Finance 702

# Assignment 1

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# Contents

# 1 Brand & Franchise Analysis

## 1.1 Brand Name & Organisation Specific Assets

A brand name is classified as an organisation specific asset. Asset Specificity is the degree an object or person of value can be readily adapted for other purposes. Levels of specificity determine the flexibility and usefulness for assets across multiple situations and purposes. A brand name identifies the franchisor's organisation as distinct from competitors. Brand names are considered indefinite intangible assets as they stay with the entity for the duration of their operating period and are not physical by nature. Brand names (e.g. McDonalds, Taco Bell etc.) are highly specific as aren't interchangeable for many purposes or situations. Their purpose is to label the franchisor organisation with contractual agreements enabling the franchisees/lessees to use the brand name. These contractual agreements between franchisors and franchisees/lessees require the franchisees/lessees to use highly specific assets which are of value to the franchisor in the form of brand name(s). Subsequently, brand names can be viewed as specific assets to an organisation (Investopedia, 2021).

## 1.2 Benefits of Franchising

The dichotomy between outlet ownership retention and leasing to franchisees/lessees for a franchisor is interesting. Franchising is another form of product distribution. The ability to achieve potential benefits associated with large scale e.g. brand name development while utilizing local profit incentives and retailing efforts rationalise the decision to franchise. Three factors define franchising: Firstly, distribution of goods and services associated with the franchisor's trademark. Secondly, exercise of significant control over, or giving of significant assistant to, the franchisee by the franchisor. Lastly, payment to the franchisor by the franchisee. These factors inform the benefits on either side of the dichotomy (Klein, 1995).

### 1.2.1 Retention of Ownership

There are several benefits a franchiser receives from the retention of ownership for some outlets that use the brand. Firstly, a franchisor may utilize economies of scale to increase profits when outlets are densely located in a geographic area. For example, several McDonalds outlets within close proximity may generate cost savings from shared distribution networks and proximity to dispatch centres in high-density urban areas (Tokyo, New York, Auckland etc.) In this instance, a franchisor has greater control over the quality of staff employed in the outlets. Although franchising enables greater access to talent, the franchisor would have greater control over who the outlets hire, ability to build a better community amongst outlets and ability to innovate.

### 1.2.2 Leasing Brand Name

Conversely, there are benefits to leasing brand names out to franchisees or lessees. Franchising enables the franchisor to further build their brand without managing the daily operations of each outlet. The franchisor may be able to have greater access to capital and expand at a higher rate with lower growth risk as each outlet is managed by the outlet operator. Additionally, they collect royalties and initial franchise payments with lower risk as the initial capital investment in opening the outlet is fronted by the outlet operator. The franchisor still has the ability to exercise control over the franchisees/lessees through a franchise contract. Contributions made by the franchisee/lessee may contribute to funding brand improvements, product R&D, training and/or corporate functions. The franchisor may also have greater access to talent who they can monitor in franchisee/lessee outlets and transfer to corporate functions if needed.

## 1.3 Failures in Corporate Governance by RFG

### 1.3.1 Introduction to Retail Food Group (RFG)

Retail Food Group (ASX: RFG) is a global beverage and food company headquartered in Queensland, Australia. The company is Australia's largest multi-brand retail food and beverage franchise owner. They also roast and supply high quality coffee products (Retail Food Group, 2021). Their brands include: Donut King, Brumby's Bakery, The Coffee Guy, Michel's Patisserie, Gloria Jean's, Di Bella, Crust, Pizza Capers and Cafe2U. These brands serve over 17 million Australian customers annually, recording more than 70 million customer transactions in 2020. Their core focus is supporting the success of franchise partners and improving profitability. Interestingly, their home page outlines three provisions to franchisees: training facilities, product innovation and on-going support. These provisions will be relevant further in our discussion.

### 1.3.2 Background on Corporate Governance & Case

Corporate Governance is a system of rules, practises and policies dictating the managerial responsibilities and operational oversight of the board of directors. Three principles underpin Corporate Governance: Accountability, Transparency and Security (Corporate Finance Institute, 2021). These factors inform the assessment of RFG's corporate governance failure. For background, RFG was accused by the franchisees operating Michel's Patisserie, Brumby's Bakery, Donut King and Gloria Jean's brand for false, deceptive and misleading conduct during the sale of stores to franchisee owners. The ACCC alleged RFG's action were unconscionable as critical financial information was withheld during the sale or licensing of 42 unprofitable stores. The ACCC's investigation ramped up after the Australian Securities and Investment Commission (ASIC) scrutinized RFG on a lack of transparency for investors but subsequently escaped enforcement (Maskiell, 2020).

### 1.3.3 Failure of Corporate Governance

Firstly, the Board of Directors failed to upheld satisfactory levels of transparency regarding the profitability in the sale or licensing of 42 stores. Each participant in the franchise community is entitled to accurate information related to the goals, strategy and performance of the franchise. Deceiving franchisees on the financial outcomes on the outlet enables the franchisor to shift default risk to outlet manages while collecting royalties and capital injections from the sale of stores. An article in the Australian Financial Review highlights RFG suffered an $88 million AUS loss, forecast the closure of 200 stores and the financial devastation incurred by store owners dreaming of owning a small business (Ferguson, 2018). This is a clear violation in good corporate governance. Secondly, their was no clear system in place to manage or support financially-distressed stores. Good corporate governance should provide frameworks to manage cost cutting exercises to support distressed stores. Franchisees were left to fend for themselves rather than RFG rolling out cost cutting plans and financial support plans to the franchisees. Thirdly, corporate governance should ensure RFG operates ethically with high standards of integrity. The allegations of insider trading, tax avoidance, breaches of consumer law, market disclosure and valuation violations by RFG and it's directors indicate otherwise. These allegations inform unethical behaviour and the poor corporate governance. Directors failed to take accountability for their responsibilities. RFG failed to provide satisfactory supply arrangements and good quality products to two Michel's Patisserie franchisees in Townsville, leading to a breach in consumer law (Maskiell, 2020). These are basic provisions expected from franchisors and should be specified in a franchise contract. This is another example of a failure in corporate governance. Subsequently, RFG failed multiple times to practise good corporate governance, leading to the destruction of value.

# 2 Long/Short-selling & Corporate Governance

## 2.1 Definition of Hedge Funds

Hedge funds are a form of investment vehicle and are usually identified by four characteristics. Firstly, they are privately organised, pooling capital from several parties. Secondly, professional investment managers administer the fund. They are incentivised by performance-based compensation and significant carry in the fund. Thirdly, they are inaccessible to the public. Lastly, they operate externally to securities regulation and registration requirements. A hedge fund is managed by general partners (GP) who manage limited partners' (LP) investments in the fund. LPs make passive investments with little to no control in the fund's operations. Hedge funds typically charge a 2% annual fee and 20% performance fee on the fund's annual return. They raise capital through private offerings and pursue multiple, complex investment strategies in public and private markets to generate returns for investors (BRAV, JIANG, PARTNOY, and THOMAS, 2008). Two examples of investment strategies deployed by hedge funds are long positions and short selling. Short selling is a strategy to bet against a securities performance. This strategy capitalises on an expectation the security will fall in value and may be used as a hedge to the mitigate downside risk of a long position in a similar security. A portfolio manager borrows the security, immediate sells it on the market and buys the security back later at a lower price to generate a return. A long position is a strategy to bet on a securities performance, capitalising on the expectation the security will rise in value. A portfolio manager buys the security, holds as the price rises, then sells at a higher price to generate returns for investors.

## 2.2 Impact of Hedge Funds

Good corporate governance maximises operational efficiencies and returns for stakeholders. Corporate governance is defined in section 1.3.2. Existing literature and articles suggest hedge fund activity does influence organisations.

