Operating Flexibility and Earnings Manipulation

Thomas Bourveau*

HEC Paris

January 24, 2015

Abstract

I examine the relationship between operating flexibility and firms' accounting quality. I use the staggered adoption of wrongful discharge laws across U.S. states as a plausibly exogenous increase in firms' dismissal costs. These laws protect employees against unfair dismissals, increasing the rigidity of firms' cost structure. I hypothesize that when regulation makes it more costly to cut labor costs, managers manipulate accruals in lieu of terminating employees in order to increase reported income. I find that regulated firms engage in more income-increasing accrual manipulation than their unregulated peers in response to decreases in demand following the adoption of these laws. This result is strongest for sub-samples of firms that experience larger increases in expected firing costs and for firms with enough flexibility left to engage in more accrual manipulation. My findings shed light on the unintended consequences of pro-labor regulations and contribute to the emerging literature on how firms' cost structures shape reporting incentives.

Keywords: Earnings Management, Cost Behavior, Labor Adjustment Cost, Labor Regulation

*HEC Paris, 1 rue de la Libération, 78351 Jouy-en-Josas France. *Contact*: thomas.bourveau@hec.edu

I am indebted to François Brochet, Vedran Capkun (Chair), Gilles Hilary and Greg Miller for their guidance throughout this project. I also thank Pat Akey, Walid Alissa, Romain Boulland, Jason Chen, Hans Christensen, Ted Christensen, Bart Dierynck, Ulrich Hege, Itay Kama, Han Kim, Roby Lehavy, Yun Lou, Adrien Matray, Venky Nagar, Delphine Samuels, Jordan Schoenfeld, Boris Vallée and Stefan Zeume as well as audiences at the University of Michigan, HEC Paris, INSEAD, the 2015 AAA MAS Meeting and the University of Miami for their insightful comments and suggestions. I acknowledge support from the HEC Paris Foundation and the French Ministry of Research. This project was initiated while I was visiting the University of Michigan. Any remaining errors are mine.

1 Introduction

This study focuses on labor adjustment costs as a component of firms' operating flexibility, and their impact on firms' financial reporting quality. There is an extensive literature linking accounting quality to investment decisions.[1] However, the role of frictions in the labor market has received little attention from accounting scholars despite the significant cost of labor.[2]

The economics literature has recognized that the cost of establishing or severing an employment relationship is comparable to the cost of frictions in the physical capital market (Oi, 1962; Dixit, 1997). Dismissal costs arise from job security regulations that impose substantial constraints on firms by making it more difficult and costlier to discharge employees. From a cost accounting perspective, dismissal costs increase the rigidity of a firm's cost structure.[3]

Prior empirical research suggests that poor corporate performance has a significant impact on executives' careers. For example, executives who fall short of targets can miss out on bonuses and even face termination (Warner et al., 1988; Murphy and Zimmerman, 1993). Therefore, in economic slowdown, when a firm's economic performance decreases, managers have greater incentives to engage in actions to meet or beat profitability targets (Degeorge et al., 1999). Managers can improve reported earnings through real actions such as cost cutting, upward accrual manipulation, or both (Zang, 2012). More specifically, one of the levers they can use to achieve greater short-term profitability is to save on wages by firing employees that became unproductive due to the decline in demand, as labor represents a major cost item. Thus, I hypothesize that when regulation makes it more costly to cut labor costs, it induces managers to rely more intensively on income-increasing accrual manipulation.

[1] See for example Biddle and Hilary (2006), Biddle et al. (2009), Beatty et al. (2010a), Beatty et al. (2010b), Chen et al. (2011) and Balakrishnan et al. (2014).

[2] Labor expenses range from 18% to 52% of total operating expenses across industries. In comparison, capital expenditures represent, on average, 8% of total assets and 5% of total operating expenses for U.S. listed companies.

[3] In this paper, the term *rigidity* refers to a firm's general ability to adjust the inputs of its production function, while in other recent studies it is defined as the mix of fixed and variable costs (Banker et al., 2014).

However, causality is difficult to discern. One concern is that firms' operating flexibility and reporting choices are simultaneously determined by managers' incentives to reach financial thresholds. Indeed, recent studies argue that managers deliberately lessen the rigidity in firms' cost structure to reach financial targets (Dierynck et al., 2012; Kama and Weiss, 2013). Thus, to establish causality, I use a difference-in-differences research design and exploit the adoption of wrongful discharge laws at the state level in the U.S. as a plausible source of exogenous variation in firing costs. A key advantage of this approach is that it requires only a specification of a reduced-form model of the equilibrium level of operating flexibility, along with a conjecture about how this equilibrium level changes in the context of an exogenous shock (Angrist and Krueger, 2001). In this difference-in-differences design, I use both the same firm over time and similar firms in different states at the same time as the control group to mitigate concerns that my findings are influenced by time trends or unobservable differences across firms (Bertrand et al., 2004).

Wrongful discharge laws were passed between 1959 and 1998 and constitute exceptions to the traditional fire-at-will doctrine that otherwise prevails in the United States. Wrongful discharge laws, and especially the good-faith exception in its broadest sense, protect employees from termination for any reason other than a *just* cause. These laws increase managers' uncertainty about the legal outcome of the dismissals. They generated a flood of lawsuits that raised the expected legal and settlement fees associated with the termination of workers. For instance, Dertouzos et al. (1988) find that discharge lawsuits are commonly filed in Californian state courts and that jury awards can cost firms hundreds of thousands of dollars per worker. In a more recent study, Boxold (2008) reaches similar conclusions. Overall, these laws have been used as a plausible source of exogenous decrease in operating flexibility to study firms' response in terms of capital structure (Serfling, 2014) and corporate investments (Fairhurst and Serfling, 2014).

I use annual decline in sales as a measure of economic slowdown. Assume that fixed costs and the ratio of variable costs to sales are similar in the current and immediate past year. Then, when sales decrease, firms experience an earnings shortfall that is likely to place them further away from their financial targets.[4] In line with my prediction, I find that firms experiencing a temporary decline in demand engage in more intensive income-increasing accrual manipulation after the adoption of the good-faith exception relative to a control group of firms headquartered in unregulated states.[5]

To better explore the economic mechanisms behind my results, I perform two cross-sectional tests. First, I find that the change in accrual manipulation after the adoption of the good-faith exception is concentrated among relatively low-unionized firms. This is consistent with studies in economics arguing that wrongful discharge laws do not pertain to employees already covered by collective agreements (Miles, 2000). Next, I conjecture that firms' reaction to the change in labor laws is conditioned by their ability to engage in more accrual manipulation. Indeed, using a measure of balance sheet constraints as in Barton and Simko (2002), I find that the change in accrual manipulation is more pronounced for firms with more initial accounting flexibility.

Furthermore, I perform an endogeneity test and I fail to find that the change in accrual manipulation by firms in adopting states was anticipated nor that the amount of discretionary accruals when firms experience an economic slowdown was trending. These tests suggest that the assumptions required to use a difference-in-differences research design are not violated. Finally, I perform several robustness tests to ensure the validity of my results. I do not find that my results are solely driven by observations in California that is the largest adopting state. Besides, I also find that, as expected, firms in industries whose workforce is likely dispersed across the entire country do not react to the change in labor laws as they are marginally only affected compared to other firms.

[4]Under similar assumptions, Beneish et al. (2014) find that sales decreases lead to a median earnings shortfall that represents 4.9% of firms' total assets.

[5]I estimate several variations of the Jones (1991) model and use discretionary accruals to capture discretion afforded within U.S. GAAP.

The central contribution of this paper is to provide empirical evidence that the lack of operating flexibility in the form of labor adjustment costs impacts a firm's reporting choices. Broadly, my findings contribute to the vast literature examining the determinants of earnings management (Dechow et al., 2010). In particular, my paper is related to the growing body of literature that investigates how labor characteristics affect firms' information environment (DeAngelo and DeAngelo, 1991; D'Souza et al., 2000; Hilary, 2006; Matsa, 2010; Bova, 2013; Bova et al., 2013; Dou et al., 2014; Aobdia and Cheng, 2014). These papers focus mostly on managers' choices to reduce employees' bargaining power and ultimately limit the risk of rent extraction, which is increasing with firm profits (Blanchflower et al., 1996; Card, 1996). I depart from this literature and document that firing costs shape reporting incentives when corporate performance is relatively poor. Besides, my results contribute to the growing literature that lies at the intersection of cost and financial accounting (See Banker and Byzalov (2015) for a review).

Overall, my results also suggest that regulations governing dismissal costs cause managers to opt for more aggressive reporting choices. Thus, I contribute to the literature on regulations and accounting by providing evidence of an unintended consequence of a change in labor regulation on firms' reporting quality (Leuz, 2010).

Finally, my results contribute to the economics and finance literature relating dismissal costs to various corporate outcomes including labor volatility Autor et al. (2007), innovation (Acharya et al., 2013, 2014), capital structure (Kuzmina, 2013; Serfling, 2014; Schmalz, 2013; Simintzi et al., 2014), restructuring decisions (Atanassov and Kim, 2009), investment (Fairhurst and Serfling, 2014) and cost of equity capital (Chen et al., 2011).

The rest of the paper is organized as follows. Section II states my main hypothesis and introduces the institutional background. Section III describes the research design and the sample. Section IV presents the results, and Section V concludes.

2 Hypothesis Development and Legal Background

2.1 Hypothesis Development

Under the theoretical framework by Fudenberg and Tirole (1995), managers engage in income smoothing. That is, they take actions that decrease reported income when income is relatively high because investors put more weight on recent past performance in assessing managers' current performance. Besides, such behavior is likely to help managers maintaining earnings growth in order to maximize their compensation (Healy, 1985). Managers also take actions that increase reported income when income is low relative to investors' expectations to avoid immediate turnover. Indeed, prior research documents that poor corporate performance has a significant impact on executive turnover (Warner et al., 1988; Murphy and Zimmerman, 1993).

