore and his co-authors examined 325 instances of executive indiscretions, which were divided into four categories: substance abuse, violence, sexual indiscretions and dishonesty. The analysis found an immediate 1.6 percent loss in shareholder value in instances of managerial missteps, which translates into an average loss of $110 million in market capitalization. When indiscretions were committed by the CEO, the loss in shareholder value is 4.1 percent or $226 million. The dishonesty indiscretions were found to be the most damaging.

Furthermore, Yore found CEO indiscretions are associated with significant declines in the number of new major customers and joint venture partnerships. Yore says customer losses are particularly severe for those indiscretions that damage the firm's reputation.

"The basic premise of our study is, 'If you cheat on your wife, would you lie to your shareholders or business partners?' Our research certainly suggests shareholders and potential business partners perceive that someone who is duplicitous in his or her private life could be more

willing to mislead professionally," Yore said. "Personal integrity at the top matters and can have major impacts on these companies."

Yore's study looked at single instances of managerial indiscretions and "repeat offenders." The likelihood of disciplinary turnover was similar for either type of indiscretion, but both were much more likely to occur at family-managed firms. In general, the researchers found that indiscretions occur more often at poorly governed firms where disciplinary turnover is less likely.

Researchers did find a caveat in examining indiscretions and value: companies that researchers categorized as "shady"—or industries where firms have a propensity for non-compliance with federal rules—saw smaller market reactions after such revelations came to light.

The study, "The Consequences of Managerial Indiscretions: Sex, Lies and Firm Value" is written by Yore, Brandon Cline at Mississippi State University and Ralph Walkling of Drexel University. It will be published in an upcoming edition of the *Journal of Financial Economics*.

More information: Brandon N. Cline et al. The Agency Costs of Managerial Indiscretions: Sex, Lies and Firm Value, *SSRN Electronic Journal* (2010). DOI: 10.2139/ssrn.1573327

Provided by University of Missouri-Columbia

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