## 2.3 J Capital and Nearmap Analysis

The incident involving J Capital exemplifies how hedge fund's engagement in short selling activities can unethically affect value. J Capital published comments related to layoffs, discounting to artificially lift margins, failures to monetise products in the US market and the cost advantages of competitors. Subsequently, Nearmap shares slid 7% in response to the research, destroying value for Nearmap's shareholders before the execution of a trading halt. Nearmap produced an ASX release falsifying the claims made on the following areas by J Capital: sales strategy, churn, pricing, technology, capture efficiencies, AI, pushpin and accounting practises (Nearmap, 2021). Additionally, several equity analysts criticised the research, emphasising a $3 price target, stating US market performance was priced in and the layoff accusations were overblown (Kruger, 2021). However, J Capital created an opportunity to capitalise on the falling share price and exit their short positions to generate returns. In this example, J Capital destroyed value for Nearmap shareholders. However, Nearmap's board were quick to react and provide evidence falsifying the claims made by J Capital. They exemplified good corporate governance in reassuring shareholders J Capital was acting unethically.

## 2.4 BHP & Elliot Management Analysis

Elliot Management, who represent Elliot Funds, prepared a presentation to the directors of BHP Billiton Plc and BHP Billiton Limited on how to increase shareholder value through recommending the BHP Shareholder Value Unlock Plan. Elliot Management identified three key initiatives for management to implement to unlock value for shareholders. Firstly, unify BHP

under into a single Australian-headquartered and Australian tex resident listed company. Secondly, demerge and separately list BHP's US petroleum business to monetise intrinsic value. Lastly, adopt a policy of consistent and optimal capital return to BHP's shareholders. The demerger, accretion value from buybacks and franking credits from buybacks would unlock $15 billion, $20 billion and $11 billion in enterprise value respectively. The implementation of the plan recommended unlocks a total $46 billion (USD) in enterprise value (Elliot Management, 2021). This plan is validated by FTI Consulting report on the incumbent management's oversight preventing the realisation of approximately $40 billion (USD) in value (FTI Consulting, 2021). Elliot Management, on behalf of Elliot Funds, provided recommendations to improve corporate governance and increase long-term shareholder value to create value. This case study shows hedge funds who engage in long positions can hold director's accountable, encourage good corporate governance and create value.

### 2.5 Activist Hedge Funds

Activist hedge funds have a role to play in ensuring good corporate governance. One paper analysed hedge fund activism documenting the heterogeneity in hedge fund objectives and tactics, showing how tactics relate to target firm responses. The paper finds positive market reactions to hedge fund intervention is consistent with improved post-intervention target performance, the effect of interventions on CEO remuneration and turnover, and changes in payout policy. The findings were consistent with informed shareholder monitoring can reduce agency costs at target firms. Most importantly, the paper found hedge fund activism generates value on average from both the activist's credible commitment to intervention and conviction to follow through on their commitments (BRAV et al., 2008). Recently, ExxonMobil faced scrutiny for it's energy strategy. Engine No. 1, an activist investment group, nominated four qualified potential board members to improve governance and reposition the organisation to achieve sustainable, long term value for shareholders. The company recently appointed two new board members, one who cofounded an investment firm focussing on increasing shareholder value and promoting sound ESG practises, in efforts to improve corporate governance (Engine No. 1, 2021). These articles exemplify the role activist hedge funds, who engage in long and short selling activities, play in forcing better corporate governance and create long term shareholder returns.

### 2.6 Positional Dichotomy: Short vs Long

J Capital, BHP Billiton and activist hedge funds and their action taking positions in an entity show evidence of changes in corporate governance, long-term shareholder returns and value. The directionality of change depends on the position. Short positioning would incentivise poor corporate governance and the destruction of long-term shareholder value from the perspective of the hedge fund. Investors hedging against a firm's success may give unethical recommendations or slander the organisation to drive down perceived value and generate returns as seen with J Capital and Nearmap. It was fortunate Nearmap's board and executive team took swift action to mitigate the damage. Alternatively, long positioning incentivises hedge funds to influence good corporate governance and generate long term shareholder returns as there is more to gain from the upside of improved performance. This was shown through the BHP example and literature on activist hedge funds. In conclusion, hedge funds will take a position in alignment with their investment thesis, own corporate governance and likelihood to generate returns. Whether the involvement of hedge funds leads to better corporate governance and improved long-term shareholder returns depends on their influence, market conditions, thesis and the resolve of the incumbent board of directors.

# 3 References

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# Variable Systems Model ExxonMobil Australia

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# List of Figures

# 1 Model Interpretations

Davis, Schoorman & Donaldson (2018) outline the discrepancies between agency and stewardship theory developed in preceding literature. Principal Agency Theory (PAT) informs the behaviours of a rational agent who seeks to maximise his or her utility and manage an organisation's operations on behalf of executives. However, diverging approaches to maximising the utility for each party create agency conflicts as there is a separation of control and ownership (Jensen and Meckling, 1976). Principal Stewardship Theory (PST) informs the behaviours of stewards who gain more utility from pro-organisational, collectivistic behaviours than individualistic, self-serving behaviours (Donaldson and Davis, 1991). A Variable Systems Model (VSM) articulates the structure required by organisations to maintain viability in complex and dynamic environments (Davis, Schoorman, and Donaldson, 2018). Conflicts between PAT and PST enable different interpretations of the Variable System Model (2.1).

## 1.1 Principal Theories: Stewardship vs Agency

In general terms, the stewards and agents may interpret the interactions between systems and linkages differently at ExxonMobil Australia. Stewards would recognise the various linkages between exploration, extraction, processing and commercialisation of hydrocarbon assets as integral to business performance. Each resource unit employee and manager (System 1: Drilling, Wells etc.) will uphold their integrity and communicate both good and bad outcomes, e.g. Safety incidents, NPV negative projects, failed negotiations with governments or private consortiums when executing gas contacts. The rationale behind this transparency is an increase in pro-organisational, collectivistic outcomes to derive utility. The Lead Country Manager, Resource Unit Managers, Finance Managers, and Legal Managers will be across most business needs and issues, seeking support from the global policy and intelligence systems if required.

Agents may not be so transparent. The individualistic, self-serving actions under PAT may interpret the model differently. They may game the linkages (a subset described in 1.2) only to communicate positive outcomes. For example, only communicate information meeting compliance through command channels, positive information when resource bargaining or change audit information in the audit channel to reflect good financial outcomes. Progression/promotion at ExxonMobil Australia (and other large corporates) aligns with the financial performance and the benefits you generate for the company or resource unit (system one). Additionally, agents in system one may see a disconnect from the global organisation (Global Executive Team, Board of Directors) as indirectly linked to the Intelligence or Policy systems. Agents may interpret the variable systems model as a set of smaller variable models where linkages solely depend on their place within the

hierarchy i.e. many smaller businesses, not one global business.

## 1.2 Amplifiers & Attenuators

Variety engineering (VE) informs how regulatory processes operate (Beckford, 1993). VE matches the variety of the environment and the regulator through the judicious use of attenuation and amplification (Achterbergh and Vriens, 2011). Attenuation in this context refers to organisational efforts to reduce (attenuate) the variety of the environment. Amplification refers to efforts to increase (amplify) the ability to respond to it (O'Grady, Morlidge, and Rouse, 2016). There are several linkages between systems 2, 3, 3* with system 1: Command (S1 - S3); Resource bargaining & accountability (S1-S3); Anti-oscillation or Coordination (S1-S2-S3); and Audit (S1-S3*-S3). Command communicates and manages compliance to legal and corporate requirements and cultural norms. Resource bargaining & accountability supports negotiations about action programs and resourcing and conveys accountability information. Anti-oscillation or Coordination communicates common standards and conventions through guidelines and maintains routine information systems. Audit conveys detailed information about specific aspects of operational performance on an ad-hoc basis (O'Grady et al., 2016).

The diverging methods of maximising utility between stewards and agents affect the provision of attenuators and amplifiers. In the command channel, resource unit managers will regularly amplify legal and corporate requirements in face to face discussions with other units to align compliance across teams under a stewardship mindset. However, under an agency mindset, resource unit managers may only intervene on legal/compliance concerns (attenuate) in their business units when operations affect their unit and amplify compliance with their unit, regardless of the impact on other resource units in system one. Resource unit managers may work together to optimally allocate (amplify) resources, e.g. capital or labour, across units as a steward in the resource bargaining channels. Conversely, an agent may look to maximise resource allocation without considering the needs of other units. In the coordination channel, weekly reporting on performance (attenuator) may be available organisation-wide under stewardship theory but only available to the resource unit under an agency theory. The corporate culture (amplification) either fosters or inhibits information sharing/group problem solving using stewardship or agency theory, respectively. In the audit/monitoring channel, the prompt publication of internal audits (amplifier) helps diagnose problems under stewardship or hide results to fix issues before publication delaying diagnosis under an agency theory.