In this paper, I make three assumptions. First, I assume that each year firms operate either in a good state or a bad state of the world, which correspond to temporary business fluctuations. Second, I assume that managers privately observe the true economic performance of the firm and that they subsequentely choose the amount of reported earnings, that may or not be distorted. Finally, I consider that investors are not able to fully see through earnings manipulation.

When managers observe that their firm's economic performance is likely to fall below investors' expectations, they can try to boost reported earnings through real actions such as cost cutting, upward accrual manipulation, or both (Zang, 2012). It is not clear *ex ante* which solution is preferable as both actions carry different costs and benefits that vary with firms' characteristics, managers' preferences and the legal environment. Overall, prior theoretical and empirical studies document that firms trade off the costs and benefits of both options (Ewert and Wagenhofer, 2005; Cohen et al., 2008; Cohen and Zarowin, 2010; Zang, 2012).

One of the lever that managers can use to increase reported earnings is to terminate employees that are unproductive due to the decline in demand.[6] However, terminations of employees usually impose adjustment costs to firms, such as severance fees, and legal fees and settlements associated with lawsuits arising from violations of labor laws. When firing costs increase, it makes it more costly for firms to terminate employees in order to save on wages.

In a standard competitive model of the labor market, employment protection through the form of dismissal costs correspond to mandatory benefits that can be undone by Coasean bargaining such that employment levels are unchanged while wages fall to cover exactly the cost of the benefit (Lazear, 1990). However, when firing costs cannot be undone by Coasean bargaining, it creates a deadweight loss for the firm that functions as a tax on separations. Specifically, if the payment of the dismissal benefit incurs a deadweight loss, firms will find it optimal to retain unproductive workers in the short-run as long as the present value of their productivity shortfall is smaller than the additional adjustment cost. As a result, larger adjustment costs lead to reduced employment volatility when firms experience economic fluctuations (Autor et al., 2007).

As firing costs increase, it makes it more costly for firms to terminate some of their unproductive employees to save on wages when demand declines. Consequently, managers have to rely on other levers to increase reported earnings, such as accrual manipulation.[7] Thus, I predict that managers will rely more intensively on accounting discretion when firing costs are larger. In other words, an increase in the rigidity of a firm's cost structure should cause managers to opt for more income-increasing accounting manipulation.

[6]This assumes that labor regulation imposes a downward rigidity on wages that prevents wages to completely adjust to employees' productivity as in a standard competitive labor market.

[7]Accrual manipulation encompasses a range of accounting choices, such as delaying inventory write-offs, not recognizing payables in a timely or under-estimating the allowance for doubtful accounts.

2.2 Institutional Framework

It is empirically challenging to test my hypothesis that a lack of operating flexibility increases managers' propensity to rely more on accrual manipulation when economic performance decreases. I could estimate the relationship between several measures of operating flexibility and accrual manipulation and then rely on cross-sectional variations to test my hypothesis. A major drawback of this approach is that it does not account for the endogenous relationship between operating flexibility and accounting manipulation. One concern is that managers simultaneously engage in accrual manipulation while altering firms' cost structure in response to incentives to reach some level of profitability. Indeed, recent studies suggest that managers deliberately lessen the rigidity in firms' cost structure depending on such incentives (Dierynck et al., 2012; Kama and Weiss, 2013).

To overcome this challenge, I rely on the staggered adoption of state wrongful discharge laws in the United States over three decades, which unexpectedly decreased firms' operating flexibility. A key advantage of this approach is that it requires only a specification of a reduced-form model of the equilibrium level of operating flexibility, along with a conjecture about how this equilibrium level changes in the context of the exogenous shock (Angrist and Krueger, 2001).

Since the 19^{th} century, the original common law rule for dismissal of employees is the fire-at-will doctrine. Under this type of contractual relationship, an employee can be dismissed by an employer for any reason and without warning. However, since the 1970s, state courts have ruled in favor of so-called wrongful discharge laws that specify exceptions to the common law fire-at-will doctrine. There are three main exceptions: public-policy, implied-contract and good-faith.[8]

[8]While it is beyond the scope of this paper to provide an extensive analysis of wrongful discharge laws, the reader can refer to Miles (2000), Autor (2003), Kugler and Saint-Paul (2004), Autor et al. (2006) and MacLeod and Nakavachara (2007) for thorough reviews of the legal content and consequences of these rulings.

The public-policy exception was first recognized by the California Supreme Court in 1959. By 1999, forty-three states had adopted this widespread exception. It prevents termination for reasons that violate a given state's public policy, such as refusing to break the law upon the request of the employer. Autor et al. (2007) argue that courts recognize only certain violations of legal policies, thus limiting the constraints on employers and ultimately the scope of this exception.

The implied-contract exception prevents workers' termination in cases of an implicit employment agreement between an employer and an employee. For instance, the implied-contract exception considers unwritten promises or the existence of an internal personnel policy handbook to assess the existence of an implicit contract. This exception has been extended to industry practices and the employee's tenure or promotion history within a company. By 1999, forty-one states had recognized this exception. However, legal scholars also argue that this exception is not particularly binding, as firms can include disclaimers in their handbook to preserve the use of the employment-at-will doctrine (Autor et al., 2007; Miles, 2000).

The good-faith exception was adopted by thirteen states between 1974 and 1999. It represents the most significant departure from the fire-at-will doctrine. It was first recognized to prohibit terminations made in bad faith. The case of *Fortune v. National Cash Register Co.* in the state of Massachusetts in 1977 constitues an example in which a firm wrongfully terminated a salesman right before the payment of a substantial commission. However the jurisprudence evolved such that ultimately the scope of the exception is large, as it can be interpreted as preventing any termination without just cause (Kugler and Saint-Paul, 2004).

The adoption of the good-faith exception constitutes a well-suited natural experiment to investigate my research question for several reasons. First, as noted by Acharya et al. (2014), the good-faith exception is the most influential of the three exceptions. Second, as mentioned in the previous section, economic theory predicts that labor adjustment costs affect hiring and firing

decisions, such that firms retain unproductive employees in bad times and require a higher productivity to hire in good times (Blanchard and Portugal, 2001). Empirically, Autor et al. (2007) document that the adoption of the good-faith exception leads to a reduction in annual employment fluctuations in adopting states. This validates the use of the good-faith exception as a change in firms' operating flexibility. Third, the precedent-setting court rulings were unexpected while exhibiting variation in the timing of their implementation, which allows a powerful identification strategy (Bertrand et al., 2004). In addition, the application of tort law imposes strong litigation risk on firms that do not comply with this exception, so violations can result in a large amount of damages. Indeed, Dertouzos et al. (1988) examine the outcome of legal actions filed under the good-faith exception in the state of California between 1980 and 1986. They find that plaintiffs (i.e., the employee) won in 68% of cases, with an average individual settlement amount of $0.656 million. Recent studies document that lawsuits related to wrongful discharge laws have sharply increased over the last decades (Boxold, 2008), leading 46% of surveyed listed companies to express concerns regarding financial losses arising from such legal actions.[9] More generally, Autor et al. (2007) note that the adoption of the good-faith exception generated a flood of litigation in adopting states and increased the uncertainty and expected costs of discharging workers.

Interestingly, the state of Montana enacted the Montana Wrongful Discharge Act four years after a court ruled in favor of the good-faith exception. This Act consider that business needs, such as economic slowdown are part of the definition of a "good cause". However, Corbett (2005) documents that discharges under business reasons can be challenged in courts under the good-faith argument in two ways. Plaintiffs can deny the occurence of a economic slowdoan that has to be proven in court. In addition, former employees can argue that the economic motives constitute a pretext to terminations based on discriminatory reasons, which ultimately raises adjustment costs.

[9]This point is mentioned by Serfling (2014), who refers to the Chubb 2012 Public Company Risk Survey, entitled "U.S. Public Companies' Perceptions of Risk, and Their Risk Mitigation Strategies."

3 Identification Strategy and Sample Selection

3.1 Empirical Specification

I use the passage of wrongful discharge laws as a source of exogenous variation in dismissal costs to identify the impact of operating rigidity on firms' reporting quality. I estimate the following model:

$$DA_{ijt} = \beta_0 + \beta_1 Post\ GF_{jt} + \beta_2 Demand\ Shock_{ijt} + \beta_3 Post\ GF_{jt}\ X\ Demand\ Shock_{ijt} + \quad (1)$$
$$\beta_4 Post\ PP_{jt} + \beta_5 Post\ IC_{jt} + Firm\ Controls_{ijt} + State\ Controls_{jt} + \alpha_i + \gamma_t + \epsilon_{ijt}$$

In this model, i indexes the firm, j indexes the state in which the firm's headquarter is located and t indexes time. The dependent variable, DA, corresponds to the estimated amount of discretionary accruals. The variable *Post GF* takes the value of one if a given state j has a good-faith exception in place in year t, and zero otherwise. I define the *Post PP* and *Post IC* variables similarly for the public-policy and the implied-contract exception, respectively. The variable *Demand Shock* is a dummy variable that equals one if a firm experiences a temporary decline in demand in a given year.

Equation (1) essentially represents a difference-in-differences specification that is similar to the one in Bertrand and Mullainathan (2003). This research design is powerful for drawing causal inferences (Bertrand et al., 2004). The accounting literature has recently begun to make use of staggered changes in regulation, in both single-country (Armstrong et al., 2012; Dou et al., 2013; Burks et al., 2013) and cross-country studies (Christensen et al., 2013; Hail et al., 2014). In this model, α_i denotes firm fixed effects and γ_t year fixed effects. Firm fixed effects deal with time-invariant omitted variables. Year fixed effects account for unobserved heterogeneity that varies across time (e.g., macroeconomic shocks).

The identification on β_1 (and β_4 - β_5) depends on comparing the behavior of treated firms before and after the adoption of wrongful discharge laws relative to the behavior of a control group of firms located in states where courts did not rule in favor of more stringent labor laws in the same year. Specifically, the coefficient on β_1 captures firms' change in accrual manipulation after the adoption of the good-faith exception in economic upturns. The coefficient on β_2 captures the average effect of bad states of nature on firms' accrual manipulation. Finally, the main coefficient of interest, β_3, measures the incremental change in discretionary accruals in response to an economic slowdown after the adoption of the good-faith exception relative to unregulated firms.

