

# **Elections and Discretionary Accruals: Evidence from 2004**

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**Working Paper**

**09-103**

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# **Elections and Discretionary Accruals: Evidence from 2004\***

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This draft: March 9, 2009  
Original Draft: March 31, 2008

## **Abstract**

We examine the accrual choices of outsourcing firms with links to US congressional candidates during the 2004 elections, when corporate outsourcing was a major campaign issue. We find that politically-connected firms with more extensive outsourcing activities have more income-decreasing discretionary accruals. Further, relative to adjacent periods, the evidence is concentrated in the two calendar quarters immediately preceding the 2004 election, consistent with heightened incentives for firms to manage earnings during the election season. The incentives can be attributed to donor firms' concerns about the potentially negative consequences of scrutiny over outsourcing for themselves and for their affiliated candidates.

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\* We thank William Baber, Richard Frankel, Paul Healy, S.P. Kothari, Krishna Palepu, Douglas Skinner, Rodrigo Verdi, Ross Watts, an anonymous referee, and seminar participants at Georgetown University and Massachusetts Institute of Technology for helpful comments; Harvard University and Massachusetts Institute of Technology for financial support; and the division of research at Harvard Business School for research assistance. Any errors are our responsibility. This paper was previously circulated under the title: "Accounting information as political currency."

## 1. Introduction

We examine the accrual choices made by outsourcing firms with links to US congressional candidates in the 2004 elections, when corporate outsourcing was a major campaign issue. We find that the politically-connected firms' discretionary accruals in the two calendar quarters immediately preceding the 2004 election vary negatively with the extent of their past outsourcing activities. The results are consistent with firms using accounting choice to manage the political costs they face from negative outsourcing-related scrutiny. In the process, donor firms are also likely to shield their affiliated candidates from political embarrassment resulting from similar scrutiny, thus consolidating their relationships with the candidates.

This paper attempts to broaden our understanding of the relation between accounting and the political process beyond the political cost hypothesis as specified by Watts and Zimmerman (1978, 1986). That hypothesis was originally formulated as follows: *ceteris paribus*, larger firms are more likely to choose accounting procedures that defer reported earnings from current to future periods. The intuition is that large firms, being more visible, are more likely to attract public attention when they declare large profits. Such public attention, in turn, is likely to result in higher taxes and costly regulatory oversight. By deferring earnings from current to future periods, large firms avoid the costs associated with high visibility and large profits. An extension of the political cost hypothesis was developed by Jones (1991) who found that firms likely to benefit from government-sponsored import relief attempted to manage earnings downward during import relief investigations. The basic premise in Jones is that firms manage earnings in order to extract first-order benefits from regulators; in Watts and

Zimmerman, it is that firms manage earnings in order to avoid first-order costs from regulators.

We develop and test the political costs hypothesis in a unique setting: US congressional elections. Elections signify events during which corporate donors and the contesting candidates they support are susceptible to increased political scrutiny, with the potential for negative consequences for both. Corporate donors thus have incentives to make accounting choices with the dual objective of minimizing the costs associated with adverse political scrutiny for themselves, while also shielding their affiliated candidates from political embarrassment to the extent possible. The latter effort is important to contributing firms because it likely consolidates their relationships with political candidates, and can be associated with future benefits if those candidates win congressional office.

We identify an election campaign where accounting earnings are likely to be relevant in the political discourse: the 2004 US general elections. A prevailing campaign issue in the 2004 elections was that firms were outsourcing US jobs to low-cost markets overseas (Taylor, 2005). Further, the profits generated by outsourcing were perceived as being concentrated in the hands of a few. Political candidates in 2004 risked the ire of the voting public if their corporate contributors were identified and highlighted as profitable outsourcing firms in the media.<sup>1</sup> Corporate contributors also faced the possibility that negative political scrutiny of their outsourcing activities during the elections would generate political costs such as voter boycotts of their products and politically motivated anti-outsourcing legislation.

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<sup>1</sup> Section 2 provides examples of press articles from 2004 in which congressional candidates were accused of accepting campaign contributions from outsourcing firms.

Profits of the firm are influenced by managers' accounting discretion. If by understating current reported profits, donor firms with outsourcing activities can mitigate negative exposure for both themselves and their affiliated politicians, we expect such firms to engage in income-decreasing accruals management prior to the elections of 2004. Specifically, we hypothesize that firms with a history of campaign contributions to congressional candidates in the 2004 election had incentives to take income-decreasing accounting actions prior to that election if they were engaged in outsourcing.<sup>2</sup>

To test our hypotheses, we first identify the Democratic and Republican candidates in most congressional election races in 2004. We then focus on corporate donors that are among the 20 largest PAC (political action committee) contributors to these candidates. We measure income-decreasing accounting actions among these corporate donors using performance-matched discretionary accruals as described in Kothari *et al.*, 2005.<sup>3</sup> To determine whether the corporate donors engaged in outsourcing prior to 2004, we develop two empirical proxies described below.

First, we collect data on the press coverage of each sample firm's outsourcing activities. We expect corporate donors that have experienced recent increases in media coverage on outsourcing to be more likely to invite further scrutiny during elections, and thus to have more pronounced incentives to make income-decreasing accounting choices in 2004. Second, we construct a measure of outsourcing based on "abnormal" workforce

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<sup>2</sup> In a given fiscal period, there are likely several agency-based incentives shaping a firm's accounting choices (*Fields et al.*, 2001). We identify a setting and sample where incentives to avoid political costs are likely prevalent. It is likely that other agency incentives also shape accounting choices in our sample of firms, but we do not expect such incentives to be systematic.

<sup>3</sup> Estimating "discretionary accruals" in the context of measuring "earnings management" is an area of active debate among accounting academics. We argue in section 2.3 that performance-matched discretionary accruals are appropriate in our setting of the 2004 congressional elections. Nevertheless, we recognize the possibility of additional limitations with performance-matched discretionary accruals, and accordingly, recommend appropriate caution in interpreting the results.

reductions, i.e., past decreases in firm-level employment not predicted by declining firm-level economic conditions. Corporate donors are likely to have incentives to understate reported income if they can be implicated in outsourcing-related job cuts: recall that the shedding of jobs by otherwise healthy companies is a primary outsourcing-related concern likely to invite voter ire.