In summary, there are different interpretations of the variable system model and inclusion of different attenuators and amplifiers, depending on principal stewardship or agency theory at ExxonMobil Australia.

# 2 Appendix

## 2.1 Variable Systems Model - NYSE: XOM

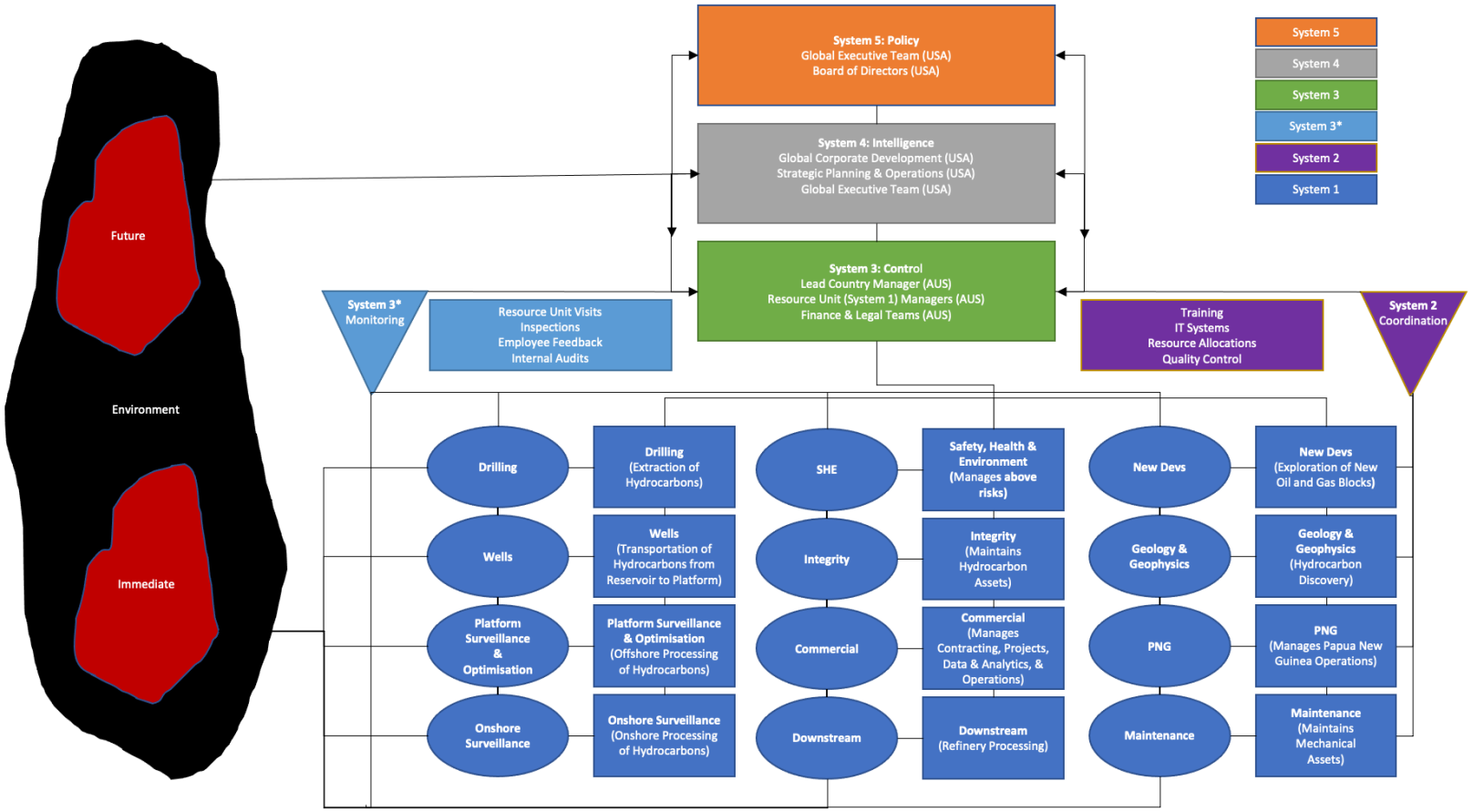


Figure 1: ExxonMobil Australia

# References

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# Corporate Governance & Blockchains

Group 7A: Connor McDowall, Yihua Lian, Xue Song , Honglin Tao

# Introduction to Blockchains

## What is Blockchain?

- Blockchain is a specific type of database.
- It differs from a typical database in the way it stores information. Blockchain stores data in blocks and then links them together.
- As new data is entered, it will enter a new block. Once the block is full of data, it is linked to the previous block so that the data is linked together in chronological order.
- Different types of information can be stored on the blockchain, but by far the most common use is as a ledger for transactions.
- The blockchain is used in a decentralized manner, so no one person or group can control it, but all users collectively retain control.
- The decentralized blockchain is immutable, which means that the input data is irreversible. This means that transactions will be permanently recorded and can be viewed by anyone.

# Advantages of Blockchain

## What are the Advantages to Blockchain?

- Cost
- Speed
- Data integrity compared with classical methods of proving ownership
- Potential savings has motivated investments by venture capitalists and by established players
- Recording ownership of a wide range of assets, from stocks and bonds to real estate, automobile titles, luxury handbags, and works of art
- Public records such as real estate titles, birth certificates, driver's licenses, and university degrees.

# Implications for Shareholders

**How does Blockchain benefit Shareholders?**

- Lower costs of trading
- More transparent ownership records
- Quicker, cheaper acquisitions of shares
- Less secrecy
- Liquidate more easily
- Corporate voting become more accurate

# Possible Emerging Market

**Three forces:**

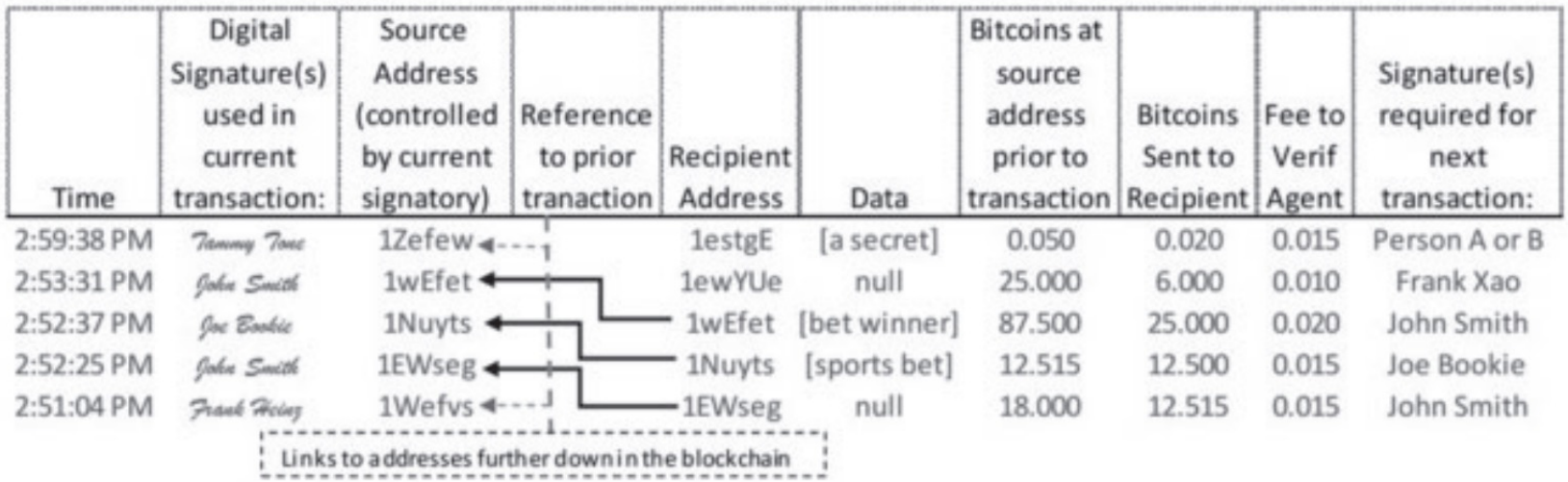
- Inadequacy of existing record-keeping systems
- Mistrust of corrupt and ineffective market regulators
- High penetration of information technology such as smartphones.