Since the change in labor laws is defined at the state level, I cluster standard errors by state.[10] This clustering method accounts for potential time-varying correlations in omitted variables that affect different firms within the same state (Bertrand et al., 2004). I further follow Bertrand and Mullainathan (2003) and replace the year fixed effects by either region-year or industry-year fixed effects to phase out the effects of regional or industry trends that are contemporaneous with the passage of the wrongful discharge law itself.[11] For example, when I include industry-year fixed effects, I compare firms within the same industry at a given point in time, which rules out the effect of any other factors that do not vary within industry-year, such as investment opportunities or other types of regulation.

I also supplement my model with two sets of control variables.[12] The first set is composed of firm characteristics previously identified as determinants of discretionary accruals. The second set of controls corresponds to states' local economic variables. I provide more details about these sets of firm and state control variables in the next section.

[10] I find similar results if I cluster the standard errors both at the state and year levels, or at the firm and year levels (Petersen, 2009; Gow et al., 2010; Thompson, 2011).

[11] I use the four U.S. regions as defined by the U.S. Census Bureau: Northeast, South, Midwest, and West. I find similar results if I use the nine divisions instead. Industry is defined using four-digit SIC codes.

[12] I define all variables in detail in Appendix B.

3.2 Sample Selection and Measures

3.2.1 Sample Selection

I use the coding of wrongful discharge laws from Autor et al. (2006). The authors provide a relevant coding as their data rely on the first major precedent-setting court decision in each state and for each exception separately. In my analysis, I also account for reversals in the jurisprudence. Accordingly, if the adoption of an exception is reversed in a higher court, this state is not coded as treated anymore. For example, the state of Oklahoma adopted the good-faith exception in 1985, but it was then reversed in 1989. In my sample, the *Post GF* variable is coded one only for the 1985 - 1988 period. Appendix A reports the year when each state passed the three exceptions and their reversals, if any.

My sample encompasses the years 1967 - 2002. My sample starts five years before the ruling in 1972 by a court in California in favor of the implied-contract exception which corresponds the second-earliest adoption of a wrongful discharge law across U.S. states. This time period allows me to identify firms' behavior before and after the adoption of such exceptions. The sample ends in 2002 with the enactment of the Sarbanes-Oxley Act (SOX) in order to fix the legal environment with respect to accounting manipulation. Indeed, Cohen et al. (2008) documents that after SOX firms sharply reduced accrual manipulation and rely more on real actions to increase reported earnings.[13] The last event in my sample occurred in 1998, when the state of Louisiana passed the good-faith exception. In my sample, 18.67% of the firm-year observations correspond to firms operating in states that have adopted the good-faith exception. This proportion is consistent with recent studies using wrongful discharge laws as an identification strategy in corporate finance, including Acharya et al. (2014) (15.6%) and Serfling (2014) (17%).

[13] I find qualitatively similar results if I use the year 1999 as another cutoff point to cover the time-span of the exact timing in Autor et al. (2006).

I follow recent studies that investigate the effect of a change in labor laws on corporate outcomes and first assign firms to a state on the basis of the company's headquarters location according to the COMPUSTAT database (Agrawal and Matsa, 2013; Serfling, 2014). As discussed by Heider and Ljungqvist (2014), the COMPUSTAT database reports only firms' current location, creating a measurement error that is likely to attenuate the results. I modify my sample using their procedure for the 1988 - 2002 period.[14]

3.2.2 Measure of Earnings Manipulations

Measures of earnings manipulations attempt to capture the discretion afforded by the U.S. GAAP. The rationale for this type of measure has been validated by Dichev et al. (2013). They surveyed CFOs of U.S. listed companies who consider significant deviations in the relation between earnings and cash flows compared to industry peers as red flags for earnings manipulations. I build a measure of accrual-earnings manipulation for all firms in my sample excluding financial institutions (SIC 6000-6999) and regulated industries (SIC 4400-5000). I estimate a variant of the Jones (1991) discretionary accruals model. I start with a modified Jones (1991) model as in Dechow et al. (1995). I further adjust this model to control for firm performance (Kothari et al., 2005).[15] I use the residuals from the following equation estimated annually for each industry (defined using two-digit SIC codes) with at least twenty observations:

$$\frac{TA_{i,t}}{Assets_{i,t-1}} = \alpha_0 + \alpha_1 \frac{1}{Assets_{i,t-1}} + \alpha_2 \frac{\triangle REV_{i,t}}{Assets_{i,t-1}} + \alpha_3 \frac{PPE_{i,t}}{Assets_{i,t-1}} + \alpha_4 ROA_{i,t-1} + \epsilon_{i,t} \qquad (2)$$

[14] Heider and Ljungqvist (2014) extract the historical headquarter's location for each fiscal year using information contained in firms' 10-K and 10-Q filings using the SEC's EDGAR service and Thomson Research. Thus, my sample does not take into account any change in the location of a firm's headquarters occurring before 1988. Such changes are still likely to generate an attenuation bias in my estimates.

[15] I control for lagged performance, but my results remain qualitatively similar if I control for contemporaneous performance or use a regular modified Jones (1991) model without controlling for performance.

where TA is total accruals, which is calculated as the change in current assets minus the change in current liabilities, minus the change in cash and equivalents, plus the change in debt in current liabilities and minus depreciation[16]; $Assets$ is total assets; $\triangle REV$ is change in net sales; PPE is the net book value of property, plant and equipment; ROA is the return on assets computed as operating income before depreciation over total assets; and i and t index the firm and the year, respectively. I trim the data at the 1^{st} and 99^{th} percentiles. Higher values of discretionary accruals indicate more income-increasing earnings manipulations.

In this article, I focus on accrual manipulation to examine the consequences of a change in operating flexibility on reporting choices. Ideally, I would supplement my main analysis using discretionary accruals with tests on specific accrual components, including the use of LIFO liquidation (Wheeler et al., 2014) and manipulation through characterizations of pension assets (Bergstresser et al., 2006). However, data on these specific components are generally not available until the mid 1990s, while the source of variation in dismissal costs that I use throughout my tests occurred mostly in the late 1970s and 1980s. Consequently, I focus exclusively on discretionary accruals.

3.2.3 Measures of Temporary Demand Shocks

In this article, I assume that managers have incentives to rely on accrual manipulation to increase the reported level of income in their financial statements when firms' economic performance falls below investors' expectations (Fudenberg and Tirole, 1995). Furthermore, I conjecture that the use of accrual manipulation depends on firms' ability to adjust their labor inputs in the short-run. Thus, I need to find plausible situations where firms' economic performance is likely to fall below investors' expectations, and labor adjustment costs also matter.

[16]This formula is known as a balance sheet approach to compute total accruals. Collins and Hribar (2002) argue that accruals should be calculated using data from the cash flow statement to limit the risk of measurement error. However, data from the cash flow statement are not available before the enactment and implementation of SFAS 95 in fiscal year 1988.

In this paper, I rely on decreases in demand at the firm level to capture situations where firms' economic performance is likely below investors' expectations. I do so because labor adjustment costs are likely to play a role when firms' demand is inferior to their production capacity. This approach does not require that I estimate managers' exact financial targets or determine whether earnings manipulations are successful at reaching a defined target. I simply consider that when firms' demand decreases, they are naturally further away from investors' initial earnings expectations.

I first define *Demand Shock* as a dummy variable that equals one if a firm reports a lower amount of net sales than that in the previous year, and zero otherwise. I exclude firm-year observations reporting an accounting impact of acquisitions, a change that has an impact on comparability of financial statements or any amount of discontinued operations in order to plausibly hold firms' business model unchanged in the short-run.[17] The rationale behind this measure is as follows. Suppose that investors' earnings expectations remain unchanged in the short-term. Assume now that fixed costs and the ratio of variable costs to sales are the same in the current and immediate past year. Then, when sales decrease, firms experience an earnings shortfall that is likely to place them further away from their financial targets. As reported in Table 1, firms in my sample experience a decline in sales in 26.07% of the firm-year observations.[18]

3.2.4 Control Variables

I first build a set of firm control variables previously identified as determinants of earnings manipulations: firm size, leverage, market-to-book ratio, profitability and whether firms paid dividends. The vast literature on earnings management documents many additional determinants (Healy and Wahlen, 1999; Dechow et al., 2010). However, as my sample starts in 1967, several determinants

[17] This approach is similar to that of Beneish et al. (2014). In the COMPUSTAT database, I use the items *aqs* (or *aqa*), *compst*, and *do* to identify the accounting impact of acquisitions, a comparability issue, or the presence of discontinued operations, respectively.

[18] This frequency is similar to the one reported in Kama and Weiss (2013).

computed using the statement of cash flows are not available before the enactment and implementation of SFAS 95 for fiscal year 1988 (e.g., proceeds from debt and equity issuance). Some other information, such as the name of the audit company, is missing in the COMPUSTAT database for the first decades of my sample period.

One potential concern is that both the adoption of the good-faith exception and the change in reporting practices are driven by states' local economic situations. To rule out this omitted-variable concern, I further include the growth rate of states' GDP as a control variable. I obtain the data from the Bureau of Economic Analysis.[19]

Table 1 displays the summary statistics for all dependent and independent variables used in this paper. I winsorize all variables at the 1^{st} and 99^{th} percentiles to eliminate the impact of outliers.

4 Results

4.1 Baseline Results

In this section, I apply my estimation strategy to test the hypothesis that rigidity in the cost structure causes firms to engage in more income-increasing accrual manipulation. I rely on decline in sales as a proxy for economic slowdown. I consider that a decline in sales puts firms further away from their profitability target, and I conjecture that managers will resort more intensively to accrual manipulation to increase reported earnings as changes firing costs limit managers' ability to save on wages. Table 2 displays the results of the baseline model.

