



## FACULTY &amp; RESEARCH

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# Labor Unemployment Insurance and Earnings Management

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## Abstract

There is relatively little prior evidence on the potential impact of rank and file employees on financial reporting choices outside union negotiations. We contribute to the literature by providing new evidence that firms appear to manage long-run earnings upward in order to manage employee 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. An increase in unemployment benefits makes unemployment relatively less costly and reduces employees' unemployment risk, thereby reducing firms' upward earnings management incentives. Consistent with the hypothesis, we find a significant reduction in abnormal accruals, increased recognition of special items and write downs, and greater downward restatement likelihood following an increase in state-level unemployment benefits. Cross-sectional tests suggest greater unwinding of prior upward earnings management when other upward earnings management incentives are weak and when unemployment risk is a relatively more important determinant of firms' labor costs. Collectively the results provide new evidence of the impact of rank and file employees on firms' financial reporting choices.

**Keywords:** [Earnings Management](#); [Employment](#); [Insurance](#); [Financial Reporting](#);

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