# Problems with Blockchain

**What are the possible problems with Blockchain?**

- Update code
- Update information in real time
- Technical reasons
- Vulnerable to sabotage
- Collective action problems
- Security reasons
- Concentrate operational risk

# Using Blockchain



| Time | Digital Signature(s) used in current transaction: | Source Address (controlled by current signatory) | Reference to prior tranaction | Recipient Address | Data | Bitcoins at source address prior to transaction | Bitcoins Sent to Recipient | Fee to Verif Agent | Signature(s) required for next transaction: |
|---|---|---|---|---|---|---|---|---|---|
| 2:59:38 PM | *Tammy Tone* | 1Zefew | | 1estgE | [a secret] | 0.050 | 0.020 | 0.015 | Person A or B |
| 2:53:31 PM | *John Smith* | 1wEfet | | 1ewYUe | null | 25.000 | 6.000 | 0.010 | Frank Xao |
| 2:52:37 PM | *Joe Bookie* | 1Nuyts | | 1wEfet | [bet winner] | 87.500 | 25.000 | 0.020 | John Smith |
| 2:52:25 PM | *John Smith* | 1EWseg | | 1Nuyts | [sports bet] | 12.515 | 12.500 | 0.015 | Joe Bookie |
| 2:51:04 PM | *Frank Heisy* | 1Wefvs | | 1EWseg | null | 18.000 | 12.515 | 0.015 | John Smith |

Links to addresses further down in the blockchain

**Figure 1.** Transaction data in the Bitcoin public ledger.
The figure shows the types of data included in Bitcoin transactions, including the source and recipient, the amount of currency conveyed, and the time. The Data field can be used to convey additional information and is useful for "colored coins" applications as discussed in the text. The Fee to Verification Agent is an optional fee that the source can set aside for the miner who includes the transaction in a block.
*Source*: SolidX Partners, Inc.
Reproduced with permission.

# Creating Blockchains

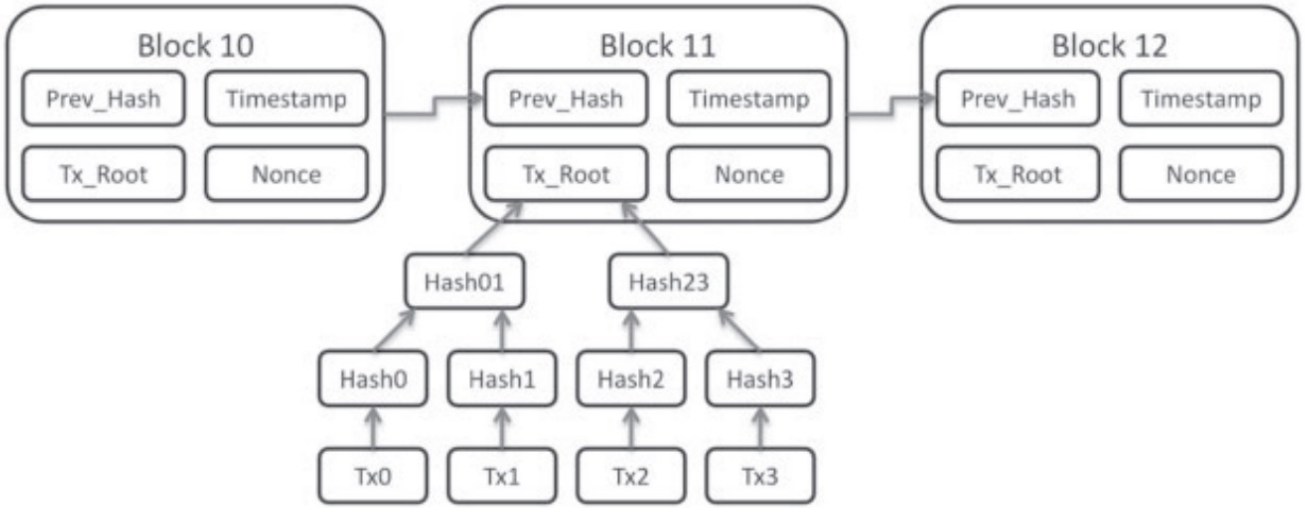



**Figure 2.** Structure of the bitcoin blockchain.
The figure shows the elements of each block on the Bitcoin blockchain, including transaction data, a timestamp, a nonce or random number related to the proof-of-work algorithm, and the hash of the header of the previous block. If any element of transaction data in a block is changed, the Tx_Root (or Merkle root) of the transaction data will change, causing the hash of the block header to change. Since the hash of the block header is included as an element in the header of the next block, the hash of the next block header will also change, as will the subsequent block headers, *ad infinitum*, thereby making fraud or theft easy to detect at the point at which it occurred.
Illustration: Matthäus Wander.

https://commons.wikimedia.org/wiki/File:Bitcoin_Block_Data.png.

# Proof of Work Methods

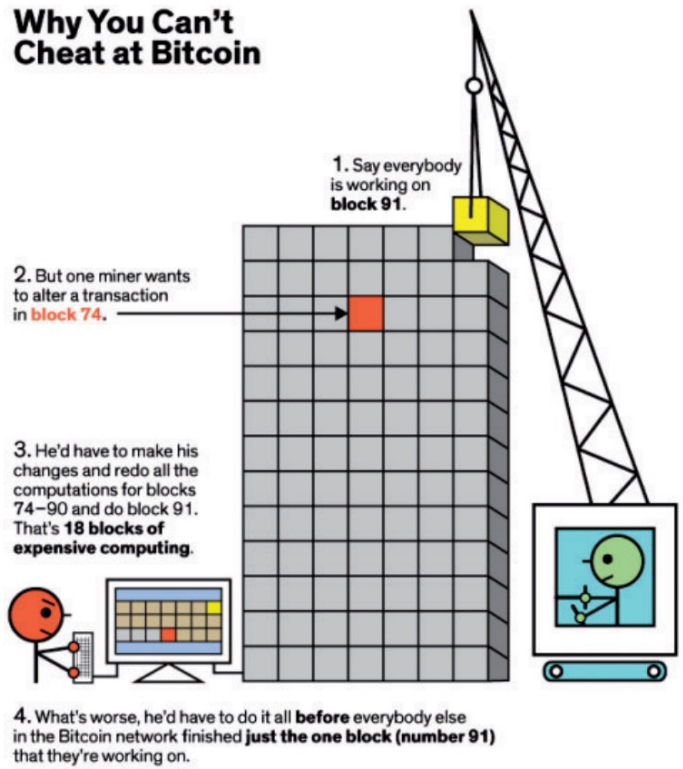



**Figure 3.** Integrity of data on a proof-of-work blockchain.
The figure illustrates how a proof-of-work scheme makes altering historical data in a blockchain prohibitively costly, since a potential thief or forger would have to alter not only the transaction record they wished to divert, but also all subsequent blocks up to the current one.
Illustration: Mark Montgomery © IEEE Spectrum.
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# Related Literature

**What is some Related Literature?**

- Bheemaiah, K. (2015) Why business schools need to teach about the blockchain. Unpublished manuscript, Grenoble Ecole de Management.
- Bohme, R., Christin, N., Edelman, B., and Moore, T. (2015) Bitcoin: economics, technology, and governance, Journal of Economic Perspectives 29, 213–238.
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# Impacts on Corporate Goverance

## Greater Transparency of Ownership

Allow all parties to participate freely

The records of each trading block are visible to all members

Beneficial to the transparency of corporate equity governance

## Improvements to Liquidity

- Reduce transaction cost
- Reduce costs and shorten the time required for executing and settling
- Offers the possibility of significant improvements in liquidity

## Impact on Institutional Investors and Activists

- Easy entry and exit for institutional investors
  - Cheaper and faster trade execution and settlement
- Possible disadvantages for institutional investors
  - Costly by activists and raiders

## Impact on Managers

- Investments will become easier to differentiate than ever before
- Reduce the effectiveness of equity-based management incentives
- Allow outsiders to observe managers' trades in real time
- Greater market awareness of when shares were pledges as collateral for loans
- Preclude managers' backdating of compensation instruments

# Impact on Market Microstructure

## Benefits of Blockchain

- Clear possible changes in market trading, price information, and the mix of information impounded into share prices
- The increased transparency of investors identities
- Informed selling easier to differentiate from noise and liquidity selling, leading to increased speed which adverse news s impounded into share prices.