In column (1), the coefficient on *Demand Shock* is positive and significant. It simply indicates that firms manipulate earnings through accruals by a larger amount when activity levels decline, consistent with the career concern perspective under the job security framework of Fudenberg and

[19]I do not include the state unemployment rate in my main regressions as the data are only available since 1976 from the Bureau of Labor Studies. However, I find similar results if I include this variable in my models and backfilled the missing years with the most recent year available at the state level.

Tirole (1995). As predicted, the coefficient on *Demand Shock X Post GF* is also significantly positive. It suggests that when revenues decrease, firms engage in more intensive upward accrual manipulation following the adoption of the good-faith exception than their unregulated peers. While it is difficult to provide a clear interpretation of the discretionary accruals, the change in behavior seems to be economically significant. Indeed, I find that conditional on being in an economic slowdown, discretionary accruals increase, on average, by a magnitude ranging from of 0.47% to 0.73% of total assets for firms headquartered in states that adopted the good-faith exception relative to a control group of firms headquartered in unregulated states. While these amounts are economically large, they are comparable to that of recent studies investigating how changes in regulation affect reporting incentives (Dou et al., 2014). Besides, other studies suggest that accrual accounts that might be subject to manipulation, such as inventory write-downs, can represent a large fraction of firns' operating income (Chen et al., 2010).

The coefficient on *Post GF* captures the change in accrual manipulation absent a decline in revenues after the adoption of the good-faith exception. It is systematically negative but not statistically significant. I conjecture that this coefficient carries a negative sign because regulated firms exhibit larger positive discretionary accruals during economic slowdown, while accruals reverse over time. Thus, in good times the amount of discretionary accruals that reverses is larger for firms in states that adopted the good-faith exception.

In column (3), I add several firm-level and state-level controls as discussed in the previous section. Both the magnitude and the significance of the coefficients of interest stay similar, so that the observed differences in discretionary accruals cannot be explained by a change in firms' or states' characteristics. In columns (4) and (5), the results continue to hold when I replace the year fixed effects with industry-year and region-year fixed effects, respectively.

4.2 Cross-Sectional Results

In this section, I perform two cross-sectional analyses to ensure the validity of my baseline results. First, I explore the role of organized labor. The legal literature argues that wrongful discharge laws do not apply to unionized workers. Indeed, collective bargaining agreements usually contain provisions that are more binding than the jurisprudence developed around wrongful discharge laws. Thus, the adoption of the good-faith exception constitutes a "no event" for unionized firms and I subsequently expect the change in accounting manipulation to be concentrated among non-unionized firms. To test this mechanism, I define *Union* as a dummy variable that equals one if a firm belongs to an industry that had at least 25% of its workforce covered by a collective agreement in 1983, as constructed in Matsa (2010).[20] Furthermore, defining unionization at the industry level is appropriate since economic studies suggest that the threat of unionization at the industry level has an impact on firms' choices that is, on average, three times larger than the one caused by actual unionization rate (Bronars and Deere, 1991).

Table 3 presents the results. The coefficient on *Post GF X Demand Shock* is positive and statistically significant in columns (1) and (3) where I focus on the sub-sample of relatively low unionized firms. On the contrary, the coefficient on *Post GF X Demand Shock* is not statistically different from zero in columns (2) and (4) where I focus on the sub-sample of firms with relatively high union intensity. These results are robust to replacing year fixed effects with industry-year or region-year fixed effects (untabulated). Overall, the results suggest changes in accrual manipulation following the adoption of the good-faith exception are concentrated among firms in industries with a lower level of unionization.

[20]Industry is defined using the two-digit SIC codes. I obtain the data in Table AI from the appendix of Matsa (2010). His data on union coverage is from Hirsch and Macpherson (2003). While this dataset is static, the year 1983 is a reasonable point in time for my study, as the adoption of the good-faith exception started in the late 1970s and continues mostly through the 1980s.

Next, I concentrate on firms' ability to perform income-increasing manipulation. Due to the limited flexibility affordable within GAAP and the reversal of accruals, managers' ability to manipulate accruals upward in a given year is constrained by accrual management activities in previous periods. Specifically, I predict that firms constrained by relatively large past manipulation will not be able to engage in more income-increasing accounting manipulation after the adoption of the good-faith exception.

To test this mechanism, I follow Zang (2012) and use the measure of balance sheet constrain developped by Barton and Simko (2002). This measure relies on the articulation between the income statement and the balance sheet such that upward accrual manipulation is also reflected in net assets. The intuition behind this approach is that managers' ability to optimistically bias earnings upward in current periods decreases with the extent to which net assets are already overstated. I compute net operating assets at the beginning of the year as shareholders' equity less cash and and marketable securities plus total debt divided by lagged sales. Then, I define a dummy *Constrain* that is equal to one if a firm's measure of net operating assets is larger than the industry-year median, and zero otherwise.

Table 4 displays the result. The coefficient on *Post GF X Demand Shock* is positive and statistically significant in columns (1) and (3) where I focus on the sub-sample of firms with higher accounting flexibility. On the other hand, the interaction term is not statistically different from zero, albeit positive, in columns (2) and (4) where I focus on the sub-sample of firms with relatively lower accounting flexibility. Overall, the results in Table 4 corroborates the intuition that only firms with enough flexibility are engaging in more income-increasing accounting manipulation after the adoption of the good-faith exception.

4.3 Evolution over Time

In this section, I investigate the evolution of the effect over time. To do so, I decompose the effect of the good-faith exception in two periods. Specifically, I set *Post GF 10*$^{-}$ equal to one only for observations in adopting states in the first ten years following the adoption of the good-faith exception, and zero otherwise. Similarly, I define *Post GF* 10^{+} as a dummy variable equal to one for observations falling in adopting states at least ten years after the adoption of the good-faith exception, and zero otherwise. Table 5 displays the results. The coefficient on *Demand Shock X Post GF 10*$^{-}$ is positive and statistically significant at the $X\%$ level, while the coefficient on *Demand Shock X Post GF 10*$^{+}$ is positive but not statistically significant in the three specifications. In addition, the magnitude of the coefficient is three to four times larger for the first ten years compared to the following years. Overall, these results indicate that the effect on accrual manipulation is concentrated in the first decade following the adoption of the good-faith exception.

The fact that the effect weakens after a decade is consistent with at least two explanations. First, studies in labor economics suggest that increases in dismissal costs lead to firms to change their hiring and firing policies as well as the composition of their workforce. In particular, Autor (2003) finds that firms outsource more in response to the adoption of wrongful discharge laws. In this case, it is possible that after a decade, firms in adopting states have reached the same level of flexibility as in the pre-regulation period, which might explain why I fail to find a difference in accrual manipulation before the adoption of the good-faith exception relative to ten years after its adoption. Consistent with this explanation, I find that firms exhibit a smaller growth rate in employment after the adoption of the good-faith exception (untabulated), suggesting that they become relatively more capital-intensive or that they rely more on outsourcing. However, this result is also consistent with the conclusion by some legal scholars that firms over-estimated the legal risk associated with wrongful discharge laws due to some high profile cases in the 1980s.

4.4 Robustness Tests

4.4.1 Endogeneity Analysis

Next, I evaluate the extent to which the adoption of a good-faith exception is exogenous. The validity of my research design relies on the assumption that the adoption of wrongful discharge laws is not driven by previous trends in earnings manipulations. To rule out a potential concern of reverse causality, I follow Bertrand and Mullainathan (2003) and decompose the adoption of good-faith exceptions into separate time periods for each state. Specifically, I re-estimate my first model and replace the *Post GF* dummy by several indicator variables: *Post* GF^{-3}, *Post* GF^{-2}, *Post* GF^{-1}, *Post* GF^{0}, *Post* GF^{1} and *Post* GF^{2+}. I then interact these dummy variables with the *Demand Shock* variable. For example, *Post* GF^{-1} is a dummy that takes the value of one in the year before the adoption of a good-faith exception, and zero otherwise. The other dummy variables are defined similarily.

Table 6 reports the results of three specifications with different sets of fixed effects to clearly separate the effect of labor laws from that of other trends. In all three specifications, the coefficients on *Post* GF^{-3} *X Demand Shock*, *Post* GF^{-2} *X Demand Shock*, *Post* GF^{-1} *X Demand Shock* are not statistically significant different from zero. First, this suggests that the effect of the ruling never preceded its adoption. Second, it also means that the amount of discretionary acruals was not trending for future regulated states before the adoption of the good-faith exception. The interactions between *Demand Shock* and both *Post* GF^{0} and *Post* GF^{1} are also not statistically significant. This rules out an alternative behavioral explanation that firms reacted only around the passage of the good-faith exception. On the contrary, the coefficient on *Post* GF^{2+} *X Demand Shock* is positive and statistically significant, indicating that the change in behavior occurred after two years.

4.4.2 Alternative Specifications

Next, I conduct a series of additional tests to assess the robustness of my findings and rule out some alternative explanations.

Employees' location The first concern is that I do not observe directly whether firms' employees (or what fraction of firms' employees) are located in the state where the firm is headquartered, which is likely to bring some noise into my estimations. To address this issue, I consider the case of firms whose workforce is likely geographically dispersed (Agrawal and Matsa, 2013).[21] The intuition is that a change in the labor adjustment costs in a given state only affects a limited fraction of such firms' workorce, which has two implications. First, it may not raise significantly firing costs at the firm level. Alternatively, such firms could potentially respond to an economic slowdown by terminating employees' located in unregulated states. Thus, I conjecture that they should be less likely to use more intensively accounting manipulation in response to the adoption of the good-faith exception. In Table 7, I find that the coefficient on *Post GF X Demand Shock* is statistically significant in columns (1) and (3) where I focus on firms with relatively less dispersed workforce. On the other hand, I fail to find a change in accrual manipulation after the adoption of the good-faith exception for firms with relatively more dispersed workforce. This result suggests that even if using firms' headquarter to measure the location of firms' activity is noisy, it does capture changes in labor adjustment costs in the predicted direction.

