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Original Article

Financial Reporting Quality and Labor Investment Efficiency[†]

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Financial Reporting Quality and Labor Investment Efficiency*

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1. Introduction

A large literature in finance provides evidence that agency conflicts and information asymmetry between managers and outsiders lead firms to undertake suboptimal levels of investment (Hubbard 1998 and Stein 2003 provide surveys of this literature). Recent accounting research builds on this notion in arguing that high-quality financial reporting can serve to mitigate such market imperfections and improve investment efficiency (e.g., Bushman and Smith 2001; Healy and Palepu 2001; Lambert, Leuz, and Verrecchia 2007). Consistent with this argument, a growing body of empirical evidence suggests that high-quality accounting is associated with more efficient capital investments (e.g., Biddle and Hilary 2006; McNichols and Stubben 2008; Biddle, Hilary, and Verdi 2009). We extend this line of research by examining investments in labor, an important factor of production that has been largely overlooked by previous literature.

We posit that high-quality financial reporting leads to more efficient investments in labor by mitigating market frictions that stem from information asymmetry between managers and outside capital suppliers. For example, overinvestment in labor could occur if agency conflicts lead self-interested managers to engage in empire-building activities such as overhiring or retaining employees associated with underperforming projects (underfiring).[1] High-quality financial reporting can potentially mitigate such moral hazard problems by enabling more efficient contracting and enhancing the monitoring abilities of investors and other outsiders. Underinvestment in labor could also occur if, for example, information asymmetry between managers and investors creates adverse selection in the timing of securities offerings. If investors protect themselves from their information disadvantage by discounting the price of securities, the financing of otherwise profitable investments in labor could prove prohibitively costly, leading to underhiring or overfiring.[2] By reducing information asymmetry between managers and investors, high-quality financial reporting also has the potential to mitigate such adverse selection problems.

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1. As argued by Williamson (1963, 1034), "the incentive to expand staff may be difficult to resist. Not only is it an indirect means to the attainment of salary, but it is a source of security, power, status, prestige, and professional achievement as well." Recent evidence linking agency conflicts with inefficient labor investments can be found in Chen, Lu, and Sougiannis (2012b), Cronqvist, Heyman, Nilsson, Svaleryd, and Vlachos (2009), and Atanassov and Kim (2009).
2. See Benmelech, Bergman, and Seru 2011 and Campello, Graham, and Harvey 2010 for recent evidence of external financing costs constraining firms' employment decisions.

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Supporting Information

Filename	Description
care12053-sup-0001-TableS7-S8.pdf application/PDF, 210.6 KB	**Table S7.** Abnormal net hiring and future performance **Table S8.** The moderating role of unionized labor

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