## Transparency

- Increased transparency of a blockchain share registration system could permit market makers to observe investor ownership positions in transacting and other shares.
- Market makers inference on purpose of trades (information or liquidity shocks) could lead to more efficient prices and reduced risk premiums charged by market makers. Additionally, there would be improvements in allocative efficiencies of the economy through better decision making around capital allocation prices and volumes for all stakeholders.

## Incentives

- Outsider investors and analysts would have greater incentives to invest in acquiring information about the firm from increased transparency. This could rearrange the overall distribution of information in the economy and improve the outside monitoring of management.

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# Voting in Corporate Elections

## Blockchain & Voting

- Proposition for blockchain use in all forms of voting, a suitable replacement of an archaic corporate proxy voting system
- Current problems with the incumbent voting systems, incomplete distribution distribution of ballets, occasional chaotic vote would be addressed using **votecoins,** transmitting to addresses on the blockchain
- The advantages of blockchain could bring increased demand for participation in corporate governance and demand votes on more topics with increased frequency, however confidential voting would still be an issue

## Accuracy of Elections

- Increased speed and precision of vote tabulation, and equal real-time transparency of the likely voting outcome for both management and dissident shareholders. The opportunity to intervene to intervene with last minute campaign tactics and resolve ambiguities about outcomes of close elections

# Voting in Corporate Elections

## Empty Voting

- Occurs when investor uses borrowed shares or certain combinations of derivative securities to acquire voting rights temporarily, without economic exposure to the cash flow rights connected to the underlying shares.
- Secrecy driving accumulations on election day for investors who shouldn't have that many shares. Some empty voting schemes are not legal.
- Often labelled undemocratic, however argument persist for efficiency as voting rights are priced according to there marginal benefit to the highest-valued voter, and it provides an opportunity for minority shareholders to profit from selling or temporarily renting out their shares
- Blockchain would make empty voting more difficult given the transparency and early warning or the rearrangement of voting shares.

# Real Time Accounting

## Blockchain & Accounting

- Business could voluntarily post all of its ordinary business transactions on a public blockchain, occurring automatically if a cryptocurrency is used or by means of tokenization. All data recorded with a time stamp on a blockchain, unalterable ex-post.
- The entire ledger becomes visible to all stakeholders with statements formulated on a real-time basis.
- Shareholders would have increased trust in the integrity of the company's data, and auditing services would no longer be required. However, proprietary information would become available to the public.

## Accountants and Financial Intermediaries

- Only need to trust the certainty of the blockchain and impose their own accounting judgement to make their own non-cash adjustments such as depreciation and inventory revaluation
- The potential US savings equals the total revenue of the accounting industry ($50B p.a.), representing the social cost of third-party validation of the accuracy of company accounts, or more simply the social cost of mistrust of corporate managers.

# Real Time Accounting

## Accruals Earnings Management

- Accounting on the Blockchain would reduce opportunities for firms to engage in accounting gimmicks and value-destroying real actions to manipulate reported earnings.
- Backdating sales contracts to prior reporting periods or amortising operating expenses and pushing them into future periods would not be allowed.
- Custom accounting formats would make standardized reporting metrics redundant and security analysts would need to work harder to assess fair values of company stocks with more information.
- Management styles may change if accrual accounting practices are increasingly difficult, potentially receding the distortion of firm's investment policies.

## Related Party Transactions

- Real-time accounting on the Blockchain could allow observers instantly to spot suspicious asset transfers and other transactions implying conflicts of interest.
- Transparency in this areas would affect managerial incentives from a lack of ability to tunnel assets outside of the firm, real-time surveillance against fraudulent conveyances by managers of financially distressed firms, and increased costs for firms explaining large numbers.

# Smart Contracts

## Introduction to Smart Contracts

- A computerized protocol that executes the term of the contract, ensuring one party that the counterparty will fulfill their promises with certainty.
- Overcome moral hazard problems such as strategic default, and they can dramatically reduce costs of verification and identification
- Ethereum are designed to apply blockchain technology to execute smart contracts based on simple events.
- There are numerous corporate finance and governance application: the mechanical exercise of options embedded in derivative securities and other contingent claims; the instance transfer of collateral in the event of a default; and the payment of employee compensation if performance goals are achieved.
- Smart contracts are a promising devise for reducing agency costs.
- Although they don't have the direct impact on governance as blockchain, they can create significant long-term effects by deterring widely known agency costs of debt such as risk shifting or strategic defaults.
- This would create benefits such as reduced adverse selection in credit markets and a lower cost of debt market-wide.

# Governance of Blockchains

## Process in Private and Permissioned Blockchains

- Provisions for dispute resolution
- Sanctions for violating the agreed upon rules
- Procedures for enforcement of penalties

## Issues causing Governance Crisis

- 51% attack
  Other divide-and-conquer strategies

## Ethereum Classic

- Hackers transferred about $50 million worth of Ether from the DAO group
- Ether's sponsors, and 85% of miners, removed their blockchain from hacking by implementing a "hard fork"

## Implications on Governance with Blockchains

- Rewriting the history of transactions
- Introducing human intervention

# Conclusion

**Blockchain has many implications on Corporate Governance:**

- Greater Transparency of Ownership
- Improvements in Liquidity
- Impact on Institutional Investors and Activists
- Impact on Managers
- Impact on Market Microstructure
- Voting in Corporate Elections
- Real-Time Accounting
- Smart Contracts

# Questions

# The Consequences of Managerial Indiscretions: Sex, Lies & Firm Value

Group 12A: Connor McDowall, Yihua Lian, Xue Song , Honglin Tao

# Discussion Questions

Can anyone give an example of a company scandal affecting the value of a company?

| People/Company | Event | Time period and share price |
|---|---|---|
| **Elon Musk / Tesla** | Using cannabis during a live show | 06/08/2018-07/09/2018 |
| | | -229.00 |
| **Qiangdong Liu / JD** | Arrested on suspicion of sexual assault | 04/09/2018-10/09/2018 |
| | | -57.84 |
| **Leslie Moonves / Columbia Broadcasting System (CBS)** | Resigned due to sexual harassment | 10/09/2018 |
| | | -3.23 |
| **Brain Krzanich / Intel** | Resigned due to office romance | 21/06/2018-27/06/2018 |
| | | -266.50 |
| **Martin Sorrel / WPP plc** | Resignation due to misappropriation of public funds for prostitutes | 14/04/2018 |
| | | -4.83 |
| **Steve Wynn / Wynn** | Resignation due to sex scandal | 06/02/2018 |
| | | -10.00 |
| **Lee Jae-yong / Samsung** | Arrested on suspicion of bribery and misappropriation of public funds | 16/02/2017 |
| | | -51.00 |
| **Mark Hurd / HP** | Resignation due to a romantic relationship with a stakeholder | 06/08/2010 |
| | | -96.80 |

# Introduction

## Research questions:

1) Is there a financial market response that signals damage to the company's reputation following a personal indiscretion?
2) Are there consequences in the product markets to these reputational losses?
3) Do managerial indiscretions signal that accused executives are willing to abrogate contracts or act opportunistically
4) What are the labor market consequences to this behavior for the indiscretion managers or their monitors?

## Prior literature:

- Jones and Rubin, 2001;
- Karpoff et al., 2005;
- Murphy et al., 2009;
- Alexander, 1999;
- Cheung et al., 2012;
- Karpoff et al., 2015;

**Separate affairs hypothesis** →

They believe that personal indiscretions may be like environmental violations and do not affect the company's reputation

- Erhard and Jensen (2014
- Erhard et al. (2014)

**Integrated affairs hypothesis** →

They believe that argue that management's reputation for integrity is a factor of production. These personal indiscretions signal low integrity, their revelation can impact the firm

# Discussion Question

What do you think of a company when its executives have committed misdeeds against the law?