Decline in sales Another concern is related to the validity of my measure to capture temporary decrease in firms' demand. In my main model, I simply define temporary shocks to demand as any negative change in sales from one year to another. As a change in firms' business model can also happen through a sequence of sales declines, I further restrict the definition of *Demand Shock* to

[21] Dispersed industries include retail, wholesale and transportation.

cases where a negative change in sales is followed by an increase in sales in the next year. In all specifications of Table 8, I find that the coefficient on *Post GF X Demand Shock* remains positive and statistically significant, which indicates that my results are driven by temporary decline in demand.

Balance of the sample One concern is related to the validity of the difference-in-differences methodology with respect to the staggered adoption of the labor laws. By 1999, thirteen state courts had ruled in favor of a good-faith exception. However, the number of firms headquartered within each of these thirteen states is largely unbalanced across states. Specifically, the state of California accounts for 51.4% of the number of firm-year observations with a good-faith exception in place. One issue is that my results may be driven solely by firms headquartered in California. This would be problematic as the change in behavior of Californian companies could be due to an unknown event that is unrelated to the change in labor laws. To rule out that concern, I re-estimate my models excluding the state of California from the sample. As shown in Table 9, my results continue to hold, albeit exhibiting a statistical significance only at the 5% or 10% levels.

Consequences of Decline in Sales on Accruals One additional concern is that the adoption of the good-faith exception could have hurt firms' competitiveness so that firms' declines in sales are more pronounced afterwards. If this is the case, my results could be spurious due to the correlated omitted variable problem discussed by Ball (2013). Indeed, the discretionary accruals Jones model relies on a linear relationship between total accruals and revenues. Thus, a negative change in revenues should translate in a linear decrease in total accruals. However, if the economic slowdown is not fully anticipated, firms will record a higher level of unsold inventory, which will increase positive discretionary accruals and lead to over-rejection of the null. To rule out this concern, I test whether a decline in sales is more pronounced in regulated states. I focus only on the sub-sample of

firms experiencing a decline in sales. Table 10 displays the results. In all columns, the coefficient on *Post GF* is statistically and economically not significant, suggesting that my results are not driven by the nature of changes in economic conditions after the adoption of the good-faith exception.

Strategic choices around courts' ruling An alternative story would be that managers strategically use the timing of the adoption of the laws to reset firms' reporting quality. That is, upon observing the adoption of the good-faith exception, managers whose firm is performing poorly could blame the increase in labor costs due to the regulation in order to engage in downward earnings manipulations, seeking a fresh start. This behavior is unlikely because it would require that managers immediately recognize the scope of the ruling in order to promptly blame the change in jurisprudence induced by the court. Besides, as shown in Table 6, managers do not seem to react on the year of the adoption of the good-faith exception. Nevertheless, in untabulated analyses, I test whether firms are more likely to engage in big bath manipulations around the adoption of the good-faith exception, and I fail to find supportive evidence of such behavior.[22]

[22]I define big bath using firms' special items as in Elliott and Shaw (1988) and Riedl and Srinivasan (2010).

5 Conclusion

In this paper, I use the adoption of the good-faith exception by U.S. courts as a source of plausibly exogenous variation in firing costs at the state level to examine the causal relation between a firm's operating flexibility and its reporting choices. I find robust evidence that firms substitute income-increasing accrual manipulation to firing decisions when they experience an economic slowdown. The results are more pronounced for firms more exposed to stringent labor laws and for firms with enough flexibility left to engage in more accrual manipulation.

My results provide evidence that rigidity in a firm's cost structure alter managers' reporting incentives. This paper contributes to several streams of accounting research. First, my paper is related to the growing body of literature that investigates how labor characteristics affect firms' information environment (Hilary, 2006; Bova, 2013; Bova et al., 2013; Dou et al., 2014). Second, my results contribute to the emerging literature lying at the intersection of cost and financial accounting (Banker and Byzalov, 2015). Third, my results relate tot the broad literature on the determinants of firms' reporting incentives (Dechow et al., 2010). Finally, my results speak to the literature on regulations and accounting by providing evidence of an unintended consequence of a change in labor regulation on firms' reporting quality (Leuz, 2010).

Appendix A - Wrongful Discharge Laws by State

This table reports the year when each state passed the public-policy, implied-contract and good-faith exception. When there is a reversal by a higher court, the year of reversal is indicated in brackets.

State	Public-Policy Exception	Implied-Contract Exception	Good-Faith Exception
Alabama	-	1987	-
Alaska	1986	1983	1983
Arizona	1985	1983 (1984)	1985
Arkansas	1980	1984	-
California	1959	1972	1980
Colorado	1985	1983	-
Connecticut	1980	1985	1980
Delaware	1992	-	1992
Florida	-	-	1983
Georgia	-	-	-
Hawaii	1982	1986	-
Idaho	1977	1977	1989
Illinois	1978	1974	-
Indiana	1973	1987	-
Iowa	1985	1987	-
Kansas	1981	1984	-
Kentucky	1983	1983	-
Louisiana	-	-	1998
Maine	-	1977	-
Maryland	1981	1985	-
Massachusetts	1980	1988	1977
Michigan	1976	1980	-
Minnesota	1986	1983	-
Mississippi	1987	1992	-
Missouri	1985	1983 (1988)	-
Montana	1980	1987	1982
Nebraska	1987	1983	-
Nevada	1984	1983	1987
New Hampshire	1974	1988	1974 (1980)
New Jersey	1980	1985	-
New Mexico	1983	1980	-
New York	-	1982	-
North Carolina	1985	-	-
North Dakota	1987	1984	-
Ohio	1990	1982	-
Oklahoma	1989	1976	1985 (1989)
Oregon	1975	1978	-
Pennsylvania	1974	-	-
Rhode Island	-	-	-
South Carolina	1985	1987	-
South Dakota	1988	1983	-
Tennessee	1984	1981	-
Texas	1984	1984	-
Utah	1989	1986	1989
Vermont	1986	1985	-
Virginia	1985	1983	-
Washington	1984	1977	-
West Virginia	1978	1986	-
Wisconsin	1980	1985	-
Wyoming	1989	1985	1994

Appendix B - Variable Definitions

This table provides the definitions and sources used to measure all dependent, independent and partitioning variables used in the various models throughout this paper.

Variable Name	Definition	Source
Discr. Acc	Residuals from a discretionary accruals model	Compustat
Post GF	Indicator that takes a value of one for firms headquartered in a state that adopted the good-faith exception	Autor et al. (2006)
Post IC	Indicator that takes a value of one for firms headquartered in a state that adopted the implied-contract exception	Autor et al. (2006)
Post PP	Indicator that takes a value of one for firms headquartered in a state that adopted the public-policy exception	Autor et al. (2006)
Demand Shock	Indicator that takes a value of one if a firm experiences an annual decrease in sales	Compustat
Size	Logarithm of a firm's total assets	Compustat
Leverage	Long-term debt over book value of assets	Compustat
Market-to-Book Ratio	Market value of assets divided by book value of assets	Compustat
ROA	Operating income divided by total assets	Compustat
State GDP Growth	State GDP growth rates computed	BEA
Constrain	Indicator that takes a value of one if the measure of net operating asset is over the median of the distribution in a given industry - year	Compustat
Union	Indicator that takes a value of one if a firm belongs to a industry with at least 25% of its workers covered by collective agreement in 1983, as in Matsa (2010)	Compustat
Dispersed	Indicator that takes a value of one if a firm belongs to an industry classifed as dispersed in Agrawal and Matsa (2013)	Compustat
ΔSale_t	Annual change in sales	Compustat

References

Acharya, V., P. Baghai, and K. Subramanian, 2013, Labor Laws and Innovation, *Journal of Law and Economics* 56, 997 – 1037.

Acharya, V., P. Baghai, and K. Subramanian, 2014, Wrongful Discharge Laws and Innovation, *Review of Financial Studies* 27, 301 – 346.

Agrawal, A., and D. Matsa, 2013, Labor Unemployment Risk and Corporate Financing Decisions, *Journal of Financial Economics* 108, 449 – 470.

Angrist, J., and A. Krueger, 2001, Instrumental Variables and the Search for Identification: From Supply and Demand to Natural Experiments, *Journal of Economic Perspectives* 15, 69 – 85.

Aobdia, D., and L. Cheng, 2014, Unionization, Product Market Competition, and Strategic Disclosure, Working Paper.

Armstrong, C., K. Balakrishnan, and D. Cohen, 2012, Corporate Governance and the Information Environment: Evidence from State Antitakeover Laws, *Journal of Accounting and Economics* 53, 185 – 204.

Atanassov, J., and H. E. Kim, 2009, Labor and Corporate Governance: International Evidence from Restructuring Decisions, *Journal of Finance* 64, 341 – 374.

Autor, D., 2003, Outsourcing at Will: The Contribution of Unjust Dismissal Doctrine to the Growth of Employment Outsourcing, *Journal of Labor Economics* 21, 1 – 42.

Autor, D., J. Donohue, and S. Schwab, 2006, The Costs of Wrongful-Discharge Laws, *Review of Economics and Statistics* 88, 211 – 231.

Autor, D., W. Kerr, and A. Kugler, 2007, Does Employment Protection Reduce Productivity? Evidence from U.S. States, *Economic Journal* 117, 189 – 217.

Balakrishnan, K., J. Core, and R. Verdi, 2014, The Relation Between Reporting Quality and Financing and Investment: Evidence from Changes in Financing Capacity, *Journal of Accounting Research* 52, 1 –36.

Ball, R., 2013, Accounting Informs Investors and Earnings Management is Rife: Two Questionable Beliefs, *Accounting Horizons* 27, 847 – 853.

Banker, R., and D. Byzalov, 2015, Asymmetric Cost Behavior, *Journal of Management Accounting Research* Forthcoming.

Banker, R., D. Byzalov, and J. Plehn-Dujowich, 2014, Demand Uncertainty and Cost Behavior, *Accounting Review* 89, 839 – 865.

Barton, J., and P. Simko, 2002, The Balance Sheet as An Earnings Management Constraint, *Accounting Review* 77, 1 – 27.