We examine in cross-sectional tests whether downward earnings management among donor firms in the sample varies with the outsourcing proxies described above. In these tests, we focus on accruals management in the second and third calendar quarters of 2004 (hereafter, the *MID-2004* period), since these quarters immediately preceded the November elections. The results indicate that in *MID-2004*, firms with increased press coverage of donors' outsourcing exhibit lower performance-matched discretionary accruals, consistent with greater downward earnings management. Results using the second proxy for outsourcing, abnormal workforce reductions, are more nuanced. We find greater evidence of downward earnings management among donor firms with greater workforce reductions, but only when the firms are contributors to candidates in "closely watched" elections, i.e., elections without incumbents or with close or contradictory information being reported by pollsters.

The contrasting results on press coverage and abnormal workforce reduction suggest the former outsourcing proxy is perceived by firms as more likely than the latter to generate undesirable political scrutiny during elections. Thus, firms with increased media coverage of outsourcing activities make income-decreasing accounting choices irrespective of the nature of their affiliated candidates' races. In contrast, the association between downward earnings management and abnormal workforce reductions is limited

to firms whose affiliated candidates contest closely watched races. In closely watched elections, the dissemination of unfavorable information (such as outsourcing-related workforce reductions not already highlighted in the media) is both more probable because of opponents' incentives to uncover such information, and more undesirable since these races are usually tight contests.<sup>4</sup>

We next investigate whether the incentives for downward earnings management among outsourcing donor firms were particularly pronounced in *MID-2004* relative to the periods immediately preceding and following the elections. In time-series tests where the four quarters that precede and follow *MID-2004* serve as benchmark periods, we find that the association between outsourcing and downward earnings management is restricted only to the *MID-2004* period. The results are consistent with heightened incentives for firms to manage their political costs during the election season. The incentives can be attributed to donor firms' concerns over the fallout of bad publicity from their outsourcing for themselves or for their affiliated politicians.

We perform a number of additional analyses. First, we document that outsourcing-related press coverage and abnormal workforce reductions exhibit incremental negative associations (relative to each other) with the performance matched discretionary accruals of donor firms in *MID-2004*. This is consistent with the two measures capturing different aspects of the firms' outsourcing concerns during the election period. Second, we develop alternate measures to capture changes in outsourcing-related press coverage and workforce reductions that are contemporaneous to

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<sup>4</sup> The results are consistent with there being costs to managing earnings. If earnings management is costly, then it should be observed when the expected benefits are more pronounced. The potential costs of earnings management include the obfuscation of relevant information for firm investors, and the associated risk of detection by auditors and/or investors with consequent regulatory scrutiny and shareholder litigation (see Dechow and Skinner, 2000).

our measurement of earnings management. Performance matched discretionary accruals continue to exhibit a significant negative association with the contemporaneous measure of abnormal workforce reductions, but not with the contemporaneous measure of outsourcing-related press coverage. Time-series patterns in outsourcing-related press coverage are consistent with the possibility of contemporaneous press coverage itself being subject to management by donor firms in the *MID-2004* period.

The remainder of this paper is organized as follows. Section 2 describes our choice of the setting and sample, defines key variables, and describes the data. Section 3 provides evidence on sample firms' management of information relating to outsourcing in 2004. That section also describes the results of additional tests to corroborate the main results. Section 4 concludes.

## **2. Setting, sample, key definitions, and description of the data**

Any politically motivated earnings management is likely balanced against other incentives that shape accounting and financial reporting (see for example, the vast literature on agency-related incentives and accounting choice, Fields *et al.*, 2001). Thus, testing our hypothesis requires identifying a setting and sample where the political incentives make a clear directional prediction on the nature of earnings management. For the setting, we identify an election season where corporate policies were a major part of the political debate—the 2004 US elections when overseas outsourcing by US firms was heavily discussed. For the sample, we focus on the major corporate contributors to the Democratic and Republican candidates in the 2004 congressional races.

## 2.1. Setting

The year 2004 was a presidential election year with a hotly contested race for the White House. Democratic presidential challenger, Sen. John Kerry, and allied political groups made outsourcing of US jobs a key theme in their campaigns. They alleged that policies of the incumbent Republican president, George Bush, and the Republican-controlled Congress were facilitating the outsourcing of US jobs overseas (see for example, *Fox News*, 2004 and *New York Times*, 2004). The issue of outsourcing—and campaign contributions received from alleged outsourcers—entered the debate in specific congressional races as well. For example, the *Dayton Daily News* reported in October 2004 on challenger Jane Mitakides’ (Democrat) attempts to highlight Rep. Mike Turner’s (R-OH) involvement with outsourcers: “...Jane Mitakides (D) said Mike Turner’s (R) support for outsourced jobs is seen in the political contributions his campaign has received from ... Raj Soin, founder of Dayton-based Modern Technologies Corp... Soin denies the claim that his company outsources jobs.” Democratic candidates and non-incumbents were not immune to outsourcing-related criticism either. In an October 2004 article titled “Missouri Senate candidates spar over job, trade policies,” the *Columbia Daily Tribune* reported that incumbent Republican senator Kit Bond had said his Democratic challenger Nancy Farmer had “...accepted campaign money from employees of companies that outsource.<sup>5</sup>”

Stagnant to slow job growth in the years leading up to the 2004 election helped support the claims against outsourcing. Taylor (2005, p. 367) notes how “‘outsourcing’ became a political dirty word during the 2004 election campaign.” The media widely reported on the outsourcing issue and it became part of the information environment in

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<sup>5</sup> Note corporate PACs are financed by contributions from their employees and shareholders.

the 2004 election (a Factiva search for articles in the *New York Times* and the *Wall Street Journal* between January 1, 2004 and Election Day, 2004 that contained both “outsource” and “election” returned 191 unique stories). Even prominent economists weighed in on the debate (see for example, Bhagwati *et al.*, 2004, and Samuelson, 2004).