Do you think that the personal indiscretions of a company senior manager can affect the reputation of the company?

# Introduction

## The 4 potential channels

1) Personal managerial guarantees can be important to the formation of profitable business relationships

2) The managerial indiscretion could increase the probability that the manager will be replaced

3) The indiscretion could signal a shift in the firm's culture

4) The managerial indiscretion shows that managers are willing to sacrifice long-term relationships for short-term gains

# Hypotheses Development

## Separate affairs hypothesis:

- Personal managerial indiscretions have no bearing on firm value or performance.

Firm value is dependent largely on the skills and talents each executive brings to the firm instead of personal traits

Auditing standards list that personal misconduct is unrelated to the business activities of the entity

Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities

# Hypotheses Development

## Integrated affairs hypothesis

- Personal indiscretions are associated with losses in firm value, operating performance, and strategic partnerships or stakeholder relationships

The indiscretion can disrupt and distract the executive from optimal performance and create associated morale problems within the firm

The potential for personal misconduct to affect business value is due to the importance of reputation and trust in economic exchange

Personal misconduct reduces the trust of counterparty, contracts and controls become substitutes for trust and additional transaction costs

Personal misconduct can have a direct impact on the company's reputation

# Data: Indiscretion Categories

## Four categories of indiscretions:

1) Sexual misadventure:
   - Extramarital affairs, senior-subordinate inter-office romances, accusations of sexual harassment, etc.
2) Substance abuse:
   - Arrests for driving under the influence (DUI), illicit drug use, etc.
3) Violence:
   - Instances of domestic violence, sexual battery, rape, or assault
4) Dishonesty:
   - Falsifying credentials, perjury, and plagiarism

# Data: Examples of Managerial Indiscretions

**Table 1**
Examples of alleged managerial indiscretions.

| Executive | Company | Title | Notes | Media citation |
|---|---|---|---|---|
| Sexual misadventure: | | | | |
| Mark V. Hurd | Hewlett Packard Co. | Chairman, chief executive officer (CEO), and president | Dismissed for allegedly harassing Hewlett Packard contract employee and violations of the company's standards of business conduct. Hurd admits to not living up to "standards and principles of trust" upon termination. | "HP CEO Mark Hurd resigns amid sexual harassment probe," *Forbes.com* (8/6/2010) |
| Mossimo Giannulli | Mossimo Inc. | Chairman of the board | Accused of creating a "severe, pervasive, sexually hostile work environment" and of wrongful termination in retaliation for complaints. | "Former worker accuses Mossimo fashion executives of sexual harassment," *Knight Ridder Tribune Business News* (1/25/2000) |
| David C. Colby | Wellpoint Inc. | Executive vice president (EVP), chief financial officer (CFO), and vice chairman | Accused of orchestrating numerous, simultaneous affairs (at least one with a Wellpoint employee). An internal probe deemed the actions a violation of the company's code of conduct. | "WellPoint finds itself embroiled in private drama– ex-finance chief's web of multiple romances entangles health giant," *Wall Street Journal* (6/12/2007) |
| Substance abuse: | | | | |
| William D. Parker | US Airways Group Inc. | Chairman and CEO | Arrested for driving under the influence (DUI) while leaving the FBR Open golf tournament just hours after failed merger bid for Delta. | "US Airways CEO admits 2 prior DUI convictions: Parker says he was in his 20 s at time, makes apology," *McClatchy Tribune Business News* (2/10/2007) |
| Peter H. Coors | Molson Coors Brewing Co. | Chairman | Cited for DUI and failure to observe a traffic control device. | "Pete Coors is issued a charge of DUI," *Wall Street Journal* (7/14/2006) |
| Dale M. Gibbons | Zions Bancorporation | EVP and CFO | Arrested for charges of drug possession and child abuse. Salt Lake County Sheriff's office investigations revealed significant quantities of methamphetamine at his home and his 15-year old daughter intoxicated and comatose. | "CFO of parent company arrested," *Las Vegas Sun* (6/22/2001) |

# Data: Examples of Managerial Indiscretions

| | | | | |
|---|---|---|---|---|
| Violence: | | | | |
| Herbert H. Haft | Dart Group Corp. | Chairman and CEO | Wife alleges domestic violence and numerous affairs in divorce filing. | "Hafts take fight to divorce court; wife alleges physical, verbal, financial abuse in separation filing," *Washington Post* (08/11/1993) |
| Charles E. Johnson | Franklin Resources Inc. | President | Charged with misdemeanor domestic violence battery, felony false imprisonment, and misdemeanor child endangerment. Allegedly beat his wife in front of his children. | "Franklin Resources exec charged with beating wife in Hillsborough," *Associated Press Newswires* (10/2/2002) |
| Patrick J. Naughton | Infoseek Corp. | Executive vice president products | Attempted to solicit an undercover Federal Bureau of Investigation agent posing as a 13-year old girl. Infoseek was Disney's partner in the Go.com Internet portal at the time. | "Infoseek executive, due for Disney post, charged with luring minor on Internet," *Wall Street Journal* (9/20/1999) |
| Dishonesty: | | | | |
| Scott Thompson | Yahoo! Inc. | CEO, president, and director | Falsely claimed to possess a computer science degree from Stonehill College. Does hold an accounting degree. | "Yahoo cites 'Inadvertent Error' in CEO academic record," *Wall Street Journal* (5/4/2012) |
| James J. Minder | Smith & Wesson Holding Corp. | Chairman of board | Failed to disclose 15-year term in prison for armed robbery. | "Smith & Wesson chief quits over crime," *CNNMoney.com* (2/27/2004) |
| Kenneth E. Lonchar | Veritas Software Corp. | Executive vice president and CFO | Claimed unearned master of business administration degree from Stanford University. | "Veritas says books are clean, even if CFO's past muddled," *Dow Jones News Service* (10/3/2002) |

# Data: Sample Observation Frequency

## Analysis of the C-Suite:

- 437 potential indiscretion observations involving C-level executives
- We have a total of 325 unique executive-firm-year observations, which are summarized in the table

Panel A: Frequency of sample observations

| Category | Number of executives | Number of indiscretions and primary firm observations | Secondary firm observations | Total observations |
|---|---|---|---|---|
| In-sample single offenders with one role | 124 | 124 | 0 | 124 |
| In-sample single offenders with multiple roles | 54 | 54 | 87 | 141 |
| In-sample repeat offenders with one role | 10 | 24 | 0 | 24 |
| In-sample repeat offenders with multiple roles | 7 | 17 | 19 | 36 |
| Total | 195 | 219 | 106 | 325 |

# Data: Indiscretion-type and Source of Disclosure

Panel B: Frequency by indiscretion type

| | Executives | | Primary and secondary observations | |
|---|---|---|---|---|
| Type of indiscretion | Number | Percentage | Number | Percentage |
| Sexual misadventure | 92 | 47.2 | 153 | 47.1 |
| Substance abuse | 17 | 8.7 | 35 | 10.8 |
| Violence | 13 | 6.7 | 29 | 8.9 |
| Dishonesty | 73 | 37.4 | 108 | 33.2 |
| Total | 195 | 100.0 | 325 | 100.0 |

Panel C: Initial source of disclosure

| | Executives | | Primary and secondary observations | |
|---|---|---|---|---|
| Type of indiscretion | Number | Percentage | Number | Percentage |
| Company press release | 49 | 25.1 | 72 | 22.2 |
| Legal filing | 73 | 37.4 | 121 | 37.2 |
| Media report | 73 | 37.4 | 132 | 40.6 |
| Total | 195 | 100.0 | 325 | 100.0 |

# Data: Titles, Personal Characteristics & Direct Costs

**Table 2a**
(*continued*)

Panel D: Title held by executive

| | Executives | | Primary and secondary observations | |
|---|---|---|---|---|
| Executive role | Number | Percentage | Number | Percentage |
| Founding family executive | 45 | 23.1 | 62 | 19.1 |
| Director | 21 | 10.8 | 119 | 36.6 |
| CEO | 90 | 46.2 | 113 | 34.8 |
| Subordinate executive | 84 | 43.1 | 93 | 28.6 |
| Total | 195 | 100 | 325 | 100 |