Beatty, A., S. Liao, and J. Weber, 2010a, The Effect of Private Information and Monitoring on the Role of Accounting Quality in Investment Decisions, *Contemporary Accounting Research* 27, 17 – 47.

Beatty, A., S. Liao, and J. Weber, 2010b, Financial Reporting Quality, Private Information, Monitoring and the Lease-versus-Buy Decision, *Accounting Review* 85, 1215 – 1238.

Beneish, M. D., V. Capkun, and M. Fridson, 2014, Defying Gravity: Costly Signaling to Mislead or to Inform?, Working Paper.

Bergstresser, D., M. Desai, and J. Rauh, 2006, Earnings Manipulation, Pension Assumptions, and Managerial Investment Decisions, *Quarterly Journal of Economics* 151, 157 – 195.

Bertrand, M., E. Duflo, and S. Mullainathan, 2004, How Much Should We Trust Differences-in-Differences Estimates?, *Quarterly Journal of Economics* 119, 249 – 275.

Bertrand, M., and S. Mullainathan, 2003, Enjoying the Quiet Life? Corporate Governance and Managerial Preferences, *Journal of Political Economy* 111, 1043 – 1075.

Biddle, G., and G Hilary, 2006, Accounting Quality and Firm-Level Capital Investment, *Accounting Review* 81, 963 – 982.

Biddle, G., G. Hilary, and R. Verdi, 2009, How Does Financial Reporting Quality Relate to Investments Efficiency, *Journal of Accounting and Economics* 48, 112 – 131.

Blanchard, O., and P. Portugal, 2001, What Hides Behind an Uunemployment Rate: Comparing Portuguese and U.S. Labor Markets, *American Economic Review* 91, 187 – 207.

Blanchflower, D., A. Oswald, and P. Sanfey, 1996, Wages, Profits, and Rent-Sharing, *Quarterly Journal of Economics* 111, 227 – 251.

Bova, F., 2013, Labor Unions and Management's Incentive to Signal a Negative Outlook, *Contemporary Accounting Research* 30, 14 – 41.

Bova, F., Y. Dou, and O.-K. Hope, 2013, Employee Ownership and Firm Disclosure, *Contemporary Accounting Review* Forthcoming.

Boxold, D., 2008, Employment Practice Liability: Jury Award Trends and Statistics, LRP Publications Jury Verdict Research.

Bronars, S., and D. Deere, 1991, The Threat of Unionization, the Use of Debt and the Preservation of Shareholder Wealth, *Quarterly Journal of Economics* 106, 231 – 254.

Burks, J., C. Cuny, J. Gerakos, and J. Granja, 2013, Competition and Voluntary Disclosure: Evidence from Deregulation in the Banking Industry, Working Paper.

Card, D., 1996, The Effects of Unions on the Structure of Wages: A Longitudinal Analysis, *Econometrica* 64, 957 – 979.

Chen, F., O-K. Hope, Q. Li, and X. Wang, 2011, Financial Reporting Quality and Investment Efficiency of Private Firms in Emerging Markets, *Accounting Review* 86, 1255 – 1288.

Chen, H., S. Ramnath, S. Rangan, and S. Rock, 2010, Inventory Write-Downs in the Semiconductor Industry Working Paper.

Christensen, H., L. Hail, and C. Leuz, 2013, Mandatory IFRS Reporting and Changes in Enforcement, *Journal of Accounting and Economics* 56, 147 – 177.

Cohen, D., A. Dey, and T. Lys, 2008, Real and Acrual-Based Earnings Management in the Pre- and Post-Sarbannes-Oxley Periods, *The Accounting Review* 83, 757 – 787.

Cohen, D., and P. Zarowin, 2010, Accrual-Based and Real Earnings Management Activities around Seasoned Equity Offerings, *Journal of Accounting and Economics* 50, 2 – 19.

Collins, D., and P. Hribar, 2002, Errors in Estimating Accruals: Implications for Empirical Research, *Journal of Accounting Research* 40, 105 – 135.

Corbett, W., 2005, Resolving Employee Discharge Disputes under the Montana Wrongful Discharge Act (MWDA), Discharge Claims Arising Apart from the MWDA, and Practice and Procedure Issue in the Context of a Discharge Case, *Montana Law Review* 66, 329 – 404.

DeAngelo, H., and L. DeAngelo, 1991, Union Negotiations and Corporate Policy, *Journal of Financial Economics* 30, 3 – 43.

Dechow, P., W. Ge, and C. Schrand, 2010, Understanding Earnings Quality: A Review of the Proxies, Their Determinants and Their Consequences, *Journal of Accounting and Economics* 50, 344 – 401.

Dechow, P., R. Sloan, and A. Sweeney, 1995, Detecting Earnings Management, *Accounting Review* 70, 193 – 225.

Degeorge, F., J. Patel, and R. Zeckhauser, 1999, Earnings Management to Exceed Thresholds, *Journal of Business* 72, 1 – 33.

Dertouzos, J., E. Holland, and P. Ebener, 1988, The Legal and Economic Consequences of Wrongful Termination, RAND Corporation Document.

Dichev, I., J. Graham, C. Harvey, and S. Rajgopal, 2013, Earnings Quality: Evidence from the Field, *Journal of Accounting and Economics* 56, 1 – 33.

Dierynck, B., W. R. Landsman, and A. Renders, 2012, Do Managerial Incentives Drive Cost Behavior? Evidence about the Role of the Zero Earnings Benchmark for Labor Cost Behavior in Private Belgian Firms, *Accounting Review* 87, 1219 – 1246.

Dixit, A., 1997, Investment and Employment Dynamics in the Short Run and the Long Run, *Oxford Economic Papers* 49, 1 – 20.

Dou, Y., M. Khan, and Y. Zou, 2014, Labor Unemployment Insurance and Earnings Management, Working Paper.

Dou, Y., S.G. Ryan, and Y. Zou, 2013, The Effects of Credit Competition on Banks'Loan Loss Provision Timeliness, Working Paper.

D'Souza, J., J. Jacob, and K. Ramesh, 2000, The Use of Accounting Fexibility to Reduce Labor Renegotiation Costs and Manage Earnings, *Journal of Accounting and Economics* 30, 187 – 208.

Elliott, J., and W. Shaw, 1988, Write-offs as Accounting Procedures to Manage Perceptions, *Journal of Accounting Research* 26, 91 – 119.

Ewert, R., and A. Wagenhofer, 2005, Economic Effect of Tightening Accounting Standards to Restrict Earnings Management, *Accounting Review* 80, 1101 – 1124.

Fairhurst, D., and M. Serfling, 2014, Employee Firing Costs and Corporate Investment, Working Paper.

Fudenberg, D., and J. Tirole, 1995, A Theory of Income and Dividend Smoothing Based on Incumbency Rents, *Journal of Political Economy* 103, 75 – 93.

Gow, I., G. Ormazabal, and D. Taylor, 2010, Correcting for Cross-Sectional and Time-Series Dependence in Accounting Research, *Accounting Review* 85, 483 – 512.

Hail, L., A. Tahoun, and C. Wang, 2014, Dividend Payout and Information Shocks, *Journal of Accounting Research* 52, 403 – 456.

Healy, P., 1985, The Effect of Bonus Schemes on Accounting Decisions, *Journal of Accounting and Economics* 19, 29 – 74.

Healy, P., and J. Wahlen, 1999, A Review of the Earnings Management Literature and its Implications for Standard Setting, *Accounting Horizons* 13, 365 – 383.

Heider, F., and A. Ljungqvist, 2014, As Certain as Debt and Taxes: Estimating the Tax Sensitivity of Leverage from Exogenous State Tax Changes, *Journal of Financial Economics* Forthcoming.

Hilary, G., 2006, Organized Labor and Information Asymmetry in the Financial Markets, *Review of Accounting Studies* 11, 525–548.

Hirsch, B., and D. Macpherson, 2003, Union Membership and Coverage Database from the Current Population Survey: Note, *Industrial and Labor Relations Review* 56, 349 – 354.

Jones, J., 1991, Earnings Management during Import Relief Investigations, *Journal of Accounting Research* 29, 193 – 228.

Kama, I., and D. Weiss, 2013, Do Earnings Targets and Managerial Incentives Affect Sticky Costs?, *Journal of Accounting Research* 51, 201 – 224.

Kothari, S. P., A. J. Leone, and C. E. Wasley, 2005, Performance Matched Discretionary Accruals Measures, *Journal of Accounting and Economics* 39, 163 – 197.

Kugler, A., and G. Saint-Paul, 2004, How Do Firing Costs Affect Worker Flows in a World with Adverse Selection?, *Journal of Labor Economics* 22, 553 – 584.

Kuzmina, O., 2013, Operating Flexibility and Capital Structure: Evidence from a Natural Experiment, Working Paper.

Lazear, E., 1990, Job Security Provisions and Employment, *The Quarterly Journal of Economics* 105, 699 – 726.

Leuz, C., 2010, Different Approaches to Corporate Reporting Regulation: How Jurisdictions Differ and Why, *Accounting and Business Research* 40, 229 – 256.

MacLeod, B., and V. Nakavachara, 2007, Can Wrongful Discharge Law Enhance Employment?, *Economic Journal* 117, 218 – 278.

Matsa, D., 2010, Capital Structure as a Strategic Variable: Evidence from Collective Bargaining, *Journal of Finance* 65, 1197 – 1232.

Miles, T., 2000, Common Law Exceptions to Employment at Will and U.S. Labor Markets, *Journal of Law, Economics, and Organization* 16, 74 – 101.

Murphy, K., and J. Zimmerman, 1993, Financial Performance Surrounding CEO Turnover, *Journal of Accounting and Economics* 16, 273 – 315.

Oi, W., 1962, Labor as a Quasi-Fixed Factor, *Journal of Political Economy* 70, 538 – 555.

Petersen, M., 2009, Estimating Standard Errors in Finance Panel Data Sets: Comparing Approaches, *Review of Financial Studies* 22, 435 – 480.

