

Contents lists available at [ScienceDirect](http://www.sciencedirect.com)

Journal of Accounting and Economics

journal homepage: www.elsevier.com/locate/jaeLabor unemployment insurance and earnings management[☆]Yiwei Dou^a, Mozaffar Khan^{b,c,*}, Youli Zou^d^a New York University, Stern School, USA^b Harvard University, Soldiers Field, Boston, MA 02163, USA^c University of Minnesota, USA^d The George Washington University, GW School of Business, USA

ARTICLE INFO

Article history:

Received 10 June 2014

Received in revised form

1 June 2015

Accepted 4 June 2015

Available online 12 June 2015

Keywords:

Earnings management

Unemployment risk

Rank and file employees

Labor unemployment insurance

JEL classifications:

M41

J01

ABSTRACT

We provide new evidence that firms appear to manage long-run earnings upward in order to manage rank and file employees' perceptions of employment security. In particular, we exploit exogenous state-level changes in unemployment insurance benefits and test for partial unwinding of prior upward earnings management when benefits increase. Consistent with the hypothesis, we find a significant reduction in abnormal accruals, increased recognition of special items and write downs, and greater likelihood of net income-reducing restatements, following an increase in state-level unemployment benefits. A number of cross-sectional results are also consistent with the hypothesis.

© 2015 Elsevier B.V. All rights reserved.

1. Introduction

Understanding the forces that shape financial reporting outcomes is an important goal in accounting research. A large prior literature provides evidence on how financial reporting choices are affected by explicit and implicit contracts. Explicit debt contracts with firms' creditors (Watts and Zimmerman, 1986; DeFond and Jiambalvo, 1994; Dichev and Skinner, 2002), and compensation contracts with firms' executives (Healy, 1985), have been shown to influence financial reporting choices. Implicit contracts with equity investors as reflected in these investors' expectations have also been shown to influence financial reporting choices (Graham et al., 2005; Badertscher et al., 2012). Relatively less attention has been devoted however to understanding the potential influence of implicit contracts between firms and rank and file employees.

Firms sell employees a package of explicit and implicit claims, with explicit claims expressed through explicit employment contracts and implicit claims expressed through promises about long-run working conditions and employment and advancement opportunities (Cornell and Shapiro, 1987). The value of the ongoing implicit claims depends on employee expectations about the firm's future financial conditions (Bowen et al., 1995). Firms have an incentive to maximize the value of the package of explicit and implicit claims they offer by maximizing employees' perceived value of the ongoing implicit claims, and this incentive is a potentially important determinant of corporate financial and reporting policies

[☆] We acknowledge helpful comments from Qiang Cheng (discussant), Sok-Hyon Kang and seminar participants at the 2015 AAA FARS meeting, Chinese University of Hong Kong, the 2014 Washington Accounting Research Symposium, NYU, and the University of Minnesota.

* Corresponding author at: Harvard University, Soldiers Field, Boston, MA 02163, USA. Tel.: +1 617 496 1734.

E-mail addresses: ydou@stern.nyu.edu (Y. Dou), mkhan@hbs.edu (M. Khan), yzou@email.gwu.edu (Y. Zou).

(Bowen et al., 1995; Agrawal and Matsa, 2013). In this paper we provide new evidence on whether and how financial reporting choices are affected by the implicit claims of rank and file employees.

The prior literature has suggested two ways in which rank and file employees can potentially affect financial reporting. The first is in the context of union negotiations. The hypothesis posited in the literature is that firms are expected to manage earnings *downwards* in the *short-run* during union negotiations in order to justify resistance to union calls for enhanced pay and benefits. This hypothesis predicts firm behavior when shareholder–employee conflicts of interest are pronounced and employees are unionized, and empirical tests of the hypothesis appear to yield mixed results (Liberty and Zimmerman, 1986; DeAngelo and DeAngelo, 1991; D'Souza et al., 2001; Comprix and Muller 2011; Bova et al., 2015).

The second hypothesis posited in the literature, which is the focus of this paper, is that firms are expected to make *long-run earnings-increasing* choices in order to project financial security, as this reduces the cost of employee hiring and retention in competitive labor markets. The hypothesis is predicted to hold more generally when shareholder–employee conflicts of interest are not salient, and the hypothesis is not conditioned on the presence of labor unions. This idea is advanced in a number of papers in the accounting literature. Bowen et al. (1995), Burgstahler and Dichev (1997), Matsumoto (2002), and Cheng and Warfield (2005), among others, argue that firms manage their financial statements to make them appear rosier in order to improve their implicit terms of trade with various stakeholders including employees, and Graham et al. (2005) report consistent evidence from a survey of CFOs.