Panel E: Personal characteristics for primary firm observations ($N = 219$)

| Characteristic | Sexual misadventure | Substance abuse | Violence | Dishonesty | Full sample |
|---|---|---|---|---|---|
| Age | 51.7 | 52 | 50.1 | 53.3 | 52.16 |
| Male | 97.10% | 95.00% | 100.00% | 95.10% | 96.30% |
| Repeat offender | 33.01% | 55.00% | 33.33% | 16.05% | 28.77% |
| Executive turnover | 33.98% | 20.00% | 53.33% | 38.27% | 35.62% |

Panel F: Direct costs resulting from managerial indiscretions

| Cost category | Number | Mean |
|---|---|---|
| Litigation expenses: | | |
| Corporate lawsuit | 325 | 22.77% |
| Material legal expenses | 325 | 15.38% |
| Corporate settlement | 325 | 14.77% |
| Legal fees or settlement disclosed | 325 | 10.46% |
| Legal expense amount | 34 | $2,247,610 |
| Opportunity costs: | | |
| Opportunity cost | 325 | 20.00% |
| Training or rehab | 65 | 18.46% |
| Suspension or out of work | 65 | 18.46% |
| Jail or court | 65 | 80.00% |
| Opportunity cost (in days) | 65 | 27.82 |
| Opportunity cost (amount) | 65 | $27,465 |
| Severance and mitigating compensation costs | | |
| Severance | 325 | 9.85% |
| Severance amount | 32 | $3,613,113 |
| Fired for cause | 325 | 6.77% |
| Forfeiture of pay | 325 | 4.92% |
| Forfeiture of pay amount | 16 | $8,072,126 |
| Total direct disruptive and reputation costs: | | |
| Disruption costs | 325 | $616,399 |
| Disruption costs to sales | 325 | 0.19% |
| Reputational costs | 325 | $109,295,830 |
| Reputational costs to sales | 325 | 6.28% |

# Data: Firm Characteristics

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

# Results: Logistic Regressions

## Indiscretion Logistic Regression:

- We report the results of logistic regressions using the 15,950 panel data observations.
- The dependent variable in Models 1–4 is a (0, 1) indicator of whether any indiscretion, a CEO indiscretion, or a non-CEO indiscretion occurs

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

# Results: CARs during Indiscretions (Event Studies)

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

# Results: Indiscretion-specific Regressions

| | (−1, +1) cumulative abnormal return (CAR) | | | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Model 1 | | Model 2 | | Model 3 | | Model 4 | | Model 5 | | Model 6 | | Model 7 | | Model 8 | | Model 9 | |
| Variable | Estimate | *p*-value | Estimate | *p*-value | Estimate | *p*-value | Estimate | *p*-value | Estimate | *p*-value | Estimate | *p*-value | Estimate | *p*-value | Estimate | *p*-value | Estimate | *p*-value |
| Intercept | −0.013 | .61 | −0.009 | .61 | −0.094 | .11 | −0.034 | .38 | −0.035 | .38 | 0.007 | .85 | −0.021 | .55 | -0.085 | .26 | −0.004 | .87 |
| CEO | −0.036 | .00 | −0.029 | .00 | −0.012 | .48 | −0.015 | .44 | −0.077 | .00 | -0.026 | .04 | −0.046 | .00 | −0.020 | .46 | −0.036 | .00 |
| Disruption costs | 0.002 | .76 | −4.946 | .02 | −0.016 | .69 | 8.787 | .16 | 0.368 | .62 | −1.913 | .00 | 0.004 | .58 | −8.930 | .00 | 0.001 | .90 |
| Sexual misadventure | −0.006 | .74 | | | | | | | | | 0.030 | .24 | −0.034 | .18 | −0.019 | .72 | −0.003 | .87 |
| Violence | −0.012 | .55 | | | | | | | | | 0.011 | .67 | −0.030 | .30 | −0.029 | .63 | −0.006 | .76 |
| Dishonesty | −0.039 | .03 | | | | | | | | | 0.004 | .86 | −0.064 | .01 | −0.056 | .30 | -0.035 | .06 |
| With subordinate | 0.000 | .00 | | | | | | | | | 0.003 | .87 | −0.006 | .74 | 0.009 | .78 | −0.001 | .91 |
| Turnover | −0.003 | .75 | 0.024 | .01 | 0.016 | .52 | 0.022 | .36 | −0.037 | .11 | −0.010 | .45 | 0.006 | .65 | 0.015 | .55 | −0.009 | .37 |
| Arrest | −0.019 | .16 | 0.003 | .89 | 0.012 | .48 | −0.018 | .40 | −0.054 | .10 | 0.014 | .43 | −0.043 | .03 | −0.082 | .02 | −0.009 | .53 |
| Repeat offender | 0.007 | .49 | 0.006 | .54 | 0.019 | .24 | −0.022 | .37 | 0.052 | .16 | 0.005 | .71 | 0.004 | .77 | 0.029 | .26 | 0.003 | .79 |
| Founding family exec | −0.002 | .87 | 0.007 | .59 | 0.025 | .26 | 0.002 | .95 | −0.032 | .41 | −0.019 | .27 | 0.024 | .16 | −0.016 | .64 | 0.006 | .65 |
| Confounding event | 0.023 | .03 | 0.034 | .00 | 0.021 | .25 | 0.059 | .01 | −0.005 | .85 | −0.004 | .78 | 0.046 | .00 | 0.007 | .79 | 0.021 | .07 |
| Poor monitoring index | −0.002 | .75 | 0.005 | .26 | 0.009 | .27 | 0.004 | .63 | −0.006 | .69 | −0.003 | .69 | 0.007 | .29 | 0.005 | .69 | 0.001 | .84 |
| Firm size | 0.004 | .08 | −0.001 | .78 | 0.006 | .19 | 0.000 | .94 | 0.007 | .21 | −0.001 | .85 | 0.004 | .17 | 0.011 | .05 | 0.001 | .57 |
| ROA | −0.025 | .04 | −0.020 | .21 | −0.088 | .56 | 0.105 | .01 | −0.040 | .10 | −0.024 | .18 | −0.011 | .52 | −0.058 | .00 | −0.019 | .14 |
| Tobin's *q* | 0.000 | .97 | 0.000 | .89 | 0.002 | .87 | 0.002 | .54 | 0.000 | .96 | −0.003 | .04 | 0.003 | .01 | 0.003 | .21 | 0.002 | .13 |
| Market-adjusted return | 0.011 | .25 | 0.001 | .91 | 0.030 | .16 | 0.027 | .18 | 0.020 | .42 | 0.024 | .06 | 0.003 | .82 | 0.013 | .61 | 0.013 | .16 |

| Sample | All indiscretions | | Sexual misadventure | | Substance abuse | | Violence | | Dishonesty | | Shady industry (noncompliance) | | Non-shady industry (noncompliance) | | Shady industry (BPI) | | Non-shady industry (BPI) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| *F*-statistic | 3.60 | .00 | 3.59 | .00 | 1.30 | .28 | 2.97 | .02 | 2.22 | .02 | 4.07 | .00 | 3.36 | .00 | 4.27 | .00 | 2.50 | .00 |
| $R^2$ | 0.1574 | | 0.2353 | | 0.4153 | | 0.6900 | | 0.2186 | | 0.3115 | | 0.2680 | | 0.3461 | | 0.1981 | |
| *N* | 325 | | 153 | | 35 | | 29 | | 108 | | 161 | | 164 | | 146 | | 179 | |