With outsourcing of US jobs being a key issue in the 2004 election, we expect both firms engaged in outsourcing and candidates with ties to those firms to benefit from firm-actions that minimized disclosure of this information. Accordingly, in the case of accounting information related to outsourcing, we test for income-decreasing accruals management. The underlying assumption is that outsourcing is perceived to be net profitable and thus, the use of income-decreasing accruals management enables donor firms to deflect public scrutiny of both the firm and the political candidate.<sup>6</sup> By hiding information related to outsourcing, donor firms likely mitigated outsourcing-related political costs such as voter boycotts of their products and politically motivated anti-outsourcing legislation.<sup>7</sup> Further, such actions likely also assisted the firms’ affiliated candidates in their election campaigns, thus generating the possibility of future political benefits for the firms if the candidates won congressional office. *A priori* we expect that the benefits from downward earnings management accrued to the firms and their affiliated candidates irrespective of the latter’s party affiliation or incumbency status.

The view that political candidates and their donor firms exchange favors is actively debated in the political science literature. For example, it is hypothesized that monetary contributions by corporate entities, in the form of campaign finance and

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<sup>6</sup> The assumption that outsourcing is perceived as net-profitable is reasonable because if outsourcing is not cheaper than producing in-house, a firm would not choose to outsource.

<sup>7</sup> As an example of voter boycotts, *Rocky Mountain News* reported in September 2004 on efforts by the National Hire American Citizens Society to boycott Coors beer over the company’s outsourcing: Coors creates jobs, “but not for Americans,” said Richard Armstrong, the Society’s president. The Coors Company was the largest PAC contributor to the Colorado senatorial campaign of Republican Peter Coors.

lobbying expenditures, can be used to buy favors from politicians (see for example, Hart, 2001). A number of studies discuss the relationships firms and politicians establish with one another and the increasing value to firms of such relationships over time (Snyder, 1992; Kroszner and Stratmann, 2005). When a politician with a well-established relationship with a firm faces election, it is then in the firm's interest to take actions that assist the politician's election campaign. Our study can be seen as suggesting that outsourcing donor firms make income-decreasing choices during the elections to not only avoid direct political costs, but also to ensure future benefits by consolidating their established relationships with affiliated politicians.

## ***2.2. Sample***

To construct the sample, we start with all Democratic and Republican candidates in congressional races in 2004 (i.e., third-party candidates are excluded). We eliminate races in Louisiana (where multiple from the same party can contest an election) and races in the District of Columbia and US territories (whose representatives are ineligible to vote in Congress). These criteria give us an initial sample of 836 congressional candidates to follow.

We are interested in identifying firms that have established relationships with the 836 candidates. To identify such firms, we start with all firms on Compustat that have a registered Political Action Committee (PAC). There are 1,530 such firms. From this sample of firms, we keep only those firms that are among the 20 largest PAC donors to at least one of the 836 candidates in the four-year period leading up to the November 2004

election.<sup>8</sup> There are 434 such firms. The selection of firms on the criterion of being among the 20 largest PAC donors to a candidate is consistent with the proposition that large cash giving can be used to establish links between politicians and firms (see for example, Stratmann, 2005). Of the 434 firms that meet our selection criterion, 283 firms have all of the raw data required to estimate the proxies for earnings management and outsourcing (discussed shortly).

As an added measure to extract power from the sample, we identify congressional races in 2004 that were closely followed by the media due to greater uncertainty about their outcomes. We use data compiled by The Green Papers, a non-partisan election-related website, to make this identification. In particular, we classify races with no incumbents or races with “close, interesting, or contradictory information” being reported by pollsters (as compiled by The Green Papers five days prior to Election Day, November 2, 2004) as “closely watched races.” We argue candidates in such races are more likely to be vulnerable to charges that they are accepting cash contributions from outsourcing firms (because such races are usually tight contests, opponents have greater incentives to uncover this information). Accordingly, downward earnings management by outsourcing corporate donors is potentially more valuable to firms and their affiliated candidates when those candidates are in closely watched races. We define an indicator variable, *CTWGiver*, set equal to one if a donor firm in the sample has contributed to a candidate in a “closely watched race” during the four years leading up to the 2004 elections. In subsequent empirical tests, we investigate whether *CTWGiver* augments the

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<sup>8</sup> The 20 largest PAC donors to each of the 836 congressional candidates in the four-year period leading up to the November 2004 election constitute 5,458 unique organizations (including, ideological and special-interest groups, law firms and other private companies, labor unions, universities, etc.). We match the list of 1,530 Compustat firms with PACs to this list of 5,458 organizations to identify firms that are likely to have established relationships with the congressional candidates in our sample.

ability of the outsourcing proxies to explain cross-sectional variation in earnings management in the sample.

### ***2.3. Measuring earnings management***

As noted earlier, our construct for the management of earnings in response to political incentives is income-decreasing accruals management. We measure income-decreasing accruals management using performance-matched discretionary accruals (Kothari *et al.*, 2005). Specifically, we test for lower performance-matched discretionary accruals during the second and third quarters of 2004 (*MID-2004*), since these quarters immediately preceded the November elections. In subsequent time-series tests, we benchmark the performance-matched discretionary accruals from *MID-2004* against those from the two two-quarter periods immediately preceding and following *MID-2004*, i.e., Q2'2003&Q3'2003 (hereafter, "*MID-2003*"), Q4'2003&Q1'2004 (hereafter, "*2003-04*"), Q4'2004&Q1'2005 (hereafter, "*2004-05*"), and Q2'2005&Q3'2005 (hereafter, "*MID-2005*").

To obtain performance-matched discretionary accruals for a given sample firm-quarter, we first calculate abnormal accruals for that firm-quarter. The abnormal accruals for a firm-quarter are given by the residual ( $\varepsilon$ ) from the following regression run quarterly within the firm's 3-digit NAICS-defined industry.

$$\text{Acc} = \beta_0 * \text{Intercept} + \beta_1 * \Delta \text{Sales} + \beta_2 * \text{PPE} + \varepsilon \quad (1)$$

In the above equation,  $Acc$  is defined (using Compustat Industrial Quarterly definitions) as  $(data8 - data108) / lag(data44)$ , in other words, the difference between income before extraordinary items and operating cash flows, over lagged period assets. The intercept is defined as  $1/lag(data44)$ , the inverse of lagged period assets.  $\Delta Sales$  is defined as  $(data2 - lag(data2)) / lag(data44)$ , the one-period change in sales over lagged period assets.  $PPE$  is defined as defined as  $lag(data42) / lag(data44)$ , lagged period net property, plant, and equipment over lagged period assets. All ratios are winsorized at the 1st and 99th percentile level of quarterly observations.