Riedl, E., and S. Srinivasan, 2010, Signaling Firm Performance through Financial Statement Presentation: An Analysis Using Special Items, *Contemporary Accounting Research* 27, 289 – 332.

Schmalz, M., 2013, Managing Human Capital Risk, Working Paper.

Serfling, M., 2014, Firing Costs and Capital Structure Decisions, Working Paper.

Simintzi, E., V. Vig, and P. Volpin, 2014, Labor Protection and Leverage, *Review of Financial Studies* Forthcoming.

Thompson, S., 2011, Simple Formulas for Standard Errors that Cluster by Both Firm and Time, *Journal of Financial Economics* 99, 1 – 10.

Warner, J., R. Watts, and K. Wruck, 1988, Stock Prices and Top Management Changes, *Journal of Financial Economics* 20, 461 – 492.

Wheeler, S., S. Cereola, and T. Louwers, 2014, MD&A Disclosure Tendencies: The Case of LIFO Liquidations, *Accounting Horizons* Forthcoming.

Zang, A., 2012, Evidence on the Trade-Off between Real Activities Manipulation and Accrual-Based Earnings Management, *Accounting Review* 87, 675 – 703.

Table 1: Descriptive Statistics

This table presents the descriptive statistics of all dependent, independent and partitioning variables used in the various models throughout this paper.

Variable Name	Mean	Median	Std. Deviation
Discr. Acc	0.00	0.01	0.08
Post GF	0.18	0.00	0.39
Post IC	0.55	1.00	0.49
Post PP	0.57	1.00	0.49
Demand Shock	0.27	0.00	0.39
Size	4.92	4.11	1.86
Leverage	0.18	0.14	0.17
ROA	0.09	0.12	0.17
Market-to-Book	1.93	0.27	1.34
State GDP Growth	0.08	0.07	0.03
Union	0.35	0.00	0.32
Constrain	0.48	0.00	0.49
Dispersed	0.12	0.00	0.33
ΔSale_t	0.15	0.07	0.03

Table 2: Demand Shock - Baseline Results

This table presents the results from OLS regressions relating financial reporting quality to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 2002. The dependent variable is a measure of discretionary accruals. All variables are defined in Appendix B. Standard errors are corrected for heteroskedasticity and clustered at the state level. ***, **, and * indicate significance at the 1%, 5%, and 10% level, respectively.

	(1)	(2)	(3)	(4)	(5)
	Disc. Acc	Disc. Acc	Disc. Acc	Disc. Acc	Disc. Acc
Post GF	-0.0007	-0.0002	-0.0013	-0.0011	-0.0021
	(0.002)	(0.002)	(0.003)	(0.003)	(0.002)
Demand Shock	0.0177***	0.0202***	0.0206***	0.0206***	0.0210***
	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)
Post GF X Demand Shock	0.0047***	0.0070***	0.0075***	0.0072***	0.0073***
	(0.001)	(0.002)	(0.002)	(0.002)	(0.002)
Post IC	0.0003	-0.0011	-0.0009	-0.0012	-0.0016
	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)
Post PP	0.0013	-0.0009	-0.0007	-0.0022*	-0.0006
	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)
Size			0.0142***	0.0142***	0.0147***
			(0.001)	(0.001)	(0.001)
Leverage			-0.0211***	-0.0214***	-0.0208***
			(0.002)	(0.002)	(0.002)
Market-to-Book			-0.0003***	-0.0003***	-0.0003***
			(0.000)	(0.000)	(0.000)
State GDP Growth			-0.0321**	-0.0297***	-0.0192
			(0.014)	(0.010)	(0.012)
ROA			-0.0102***	-0.0103***	-0.0102***
			(0.003)	(0.003)	(0.003)
Constant	-0.0097***	-0.0233***	-0.0464***	-0.0472***	-0.0477***
	(0.001)	(0.001)	(0.003)	(0.003)	(0.003)
State Fixed Effects	Yes	No	No	No	No
Firm Fixed Effects	No	Yes	Yes	Yes	Yes
Year Fixed Effects	Yes	Yes	Yes	No	No
Industry-Year Fixed Effects	No	No	No	Yes	No
Region-Year Fixed Effects	No	No	No	No	Yes
Observations	107,023	107,023	107,023	107,023	107,023
Adjusted-R^2	0.0206	0.3555	0.3654	0.3667	0.3804

Table 3: Demand Shock - Organized Labor

This table presents the results from OLS regressions relating financial reporting quality to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 1999. The dependent variable is a measure of discretionary accruals. I define *Union* as a dummy variable that equals one for industries with high union coverage, following Matsa (2010). All variables are defined in Appendix B. Standard errors are corrected for heteroskedasticity and clustered at the state level. ***, **, and * indicate significance at the 1%, 5%, and 10% level, respectively.

	(1)	(2)	(3)	(4)
	Union = 0	Union = 1	Union = 0	Union = 1
	Disc. Acc	Disc. Acc	Disc. Acc	Disc. Acc
Post GF	-0.0003	0.0011	-0.0025	0.0011
	(0.003)	(0.002)	(0.004)	(0.002)
Demand Shock	0.0216***	0.0182***	0.0223***	0.0180***
	(0.001)	(0.001)	(0.001)	(0.001)
Post GF X Demand Shock	0.0091***	0.0019	0.0100***	0.0018
	(0.002)	(0.002)	(0.003)	(0.002)
Post IC	-0.0024	0.0006	-0.0024	0.0010
	(0.002)	(0.001)	(0.002)	(0.001)
Post PP	-0.0005	-0.0017	-0.0001	-0.0016
	(0.002)	(0.001)	(0.002)	(0.001)
Size			0.0160***	0.0104***
			(0.001)	(0.002)
Leverage			-0.0225***	-0.0183***
			(0.003)	(0.004)
Market-to-Book			-0.0003***	-0.0003*
			(0.000)	(0.000)
ROA			-0.0099***	-0.0112**
			(0.004)	(0.005)
State GDP Growth			-0.0433**	-0.0119
			(0.020)	(0.016)
Constant	-0.0269***	-0.0187***	-0.0473***	-0.0408***
	(0.002)	(0.002)	(0.003)	(0.005)
Firm Fixed Effects	Yes	Yes	Yes	Yes
Year Fixed Effects	Yes	Yes	Yes	Yes
Observations	68,875	38,300	68,756	38,267
Adjusted-R^2	0.3581	0.3508	0.3697	0.3574

Table 4: Demand Shock - Constrain

This table presents the results from OLS regressions relating financial reporting quality to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 2002. The dependent variable is a measure of discretionary accruals. I define *Constrain* as a dummy variable if a firm's measure of net operating assets is larger than the industry-year median, and zero otherwise. All variables are defined in Appendix B. Standard errors are corrected for heteroskedasticity and clustered at the state level. ***, **, and * indicate significance at the 1%, 5%, and 10% level, respectively.

	(1) Constrain = 0 Disc. Acc	(2) Constrain = 1 Disc. Acc	(3) Constrain = 0 Disc. Acc	(4) Constrain = 1 Disc. Acc
Post GF	0.0006	0.0002	-0.0006	-0.0012
	(0.003)	(0.004)	(0.003)	(0.004)
Demand Shock	0.0243***	0.0165***	0.0239***	0.0171***
	(0.001)	(0.001)	(0.001)	(0.001)
Post GF X Demand Shock	0.0069***	0.0043	0.0072***	0.0058
	(0.002)	(0.002)	(0.002)	(0.002)
Post IC	0.0003	-0.0007	0.0004	-0.0006
	(0.002)	(0.002)	(0.002)	(0.002)
Post PP	-0.0038*	0.0024	-0.0034*	0.0024
	(0.002)	(0.002)	(0.002)	(0.002)
Size			0.0163***	0.0129***
			(0.002)	(0.001)
Leverage			-0.0280***	-0.0185***
			(0.005)	(0.002)
Market-to-Book			0.0001	-0.0005***
			(0.000)	(0.000)
ROA			-0.0235***	-0.0028
			(0.004)	(0.006)
State GDP Growth			-0.0198	-0.0389*
			(0.025)	(0.020)
Constant	-0.0264***	-0.0208***	-0.0503***	-0.0431***
	(0.002)	(0.002)	(0.005)	(0.004)
Firm Fixed Effects	Yes	Yes	Yes	Yes
Year Fixed Effects	Yes	Yes	Yes	Yes
Observations	52,867	54,308	52,867	54,308
Adjusted-R^2	0.3749	0.3865	0.3754	0.3937

Table 5: Evolution over Time

This table presents the results from OLS regressions relating financial reporting quality to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 2002. The dependent variable is a measure of discretionary accruals. *Post GF 10*$^{-}$ is an indicator that equals one if a firm is headquartered in a state that adopted a good-faith exception in the first ten years after the adoption, and zero otherwise. *Post GF 10*$^{+}$ is an indicator that equals one if a firm is headquartered in a state that adopted a good-faith exception at least ten years earlier, and zero otherwise. All variables are defined in Appendix B. Standard errors are corrected for heteroskedasticity and clustered at the state level. ***, **, and * indicate significance at the 1%, 5%, and 10% level, respectively.

	(1)	(2)	(3)
	Disc. Acc	Disc. Acc	Disc. Acc
Post GF 10^{-}	-0.0021	-0.0031	-0.0018
	(0.002)	(0.003)	(0.002)
Post GF 10^{+}	0.0011	0.0007	0.0001
	(0.002)	(0.002)	(0.002)
Demand Shock	0.0185***	0.0185***	0.0187***
	(0.001)	(0.001)	(0.001)
Post GF 10^{-} X Demand Shock	0.0079**	0.0077**	0.0079**
	(0.003)	(0.003)	(0.003)
Post GF 10^{+} X Demand Shock	0.0020	0.0013	0.0023*
	(0.001)	(0.001)	(0.001)
Constant	-0.0454***	-0.0467***	-0.0498***
	(0.003)	(0.003)	(0.003)
Controls	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes
Year Fixed Effects	Yes	No	No
Region-Year Fixed Effects	No	Yes	No
Industry-Year Fixed Effects	No	No	Yes
Observations	107,242	107,242	107,242
Adjusted-R^2	0.3640	0.3652	0.3799

Table 6: Endogeneity Analysis

This table presents the results from OLS regressions relating financial reporting quality to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 2002. The dependent variable is a measure of discretionary accruals. *Post* GF^{-3} is an indicator that equals one if a firm is headquartered in a state that will pass the good-faith exception in three years. The other dummy variables are defined similarily, except for *Post* GF^{2+} that is an indicator variable that equals one if a firm is headquartered in a state that adopted a good-faith exception two or more years ago, and zero otherwise. All variables are defined in Appendix B. Standard errors are corrected for heteroskedasticity and clustered at the state level. ***, **, and * indicate significance at the 1%, 5%, and 10% level, respectively.