As in the prior literature, by long-run earnings-increasing choices (or “long-run earnings management”) we mean management of cumulative earnings over an extended period that results in a sustained wedge between ‘true’ and reported cumulative earnings. Cumulative earnings can potentially be managed through a combination of long-run income increasing choices such as depreciation, inventory, and bad debt recognition policies, and short-run accrual and real-earnings-management choices when the wedge is in jeopardy. In particular, the upward management of cumulative earnings does not require upward earnings management in every single reporting period, which makes it relatively more challenging to detect empirically. Bowen et al. (1995) provide one test of the long-run-earnings management hypothesis by examining whether firms with high labor intensity are more likely to adopt long-run income-increasing accounting policies, and find supportive results. In this paper we adopt a potentially more powerful approach by testing for changes in earnings management around an exogenous shock to employees’ cost of unemployment.

A large labor economics literature documents that employees bear substantial costs of involuntary unemployment (e.g., Gibbons and Katz, 1991; Gruber, 1997). Employees therefore care about the financial security of their employer (Brown and Matsa, 2013), and one way they assess this is through their employer’s earnings performance (e.g., Burgstahler and Dichev, 1997; Matsumoto, 2002; Cheng and Warfield, 2005; Graham et al., 2005). Firms bear at least two costs of exposing workers to unemployment risk. First, firms bear *ex ante* costs of compensating employees for the level of employment risk that exists at the initiation of employment. These “compensating differentials” are substantial and can take the form of higher wages and benefits, and better working conditions (Smith, 1976; Abowd and Ashenfelter, 1981; Topel, 1984; Hamermesh and Wolfe, 1990). The economic significance of compensating wage differentials is suggested by empirical estimates that it is up to 14% of wages (Abowd and Ashenfelter, 1981), and that up to 41% of interindustry variation in wages is explained by unemployment risk (Li, 1986; Hamermesh and Wolfe, 1990). Second, firms bear substantial turnover costs as employees seek more stable employment, and heightened search costs as potential employees shy away (Brown and Matsa, 2013), if there are significant increases in unemployment risk.

We expect firms try to mitigate these costs by managing long-run earnings in order to manage employee perceptions of unemployment risk. This implies firms’ long-run-earnings management incentives *change* when employees’ unemployment risk *changes*. Employees’ unemployment risk (and the firm’s cost of exposing employees to unemployment risk) is increasing in (i) the unemployment probability, (ii) employee risk aversion, and (iii) costs borne by workers during unemployment (Agrawal and Matsa, 2013). Our research design exploits exogenous shocks to employees’ unemployment risk through a decrease in the costs borne by workers during unemployment. This follows Agrawal and Matsa (2013) who show that the same exogenous shock affects firms’ financial policies through increased leverage.

State-level unemployment insurance (UI) programs are intended to lower employees’ unemployment costs by providing temporary income when they are involuntarily unemployed and actively seeking new employment, and UI has been shown to have economically significant effects on employee behavior and aggregate labor supply (Topel, 1984; Meyer, 1990, 1995). An increase in UI benefits decreases employees’ cost of separation from, and likely therefore their dependence on, their employers. When employees are better insured against unemployment we expect they are relatively less sensitive to their employers’ financial performance. This observation forms the basis for the empirical tests: for firms in a given U.S. state, we examine discretionary earnings decreases around large state-level increases in UI benefits as these state-level changes are relatively exogenous to the firm.

One way to view this is that cumulative or long-run earnings management results in a ‘bloated’ balance sheet. Managers likely look for opportune moments to partially clean up the bloat, and as long as one determinant of this bloat is managing employee perceptions of unemployment risk, we expect a reduction in bloat (or *partial unwinding* of prior upward earnings management) when there is a reduction in unemployment risk. As such, we are effectively testing *changes* in balance sheet bloat, rather than *levels* of bloat in the cross-section, which allows a relatively more powerful test of the hypothesis.

The empirical tests employ a difference-in-differences design by examining earnings management measures before versus after an exogenous increase in UI benefits, for treatment firms versus control firms. The treatment firms are those headquartered in states with a large increase ($> 10\%$) in maximum UI benefits, while control firms are those headquartered

Download English Version:

<https://daneshyari.com/en/article/5086563>

Download Persian Version:

<https://daneshyari.com/article/5086563>

[Daneshyari.com](https://daneshyari.com)