To obtain performance-matched discretionary accruals for a firm-quarter observation, we match that observation to one within its 3-digit NAICS-defined industry that is closest to it in terms of return-on-sales in the same fiscal quarter of the previous year. Return-on-sales is defined as the ratio of lagged period income-before-extraordinary-items to lagged period sales. The excess of a sample firm-year's abnormal accruals ( $\epsilon$ ) over its matched firm-year's abnormal accruals is its performance-matched discretionary accruals number (hereafter, *PerfAcc*).

A key concern with measuring “discretionary accruals” in the context of an “earnings management” study is that measured “discretion” in earnings can be the result of fundamental performance rather than pure accounting choice. In fact, the impact of fundamental economics on accrual policy is likely first order, while that of political incentives is likely secondary. The performance matching technique (of Kothari *et al.*) is an attempt at extracting a measure of earnings management that is conditional on economic performance and/or profitability. Since we are interested in discretionary accounting decisions that are not reflective of fundamental economic performance,

estimating performance-matched discretionary accruals is appropriate in the context of our study. Nevertheless, performance-matched discretionary accruals, like all other earnings management measures, capture managerial discretion on accounting choice with error: performance-matched discretionary accruals are possibly correlated with aspects of firm performance not controlled for in the Kothari *et al.* model. Accordingly, we recommend appropriate caution in interpreting the results.

#### ***2.4. Measuring firm-level outsourcing***

In the cross-section of firms in our sample, we expect the use of income-decreasing accruals management to vary with the firms' outsourcing activities. Accordingly, we develop firm-level measures of outsourcing.

Our first empirical proxy for outsourcing attempts to directly measure increased media coverage of the firm's outsourcing activities. For every firm and two-quarter period in our sample, we collect the number of press mentions of the firm's name and the word stem "outsourc" in the immediately preceding one-year period.<sup>9</sup> Because (a) levels of press coverage are likely to be highly associated with factors unrelated to outsourcing (e.g., firm visibility, size, location, etc.) and (b) we are interested in firms with increasing outsourcing activities, we use the percentage change in the annual "outsourc" count over the corresponding count in the prior one-year period. The resulting variable is denoted *OUTSOURC*. Thus, the performance-matched discretionary accruals of the *MID-2004*

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<sup>9</sup> Press mentions are obtained through an electronic search of 581 newspapers in the US file of the Factiva database. The specific search is for the stem of the company name (as provided in Compustat) and the word stem "outsourc." For example, a search for "Microsoft Corp" would include the terms "Microsoft" and "outsourc."

period are matched with the percentage change in the outsourcing-related press coverage in the year ended March 2004 over that in the year ended March 2003.

Since the main political concern with outsourcing has been workforce reduction within the United States, our second proxy for *ex ante* outsourcing activities is based on the unexpected decrease in employment among firms. Specifically, our firm-level measure of workforce reduction is based on the negative of the residual from the following regression estimated annually within the firm's 3-digit NAICS-defined industry.<sup>10</sup>

$$\Delta\text{Employees} = \gamma_0 * \text{Intercept} + \gamma_1 * \Delta\text{Sales} + \delta \quad (2)$$

In the above equation,  $\Delta\text{Employees}$  is defined (using Compustat Industrial Annual definitions) as  $(\text{data29} - \text{lag}(\text{data29})) / \text{lag}(\text{data6})$ , in other words, the one period increase in the number of employees, scaled by lagged assets. The intercept and  $\Delta\text{Sales}$  are defined as in equation (1), except using annual data (i.e., Intercept is  $1/\text{lag}(\text{data6})$  and  $\Delta\text{Sales}$  is  $(\text{data12} - \text{lag}(\text{data12})) / \text{lag}(\text{data6})$ ). The residual  $\delta$  represents the unexpected change in employment for a given year. Negative values of this residual are associated with decreases in employment after controlling for sales changes and are, we argue, a proxy for job losses that can be attributed to outsourcing. To allow for the proxy to *increase* with the level of outsourcing, we multiply it by -1. To allow for the proxy to be an *ex ante* measure of outsourcing we compute its two-year historical average. We call

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<sup>10</sup> The regression is estimated annually because data on the number of employees is available only at the annual level in Compustat.

the resulting variable, a measure of outsourcing-related workforce reduction,  $WFRED$ .<sup>11</sup> Thus, our measure for outsourcing for all quarters in a given year “ $t$ ,” i.e.,  $WFRED_t$ , is computed as follows.

$$WFRED_t = -1 * (\delta_{t-1} + \delta_{t-2})/2 \quad (3)$$

### ***2.5 Descriptive statistics on sample firms***

Table 1 provides average summary statistics across the second and third calendar quarters of 2004 (*MID-2004*) for the 283 corporate donor firms constituting our sample. Two-hundred-and-eighty firms have observations for both *MID-2004* quarters, while three firms have observations in only one of the *MID-2004* quarters. Accordingly, we have 563 quarterly observations in Table 1.<sup>12</sup> Corresponding statistics for the universe of Compustat firms in those quarters are also presented for comparison. As Table 1 reports, the mean sample firm has about \$18 billion in assets, relative to \$2.7 billion for the average firm on Compustat, indicating that sample firms are relatively large. This is expected given that larger firms tend to be more politically active.

Sample firms are also more profitable on average than the general population of Compustat firms. Median return-on-sales is 6.3% for sample firms and 2.8% for the Compustat universe. However, sample firms exhibit lower average performance-matched discretionary accruals (-0.0056) relative to Compustat firms (0.0012). Recall that

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<sup>11</sup>  $WFRED$  is estimated from industry-level regressions in order to extract the component of workforce reductions driven by outsourcing-related activities, rather than responses to poor economic circumstances. However, if outsourcing is clustered within industry, industry-adjustment can result in a loss of power.

<sup>12</sup> The results are similar when we exclude the three firms with only one observation in the *MID-2004* quarters.

performance-matched discretionary accruals are the measure of earnings management in this study.

