RESEARCH ARTICLE | JULY 01 2007

Profits versus Losses: Does Reporting an Accounting Loss Act as a Heuristic Trigger to Exercise the Abandonment Option and Divest Employees?

Matt Pinnuck; Anne M. Lillis

+ Author & Article Information

The Accounting Review (2007) 82 (4): 1031–1053.

https://doi.org/10.2308/accr.2007.82.4.1031

Views Share Tools Cite

The binary classification of firms into profits or losses represents a powerful heuristic. The literature that has examined the impact on the firm of this earnings heuristic has focused on the earnings management actions of small profit firms. The impact of this earnings heuristic on the actions of firms reporting accounting losses and the decision-making effects the heuristic may have other than earnings management have not been examined. In this study we hypothesize that reporting an accounting loss acts as a heuristic trigger for firms to exercise the abandonment option and discard unproductive investments. The results are consistent with the hypothesis. We find that there is a sharp and economically significant discontinuity around zero in the level of investment in labor between small profit and small loss firms. The discontinuity is due to loss firms having a lower-than-expected level of investment in labor, given their economic fundamentals. Further tests show that this discontinuity is due to the exercise of the abandonment option. We find that firms switching from a profit to a loss cut labor to a greater extent than other firms with similar changes in earnings that do not pass the loss threshold. Taken together the results are consistent with the accounting loss heuristic acting as a major disciplinary or incentive altering event that resolves agency problems.

Print ISSN: 0001-4826 **Online ISSN:** 1558-7967