	(1) Disc. Acc	(2) Disc. Acc	(3) Disc. Acc
Post GF^{-3} X Demand Shock	-0.0007	0.0010	-0.0034
	(0.004)	(0.005)	(0.004)
Post GF^{-2} X Demand Shock2	0.0141	0.0154	0.0143
	(0.010)	(0.010)	(0.009)
Post GF^{-1} X Demand Shock1	-0.0035	-0.0037	-0.0040
	(0.005)	(0.005)	(0.005)
Post GF^{0} X Demand Shock	0.0009	0.0006	-0.0001
	(0.006)	(0.006)	(0.006)
Post GF^{1} X Demand Shock	0.0036	0.0024	0.0034
	(0.007)	(0.007)	(0.008)
Post GF^{2+} X Demand Shock	0.0063***	0.0057***	0.0062***
	(0.002)	(0.002)	(0.002)
Post GF^{-3}	0.0034	0.0009	0.0031
	(0.003)	(0.003)	(0.003)
Post GF^{-2}	-0.0035	-0.0062	-0.0038
	(0.003)	(0.005)	(0.003)
Post GF^{-1}	0.0084**	0.0085*	0.0074**
	(0.004)	(0.005)	(0.004)
Post GF^{0}	0.0056	0.0036	0.0039
	(0.004)	(0.005)	(0.004)
Post GF^{1}	0.0038	0.0008	0.0024
	(0.005)	(0.005)	(0.005)
Post GF^{2+}	0.0021	0.0028	0.0014
	(0.003)	(0.005)	(0.003)
Demand Shock	0.0206***	0.0207***	0.0211***
	(0.001)	(0.001)	(0.001)
Constant	-0.0499***	-0.0509***	-0.0511***
	(0.003)	(0.004)	(0.004)
Control Variables	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes
Year Fixed Effects	Yes	No	No
Region-Year Fixed Effects	No	Yes	No
Industry-Year Fixed Effects	No	No	Yes
Observations	107,023	107,023	107,023
Adjusted-R^2	0.3747	0.3758	0.3903

Table 7: Demand Shock - Employees' Location

This table presents the results from OLS regressions relating financial reporting quality to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 2002. The dependent variable is a measure of discretionary accruals. I define *Dispersed* as a dummy variable if a firm's belong to a dispersed industry as per its SIC code. All variables are defined in Appendix B. Standard errors are corrected for heteroskedasticity and clustered at the state level. ***, **, and * indicate significance at the 1%, 5%, and 10% level, respectively.

	(1) Dispersed = 0 Disc. Acc	(2) Dispersed = 1 Disc. Acc	(3) Dispersed = 0 Disc. Acc	(4) Dispersed = 1 Disc. Acc
Post GF	0.0027	-0.0016	0.0014	-0.0021
	(0.003)	(0.005)	(0.003)	(0.005)
Demand Shock	0.0178***	0.0235***	0.0202***	0.0237***
	(0.001)	(0.002)	(0.001)	(0.002)
Post GF X Demand Shock	0.0055***	-0.0013	0.0067***	-0.0004
	(0.001)	(0.008)	(0.001)	(0.008)
Post IC	0.0005	-0.0040	0.0006	-0.0035
	(0.002)	(0.003)	(0.001)	(0.003)
Post PP	-0.0024	0.0025	-0.0021	0.0022
	(0.002)	(0.002)	(0.002)	(0.002)
Size			0.0143***	0.0061***
			(0.001)	(0.002)
Leverage			-0.0209***	-0.0229**
			(0.003)	(0.009)
Market-to-Book			-0.0004***	0.0004
			(0.000)	(0.000)
ROA			0.0132**	-0.0051
			(0.005)	(0.007)
State GDP Growth			-0.0273*	-0.0521
Constant	-0.0245***	-0.0237***	-0.0515***	-0.0324***
	(0.001)	(0.004)	(0.003)	(0.009)
Firm Fixed Effects	Yes	Yes	Yes	Yes
Year Fixed Effects	Yes	Yes	Yes	Yes
Observations	93,516	13,574	93,516	13,574
Adjusted-R^2	0.3684	0.3291	0.3795	0.3316

Table 8: Demand Shock - Accounting for Series of Sales Decline

This table presents the results from OLS regressions relating financial reporting quality to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 2002. The dependent variable is a measure of discretionary accruals. In this table, the variable *Demand Shock* is equal to one only if a sales decline in a given year is followed by a sales increase in the following year. All variables are defined in Appendix B. Standard errors are corrected for heteroskedasticity and clustered at the state level. ***, **, and * indicate significance at the 1%, 5%, and 10% level, respectively.

	(1)	(2)	(3)
	Disc. Acc	Disc. Acc	Disc. Acc
Post GF	0.0036	0.0038	0.0030
	(0.003)	(0.003)	(0.002)
Demand Shock	0.0172***	0.0172***	0.0174***
	(0.001)	(0.001)	(0.001)
Post GF X Demand Shock	0.0046**	0.0045**	0.0050**
	(0.002)	(0.002)	(0.002)
Post IC	-0.0000	0.0001	-0.0007
	(0.001)	(0.001)	(0.001)
Post PP	-0.0013	-0.0027*	-0.0009
	(0.001)	(0.001)	(0.001)
Size	0.0124***	0.0124***	0.0127***
	(0.001)	(0.001)	(0.001)
Leverage	-0.0201***	-0.0203***	-0.0202***
	(0.003)	(0.003)	(0.003)
Market-to-Book	-0.0005***	-0.0004***	-0.0004***
	(0.000)	(0.000)	(0.000)
ROA	0.0061	0.0060	0.0069
	(0.005)	(0.005)	(0.005)
State GDP Growth	-0.0527***	-0.0497***	-0.0378***
	(0.014)	(0.011)	(0.012)
Constant	-0.0442***	-0.0449***	-0.0538***
	(0.003)	(0.004)	(0.004)
Controls	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes
Year Fixed Effects	Yes	No	No
Region-Year Fixed Effects	No	Yes	No
Industry-Year Fixed Effects	No	No	Yes
Observations	107,242	107,242	107,242
Adjusted-R^2	0.3666	0.3678	0.3826

Table 9: Demand Shock - Balance of the Sample

This table presents the results from OLS regressions relating financial reporting quality to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 2002. The dependent variable is a measure of discretionary accruals. In this table, I excluded observations from the state of California. All variables are defined in Appendix B. Standard errors are corrected for heteroskedasticity and clustered at the state level. ***, **, and * indicate significance at the 1%, 5%, and 10% level, respectively.

	(1)	(2)	(3)
	Disc. Acc	Disc. Acc	Disc. Acc
Post GF	0.0032	0.0040	0.0022
	(0.004)	(0.005)	(0.004)
Demand Shock	0.0164***	0.0165***	0.0168***
	(0.001)	(0.001)	(0.001)
Post GF X Demand Shock	0.0046**	0.0035*	0.0046**
	(0.002)	(0.002)	(0.002)
Post IC	-0.0010	-0.0009	-0.0016
	(0.001)	(0.001)	(0.001)
Post PP	-0.0018	-0.0017	-0.0010
	(0.002)	(0.002)	(0.001)
Size	0.0156***	0.0156***	0.0163***
	(0.001)	(0.001)	(0.001)
Leverage	-0.0313***	-0.0316***	-0.0313***
	(0.004)	(0.004)	(0.004)
Market-to-Book	0.0001	0.0001	0.0001
	(0.000)	(0.000)	(0.000)
ROA	-0.0309***	-0.0308***	-0.0311***
	(0.005)	(0.005)	(0.005)
State GDP Growth	-0.0220	-0.0204	-0.0267
	(0.019)	(0.018)	(0.022)
Controls	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes
Year Fixed Effects	Yes	No	No
Region-Year Fixed Effects	No	Yes	No
Industry-Year Fixed Effects	No	No	Yes
Observations	92,774	92,774	92,774
Adjusted-R^2	0.3540	0.3552	0.3673

Table 10: Regulation and Amount of Decline in Sales

This table presents the results from OLS regressions relating the amount of decline in sales to the enactment of wrongful discharge laws for Compustat industrial firms from 1967 to 2002. In this table, the sample consists exclusively of firm-year observations where firms experience an annual decline in sales. The dependent variable is equal to the yearly change in sales. All variables are defined in Appendix B. Standard errors are corrected for heteroskedasticity and clustered at the state level. ***, **, and * indicate significance at the 1%, 5%, and 10% level, respectively.

	(1) ΔSale_t	(2) ΔSale_t	(3) ΔSale_t
Post GF	-0.0006	-0.0006	-0.0007
	(0.007)	(0.008)	(0.004)
Post IC	-0.0004	-0.0005	0.0025
	(0.005)	(0.005)	(0.005)
Post PP	-0.0038	-0.0045	0.0007
	(0.004)	(0.005)	(0.005)
Constant	-0.0985***	-0.0977***	-0.1002***
	(0.006)	(0.006)	(0.007)
Firm Fixed Effects	Yes	Yes	Yes
Region-Year Fixed Effects	No	Yes	No
Industry-Year Fixed Effects	No	No	Yes
Observations	29,754	29,754	29,754
Adjusted-R^2	0.3301	0.3487	0.3831