Table 2 presents key descriptive statistics for sample firms for the *MID-2004* period along with comparable information for the four benchmark periods, *MID-2003*, *2003-04*, *2004-05*, and *MID-2005*. Panel A, which covers all sample firms, indicates positive sales growth on average in each of the periods presented. Sales growth increases between *MID-2003* and *MID-2004* (from 2.58% to 3.65%) consistent with improved economic activity during this period. US GDP growth increased from 4.7% in 2003 to 6.6% in 2004 (source: Bureau of Economic Analysis). Average return on sales also demonstrates an increase between *MID-2003* and *MID-2004*. Panel A also provides data on performance-matched discretionary accruals, the primary proxy for earnings management in our paper. Performance-matched discretionary accruals are more negative in *MID-2004* than in *MID-2003* or *MID-2005*, although no overall pattern is evident relative to the other benchmark periods.

Panel B of Table 2 presents the time-series variation in our key dependent variable, performance-matched discretionary accruals (*PerfAcc*), for several sub-samples. For corporate donor firms that contribute to at least one political candidate in a closely watched race, i.e., *CTWGiver=1* firms, mean *PerfAcc* is more negative in *MID-2004* than any of the benchmark periods. No such pattern emerges in the mean *PerfAcc* of *CTWGiver=0* firms, i.e., firms that do not contribute to any candidate in a closely watched race. Similarly, mean *PerfAcc* of firms with increased press coverage of their outsourcing activities (*OUTSOURC* > 0) is more negative in *MID-2004* than in any other period; this is not true of firms who do not experience increased press coverage. Finally,

when we partition on whether firms experienced workforce reductions or not, we do not observe a clear temporal pattern in mean *PerfAcc* for either group of firms. If *PerfAcc* is a good proxy for the management of information related to outsourcing, Panel B suggests that such information management, on average, is more pronounced in *MID-2004* among donors to candidates in closely watched races, and among donors with increased press-coverage of their outsourcing activities.

Note that the discussion in this sub-section is descriptive. To test for systematic cross-sectional and time-series variation in earnings management in the sample of donors, we turn to formal regression analyses reported in the next section. Appendix A has a summary of all variables used in the multivariate analyses.

### **3. Management of information related to outsourcing in 2004**

#### ***3.1. Cross-sectional tests***

In this section, we report on evidence of donor firms making strategic income-decreasing accruals choices in *MID-2004*, i.e., the second and third calendar quarters of 2004. Table 3 presents formal evidence on the cross-sectional variation in performance-matched discretionary accruals across sample firms in *MID-2004*. The dependent variable in Table 3 is performance-matched discretionary accruals (*PerfAcc*). Since regression data in Table 3 include multiple observations from sample firms (i.e., the two quarterly observations in *MID-2004*), all standard errors are clustered at the firm level.

Model 1 of Table 3 reports the results of a regression testing whether *PerfAcc* of donor firms is significantly lower for firms experiencing an increase in outsourcing-related press coverage. Thus, the key explanatory variable in this regression is

*OUTSOURC*. We also test whether the earnings management incentives of donor firms depend on whether they contribute to candidates contesting closely watched races by including *CTWGiver* as an explanatory variable. Finally, we test whether incentives to lower earnings among firms experiencing increased media coverage on outsourcing depend on the closely watched status of their affiliated candidates' races by interacting *CTWGiver* and *OUTSOURC*.

The coefficient on *OUTSOURC* in Model 1 of Table 3 is significantly negative, suggesting that firms manage earnings downward to a greater extent when they have increased media coverage on outsourcing. The coefficient implies that a single-standard-deviation increase in *OUTSOURC* is associated with a reduction in *PerfAcc* by 0.012. This is a significant amount given that mean *PerfAcc* among all sample firms during *MID-2004* is -0.0056. Further, the coefficient on *CTWGiver* is significantly negative, but that on *OUTSOURC\*CTWGiver* is statistically indistinguishable from zero. The results suggest that firms with increased media coverage on outsourcing understate reported income, irrespective of whether their affiliated candidates are contesting in closely watched election races.

Model 2 of Table 3 is similar to Model 1 in all aspects except that it replaces *OUTSOURC* with our second empirical measure of outsourcing: abnormal workforce reduction, denoted *WFRED*.<sup>13</sup> The coefficient on *WFRED* in Model 2 is not statistically significant. However, the coefficient on *WFRED\*CTWGiver* is negative and significant with a value of -15.401, implying that a single-standard-deviation increase in *WFRED* among firms contributing to candidates in closely watched races is associated with a

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<sup>13</sup> Throughout the paper, the number of observations in regressions including *WFRED* (n=537) is fewer than that in regressions including *OUTSOURC* (n=563) because we have insufficient data to estimate *WFRED* for all firms in the sample.

reduction in *PerfAcc* by 0.011 (mean *PerfAcc* among sample firms in *MID-2004* is -0.0056). The results with *WFRED* indicate that firms with recent workforce reductions manage earnings down to understate reported income, but only if they have contributed to candidates in closely watched races.

The collective evidence in Table 3 is consistent with donor firms engaging in downward earnings management to a greater extent when they have more outsourcing activities. Further, the results suggest that press coverage of outsourcing activities is perceived by firms as more likely to generate undesirable political scrutiny during elections than workforce reductions. Thus, firms with abnormal workforce reductions manage earnings down only when they contribute to candidates in closely watched races, where the expected benefits to both firms and their affiliated candidates from such earnings management is arguably higher. In contrast, among firms with increased media coverage of outsourcing, the nature of their affiliated candidates' races is not an issue in determining downward earnings management.

### **3.2. Time-series tests**

In Table 4, we benchmark the performance-matched discretionary accruals of sample firms in *MID-2004* against those in comparable adjacent periods. The purpose of Table 4 is to demonstrate that the cross-sectional variation in *PerfAcc* with a firm's outsourcing activities shown in Table 3 is limited to *MID-2004*, the period immediately preceding the November 2004 elections. Recall that the benchmark periods are the two consecutive two-quarter periods prior and subsequent to the event period. In all regressions in Table 4, we include a fourth-fiscal-quarter indicator to control for end-of-

fiscal-year effects (e.g., Mendenhall and Nichols, 1988). As in Table 3, all standard errors in Table 4 are clustered at the firm level.