# Results: Customer and Joint Venture Acquisition

## Indiscretions may affect the ability to form new relationships:

- Counterparty response to managerial indiscretions
- Track whether indiscretion firm obtains a new major customer at least 10% of sales
- Pull the entirety of the SDC Joint Ventures database and match it to the sample

| | Model 1 Obtains a new major customer $(t+1)$ | | Model 2 Obtains a new major customer $(t+1)$ | | Model 3 Change in number of major customers $(t+1)$–$(t-1)$ | | Model 4 Initiate new joint venture $(t+1)$ | | Model 5 Initiate new joint venture $(t+1)$ | | Model 6 Change in number of active joint ventures $(t+1)$–$(t-1)$ | | Model 7 Change in total number of business venture partners $(t+1)$–$(t-1)$ | | Model 8 Change in total number of government venture partners $(t+1)$–$(t-1)$ | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Decrease the likelihood | | | | Negatively impact | | | | | | | | | | | |
| Variable | Estimate | *p*-value | Estimate | *p*-value | Estimate | *p*-value | Estimate | *p*-value | Estimate | *p*-value | Estimate | *p*-value | Estimate | *p*-value | Estimate | *p*-value |
| Intercept | −2.866 | .00 | −2.945 | .00 | 0.512 | .00 | −7.659 | .00 | −7.907 | 0.00 | −0.926 | 0.00 | −1.421 | 0.00 | −0.021 | 0.32 |
| CEO indiscretion | −1.368 | .06 | | | −0.285 | .01 | −1.553 | .03 | | | −0.222 | 0.02 | −0.367 | 0.01 | −0.016 | 0.22 |
| CEO reputation costs | | | −3.128 | .03 | | | | | −6.529 | 0.30 | | | | | | |
| CEO disruption costs | | | −0.262 | .42 | | | | | −1.692 | 0.32 | | | | | | |
| Customer base | 0.181 | .00 | 0.181 | .00 | −0.297 | .00 | 0.059 | .00 | 0.060 | 0.00 | 0.016 | 0.00 | 0.024 | 0.00 | 0.000 | 0.87 |
| Alliance experience | −0.001 | .71 | −0.001 | .70 | 0.000 | .84 | 0.030 | .00 | 0.030 | 0.00 | 0.026 | 0.00 | 0.038 | 0.00 | 0.003 | 0.00 |
| Technical intensity | 3.666 | .00 | 3.683 | .00 | 2.020 | .00 | 0.962 | .40 | 0.958 | 0.40 | 0.405 | 0.07 | 0.723 | 0.04 | 0.010 | 0.74 |
| Tobin's *q* | −0.035 | .13 | −0.035 | .13 | −0.021 | .02 | 0.026 | .39 | 0.027 | 0.37 | 0.019 | 0.09 | 0.034 | 0.09 | 0.003 | 0.09 |
| ROA | −0.238 | .24 | −0.231 | .25 | 0.090 | .41 | −0.765 | .01 | −0.756 | 0.01 | −0.205 | 0.00 | −0.356 | 0.00 | −0.024 | 0.01 |
| Firm size | −0.045 | .10 | −0.047 | .09 | −0.016 | .21 | 0.578 | .00 | 0.575 | 0.00 | 0.122 | 0.00 | 0.190 | 0.00 | 0.005 | 0.00 |
| Firm age | 0.000 | .96 | 0.000 | .94 | 0.000 | .66 | −0.004 | .10 | −0.004 | 0.10 | −0.001 | 0.03 | −0.001 | 0.25 | 0.000 | 0.89 |
| Family-managed firm | −0.001 | .99 | −0.003 | .97 | −0.010 | .75 | −0.044 | .64 | −0.050 | 0.59 | 0.030 | 0.14 | 0.058 | 0.06 | 0.003 | 0.18 |
| CAPX | 0.646 | .00 | 0.642 | .00 | −0.039 | .77 | 0.772 | .01 | 0.769 | 0.01 | 0.033 | 0.65 | 0.160 | 0.22 | 0.006 | 0.56 |
| Leverage | −0.510 | .00 | −0.506 | .00 | −0.079 | .41 | −0.344 | .16 | −0.327 | 0.18 | −0.200 | 0.00 | -0.339 | 0.00 | −0.026 | 0.00 |
| CEO ownership | 0.001 | .80 | 0.001 | .85 | 0.001 | .72 | −0.011 | .19 | −0.012 | 0.17 | 0.000 | 0.90 | 0.000 | 0.99 | 0.000 | 0.64 |
| Outside director ownership | −0.020 | .06 | −0.021 | .06 | −0.007 | .05 | 0.005 | .66 | 0.005 | 0.66 | 0.002 | 0.24 | 0.005 | 0.11 | 0.001 | 0.10 |
| Diversification | 0.005 | .76 | 0.005 | .77 | 0.004 | .65 | 0.073 | .00 | 0.073 | 0.00 | 0.017 | 0.00 | 0.017 | 0.06 | 0.000 | 1.00 |
| Poor monitoring index | −0.053 | .14 | −0.053 | .14 | −0.017 | .31 | 0.092 | .03 | 0.092 | 0.03 | 0.018 | 0.11 | 0.020 | 0.22 | 0.002 | 0.16 |
| Likelihood ratio/*F*-statistic | 684.85 | .00 | 681.50 | .00 | 31.99 | .00 | 2348.01 | .00 | 2343.77 | 0.00 | 26.24 | 0.00 | 23.49 | 0.00 | 4.04 | 0.00 |
| $R^2$ | 0.0882 | | 0.0387 | | 0.1706 | | 0.0476 | | 0.0135 | | 0.2682 | | 0.2627 | | 0.1140 | |
| *N* | 15,950 | | 15,950 | | 15,950 | | 15,950 | | 15,950 | | 15,950 | | 15,950 | | 15,950 | |

# Results: Operating Performance

## Managerial Indiscretions affect operating performance:

- Managerial indiscretions and firm operating performance
- Define operating return on assets as EBITDA to average total assets

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

Key independent variable of interest

# Results: Shareholder Class Action Lawsuits

## Managerial indiscretions cause shareholder class action lawsuits, and fraud

Panel A: Shareholder class action lawsuits

Estimate the propensity of a class period violation

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

# Results: Violation Period Fraud

Panel B: Fraud

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

# Results: Earnings Management

Suggest pervasive earnings management at firms in which a member of the top management team commits a personal indiscretion

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

# Conclusions: Personal Integrity, Valuation and Operations

**Personal integrity of executives plays an important role**

1) Investigated both the separate affairs and integrated affair hypotheses with managerial indiscretions and their affects on firm value under either hypothesis.
2) The examination of wealth effects associated with CEO indiscretion announcements finds, on average, a 4.1% loss in shareholder value. Additionally, operating performance suffer abnormal decline in the same fiscal year.
3) The decomposition of total costs into direct and reputational costs to investigate losses from low integrity through the lenses of counter party relationships. Analysis indicates significant reductions in counter party relationships. CEO indiscretions are associated with losses in new major customers and joint venture partners. Customer losses are severe for those indiscretions that damage the firm's reputation the most.
4) Firms in industries with above median amounts of enforcement actions and noncompliance reports are associated with smaller reactions to announced indiscretions.
5) Observable signals of poor performance provide 'canary in a coal mine' in regard to future malfeasance. Firms with executives more likely to engage in wrongdoing targeted by shareholder class action lawsuits and DOJ and SEC fraud investigations.
6) CEO turnover increases dramatically in the wake of an indiscretion and compensation declines for CEO's who are retained.
7) Board members are held accountable for indiscretions, receiving less votes.

# Strengths & Weaknesses

## Strengths

- Published in a top journal (The Journal of Financial Economics) contributing to the credibility of findings
- Extensive use of credible databases to inform indiscretions (News: Factiva, LexisNexis & ProQuest. Legal Information: SEC Filings, 10-K,10-Q Filings, Factiva, LexisNexus, Google, US Courts PACER. Financial/Company Information: Centre for Research on Security Prices (CSRP), Compustat, ExecuComp, RiskMetrics)
- Proven event study methods from prior research
- Panelling of data to address endogeneity
- Regression control for industry and fixed effects to control for endogeneity with pvalues calculated
- Wealth effects very statistically significant (1% Level)
- All analysis based of previous research/published literature (70+ References)

## Weaknesses

- Does not control for geography effects
- Doe not incorporate corruption indices (jurisdiction dependant)
- No confidence intervals provided for co-efficient values

# Future Research

There are several avenues for further research:

1) Investigate the effects of managerial indiscretions on Private Market (Valuation Stages)
2) Explore managerial indiscretions in professional services firms
3) Analyse the affects corruption on managerial indiscretions
4) Investigate the impact legal origin has on both legal repercussions and managerial indiscretions.

# Implications: Code of Ethics

# Implications: Russell McVeagh

# Implications: ExxonMobil, Activist Hedge Funds, Proxy Fights

# Implications: Blockchain and Managerial Indiscretions