In Model 1, the proxy for firm-level outsourcing is *OUTSOURC*. The coefficient on *OUTSOURC* in this regression indicates the average association between *PerfAcc* and outsourcing-related press coverage during the benchmark time periods. The coefficient on *OUTSOURC\*MID-2004* captures the incremental association between *PerfAcc* and *OUTSOURC* during the *MID-2004* period. The former coefficient is statistically insignificant, while the latter is significantly negative at the 90% confidence interval. The results show that the negative association between earnings management and outsourcing-related press coverage is limited to the *MID-2004* period.

The results in Model 1 of Table 4 also indicate that the coefficient on *OUTSOURC\*CTWGiver\*MID-2004* is statistically insignificant, i.e., there is no incremental association between *OUTSOURC* and *PerfAcc* in *MID-2004* for firms contributing to candidates to watch. The results confirm that press coverage on outsourcing activities generates incentives for *all* donor firms to make income-decreasing reporting choices in *MID-2004*, independent of whether they contribute to candidates to watch.

In Model 2 of Table 4, we perform the same tests as in Model 1, but with the second empirical measure of the extent of outsourcing, *WFRED* or abnormal workforce reductions. Thus, the coefficient on *WFRED\*CTWGiver* indicates the average association between *PerfAcc* and workforce reduction during the benchmark time period for firms contributing to candidates to watch. The coefficient on *WFRED\*CTWGiver\*MID-2004* captures the incremental association between *PerfAcc* and workforce reduction during the

*MID-2004* period for firms contributing to candidates to watch. The former coefficient is statistically insignificant, while the latter is significantly negative at the 95% confidence interval. The results show that among firms contributing to candidates in closely watched races, the negative association between earnings management and recent workforce reductions is limited to the *MID-2004* period.

Overall, the results in Table 4 indicate that the incentives for firms with outsourcing activities to manage earnings down was restricted to the quarters immediately preceding the November 2004 congressional elections. The evidence is consistent with elections substantially increasing the probability of negative political scrutiny for firms and affiliated candidates.<sup>14</sup>

### ***3.3 Incremental effects of *OUTSOURC* and *WFRED****

In Table 5 we examine whether the two proxies we use for outsourcing activities have incremental effects (relative to each other) on the downward earnings management by donor firms. The regression thus includes both *OUTSOURC* and *WFRED* as explanatory variables. Further, to investigate whether the joint effect of high abnormal workforce reductions and increased press coverage has a more pronounced effect on the performance-matched discretionary accruals of the donor firms, we also include the interacted variable *OUTSOURC\*WFRED*. Table 5 presents results for the time series specification which includes the four benchmark periods adjacent to *MID-2004*. Model 1 demonstrates that *OUTSOURC* and *WFRED* have incremental effects on the downwards earnings management decision of donor firms in *MID-2004*. The coefficients on both

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<sup>14</sup> If there are seasonal patterns in *PerfAcc* in the second and third calendar quarters of the year, *MID-2003* and *MID-2005* are more appropriate benchmarks to *MID-2004*. Accordingly, we re-estimate the regressions in this sub-section using only the *MID-2003*, *MID-2004* and *MID-2005* periods. Inferences are unchanged.

*OUTSOURC*\**MID-2004* and *WFRED*\**CTWGiver*\**MID-2004* are significantly negative at the 90% confidence level. Thus, donor firms with increased outsourcing-related press coverage and also those with workforce reductions that have contributed to candidates-to-watch make more income-decreasing accrual choices in *MID-2004*. In Model 2, we find that the coefficient on *OUTSOURC*\**WFRED*\**MID-2004* is negative but statistically insignificant. Thus, firms with high workforce reductions that have also received increased outsourcing-related press coverage do not appear to be incrementally likely to manage earnings down in *MID-2004*.

### ***3.4 Tests using alternate definitions of outsourcing***

In all tests reported so far, the empirical proxies for outsourcing are measured over the period immediately preceding that over which earnings management is measured. The main reason for this measurement choice is the possible endogeneity of the outsourcing measures to earnings management. In this sub-section, we test whether the findings are robust to alternate measures of media coverage and workforce reductions that are more contemporaneous with the measurement of earnings management.

To construct our alternate measure of outsourcing-related press coverage, denoted *OUTSOURC<sub>ALT</sub>*, we estimate the percentage annual change in the number of outsourcing-related press articles for the one-year period ending the quarter over which *PerfAcc* is measured. Thus, the performance-matched discretionary accruals of the *MID-2004* period are matched with the percentage annual increase in outsourcing-related press coverage for the year ended September 2004.

$OUTSOURC_{ALT}$  is a more powerful proxy of outsourcing-related incentives to manage earnings if donor firms, in making their financial reporting choices, react more to contemporaneous press mentions of outsourcing. However,  $OUTSOURC_{ALT}$ 's power is adversely affected by the likelihood that donor firms directly manage outsourcing-related press coverage in the *MID-2004* period, when the incentives to do so are high.

As with  $OUTSOURC_{ALT}$ , we construct an alternate measure of workforce reductions that is more contemporaneous with respect to the earnings management, denoted  $WFRED_{ALT}$ , and computed for a given year “t” as  $-1 * (\delta_t + \delta_{t-1})/2$ . Managing the employment base is likely to be more costly to a firm’s long-term operations than managing media coverage. Thus, the contemporaneous measure of abnormal workforce reduction is less likely to be susceptible to endogeneity than  $OUTSOURC_{ALT}$ . However, being an annual measure,  $WFRED_{ALT}$  in *MID-2004* potentially includes the effect of employment decisions made after the elections. This reduces the power of  $WFRED_{ALT}$  to capture earnings management incentives in *MID-2004*.

Table 6 presents results with the alternate media-related outsourcing and abnormal workforce reduction measures,  $OUTSOURC_{ALT}$  (Model 1) and  $WFRED_{ALT}$  (Model 2), respectively. In the regressions in Table 6, we include the four benchmark periods adjacent to *MID-2004* for comparison.<sup>15</sup> As the results in Model 1 of Table 6 demonstrate, we do not observe a statistically significant association between performance-matched discretionary accruals and  $OUTSOURC_{ALT}$  in *MID-2004*. In contrast to the results with  $OUTSOURC_{ALT}$ , we find a significantly negative association in Model 2 between  $PerfAcc$  and  $WFRED_{ALT}$  among firms that contribute to candidates in closely watched elections. Model 2 also indicates that the coefficient on

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<sup>15</sup> Results are similar when the regressions are estimated in cross-section over the *MID-2004* period only.

$WFRED_{ALT} * MID-2004$  is significantly positive (13.025), implying a positive association between  $PerfAcc$  and workforce reductions among firms not contributing to candidates-to-watch. While this positive coefficient is puzzling, the negative coefficient on  $CTWGiver * WFRED_{ALT} * MID-2004$  (-41.760) is much larger magnitude and significant at the 1% level. The coefficients imply that a single standard deviation increase in  $WFRED_{ALT}$  is associated with a  $MID-2004$  decline in  $PerfAcc$  of 0.016 among donor firms contributing to candidates in tightly-contested elections (the mean  $PerfAcc$  for sample firms in  $MID-2004$  is -0.0056).

Overall, the evidence we obtain with contemporaneously-measured  $WFRED_{ALT}$  is consistent with this measure being less susceptible than  $OUTSOURC_{ALT}$  to management by donor firms during  $MID-2004$  in order to avoid outsourcing-related scrutiny. We further examine the time-series patterns in outsourcing press mentions across the five two-quarter periods in our sample. Figure 1 plots the raw count of the total number of outsourcing-related press articles for our sample of donor firms in each two-quarter period, as well as the corresponding mean  $OUTSOURC_{ALT}$  measure for our sample firms (note that the value of  $OUTSOURC$  for a given two-quarter period used in Tables 2 through 5 is simply the lagged value of  $OUTSOURC_{ALT}$ ).

As Figure 1 demonstrates, the raw count of outsourcing related press mentions grows steadily till the  $2003-2004$  period, and is declining from  $MID-2004$  onwards, a pattern that is also reflected in mean  $OUTSOURC_{ALT}$ . Thus, the growth in annual press coverage for the  $MID-2004$  period is muted relative to that for  $2003-2004$ , which is surprising given that press scrutiny of donor firms' outsourcing activities should arguably have peaked during the period immediately preceding the elections. The patterns are

consistent with donor firms stepping up their efforts to directly manage press coverage of their outsourcing activities in *MID-2004*, making  $OUTSOURC_{ALT}$  a less powerful proxy for capturing cross-sectional variation in outsourcing-related incentives to manage earnings.

#### **4. Conclusion**

The study of the relation between accounting and the political process has long been viewed through the political cost hypothesis (Watts and Zimmerman, 1978, 1986). We attempt to broaden our understanding of that relation by developing and testing the political cost hypothesis in a unique setting: US congressional elections. Elections signify events during which the links between corporate donors and the candidates they support are susceptible to increased political scrutiny, with potential negative consequences for both. Corporate donors thus have incentives to make accounting choices with the dual objective of minimizing political costs for themselves and for their affiliated candidates. The latter is important to donor firms because it likely consolidates their relationships with political candidates, and can result in future benefits if those candidates win congressional office.

We focus our tests on the 2004 US congressional elections where outsourcing of US jobs was a major campaign issue. During those elections, outsourcing donor firms and the candidates they supported were vulnerable to media attention unfavorably portraying the outsourcing activities as “exporting” American jobs abroad in the quest for further profits. We examine the accrual choices made by the outsourcing donor firms and specifically test for income-decreasing discretionary accruals. The underlying assumption

is that outsourcing is perceived to be net profitable and thus, the use of income-decreasing accruals enables donor firms to deflect public scrutiny of both the firm and the political candidate over outsourcing.

We find that the donor firms' discretionary accruals in the two calendar quarters immediately preceding the 2004 election (*MID-2004*) vary negatively with the extent of their outsourcing activities. Outsourcing activities are measured using press coverage of the firms' outsourcing and "abnormal" workforce reductions, i.e., decreases in firm-level employment not predicted by declining firm-level economic conditions. The results are robust to benchmarking against the firms' earnings management in the four quarters that preceded and followed *MID-2004*.

The evidence is consistent with firms using earnings management to reduce both direct political costs and the costs associated with causing embarrassment to affiliated political candidates. Thus, the use of accounting discretion to manage political costs is potentially more evolved than currently discussed in the literature. One question that arises from our evidence is whether the downward earnings management of donor firms during election year appreciably improves the electoral prospects of the affiliated candidates. A comprehensive examination of this issue is beyond the scope of this paper and is left for future research.

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## Appendix A: Variable Definitions

Variable Name	Definition
<i>AbnAcc</i>	Abnormal accruals: See section 2.3.
<i>Acc</i>	Accruals, the difference between income before extraordinary items and operating cash flows, over lagged period assets
$\Delta Sales$	One-period change in sales over lagged period assets
<i>CTWGiver</i>	Candidate-to-watch Giver: Firm-level indicator coded “1” if the firm contributed to a congressional candidate contesting in a “closely watched race” (as defined by the Green Papers)
<i>MID-2003</i>	Indicator for the second and third calendar quarters of year 2003
<i>MID-2004</i>	Indicator for the second and third calendar quarters of year 2004
<i>MID-2005</i>	Indicator for the second and third calendar quarters of year 2005
<i>OUTSOURC</i>	<i>OUTSOURC</i> is a firm-level outsourcing proxy that measures the annual change in the number of press articles that mention the firm’s name and the word stem “outsourc,” measured as of the beginning of the quarter over which <i>PerfAcc</i> is measured.
<i>OUTSOURC<sub>ALT</sub></i>	<i>OUTSOURC<sub>ALT</sub></i> is a firm-level outsourcing proxy that measures the annual change in the number of press articles that mention the firm’s name and the word stem “outsourc,” measured as of the end of the quarter over which <i>PerfAcc</i> is measured.
<i>PerfAcc</i>	Performance-matched discretionary accruals: See section 2.3.
<i>Qtr4</i>	Indicator for the end-of-fiscal-year quarter
<i>Ret-on-Sales</i>	Return on sales
<i>WFRED</i>	<i>WFRED</i> is a firm-level outsourcing proxy that measures workforce reductions not explained by declining economic conditions, measured over the prior two years.
<i>WFRED<sub>ALT</sub></i>	<i>WFRED<sub>ALT</sub></i> is a firm-level outsourcing proxy that measures workforce reductions not explained by declining economic conditions, measured over the current and prior year.
<i>2003-04</i>	Indicator for the fourth calendar quarters of year 2003 and the first calendar quarter of year 2004
<i>2004-05</i>	Indicator for the fourth calendar quarters of year 2004 and the first calendar quarter of year 2005

**Table 1: Descriptive Statistics**

This table provides descriptive statistics for our primary sample of 563 firm-quarters for the *MID-2004* time period (second and third calendar quarters of 2004) and for a comparison sample of all Compustat firms with data available over the same period.

Variable	Means		Medians	
	Sample Firms	Compustat	Sample Firms	Compustat
<i>Assets</i>	18,059	2,708	6,946	199
$\Delta Sales$	0.037	0.056	0.022	0.023
<i>Ret-on-Sales</i>	0.039	-1.065	0.063	0.030
<i>Acc</i>	-0.042	-0.008	-0.036	-0.025
<i>AbnAcc</i>	-0.018	0.001	-0.009	-0.006
<i>PerfAcc</i>	-0.006	0.001	0.000	0.000
<i>N</i>	563	11,339	563	11,339

The table presents the means and medians of the following variables: assets (*Assets*), percentage sales change ( $\Delta Sales$ ), return on sales (*Ret-on-Sales*), accruals (*Acc*), abnormal accruals from a modified Jones model (*AbnAcc*) and performance-matched discretionary accruals (*PerfAcc*).

**Table 2: Time series of accruals and other characteristics in sample firms**

Table 2 presents key descriptive statistics for our sample from the second and third calendar quarters of 2004 (*MID-2004*), along with comparable information for the following two-quarter periods: Q2'2003&Q3'2003 (*MID-2003*), Q4'2003&Q1'2004 (*2003-04*), Q4'2004&Q1'2005 (*2004-05*), and Q2'2005&Q3'2005 (*MID-2005*).

**Panel A: Descriptive statistics of all sample firms**

<b>Variable</b>	<b><i>MID-2003</i></b>	<b><i>2003-04</i></b>	<b><i>MID-2004</i></b>	<b><i>2004-05</i></b>	<b><i>MID-2005</i></b>
<i>N</i>	560	566	563	566	551
$\Delta Sales$	0.026	0.032	0.037	0.030	0.027
<i>Ret-on-Sales</i>	0.016	0.029	0.039	0.039	-0.061
<i>Acc</i>	-0.046	-0.044	-0.042	-0.047	-0.044
<i>AbnAcc</i>	-0.018	-0.011	-0.018	-0.016	-0.022
<i>PerfAcc</i>	-0.002	0.000	-0.006	-0.006	-0.004

**Panel B: Descriptive statistics of *PerfAcc* across various sub-groups of the sample**

<b>Variable</b>	<b><i>MID-2003</i></b>	<b><i>2003-04</i></b>	<b><i>MID-2004</i></b>	<b><i>2004-05</i></b>	<b><i>MID-2005</i></b>
<i>CTWGiver = 1</i>	-0.007	-0.001	-0.014	-0.008	-0.008
<i>CTWGiver = 0</i>	0.001	0.001	0.001	-0.004	-0.001
<i>OUTSOURC &gt; 0</i>	0.003	-0.003	-0.016	-0.001	-0.001
<i>OUTSOURC ≤ 0</i>	-0.005	0.002	0.001	-0.009	-0.005
<i>WFRED &gt; 0</i>	0.005	-0.005	-0.014	-0.017	-0.001
<i>WFRED ≤ 0</i>	-0.006	0.004	0.001	0.005	-0.007

Panel A above presents the means of the following variables over the firm-quarters within each two-quarter period: assets (*Assets*), percentage sales change ( $\Delta Sales$ ), return on sales (*Ret-on-Sales*), accruals (*Acc*), abnormal accruals from a modified Jones model (*AbnAcc*) and performance-matched discretionary accruals (*PerfAcc*). Panel B presents the means of *PerfAcc* for various partitions on *CTWGiver*, *OUTSOURC* and *WFRED*. *CTWGiver* is a firm-level indicator coded “1” if the firm contributed to a congressional candidate contesting in a “closely watched race” (as defined by the Green Papers). *OUTSOURC* is a firm-level outsourcing proxy that measures the annual change in the number of press articles that mention the firm’s name and the word stem “outsourc” as of the beginning of the quarter over which *PerfAcc* is measured. *WFRED* is a firm-level outsourcing proxy that measures workforce reductions not explained by declining economic conditions, measured over the prior two years.

**Table 3: Cross-section of discretionary accruals in sample firms in MID-2004**

This table presents the results of cross-sectional regressions of all sample firms in the *MID-2004* period. The dependent variable is *PerfAcc*, or the performance-matched discretionary accruals of sample firms. All standard errors are clustered at the firm level.

<b>Parameter</b>	<b>Model 1: Estimate (p-value)</b>	<b>Model 2: Estimate (p-value)</b>
<i>Intercept</i>	0.006 (0.423)	0.001 (0.839)
<i>CTWGiver</i>	-0.020 (0.045)	-0.017 (0.077)
<i>OUTSOURC</i>	-0.009 (0.027)	
<i>OUTSOURC*CTWGiver</i>	0.007 (0.285)	
<i>WFRED</i>		1.523 (0.763)
<i>WFRED*CTWGiver</i>		-15.401 (0.066)
N	563	537
R-Squared	0.014	0.010

The regressions include all firm-quarters that meet the data availability constraints over the *MID-2004* period (second and third calendar quarters of 2004). The explanatory variables include *CTWGiver*, *OUTSOURC* and *WFRED*. *CTWGiver* is a firm-level indicator coded “1” if the firm contributed to a congressional candidate contesting in a “closely watched race” (as defined by the Green Papers). *OUTSOURC* is a firm-level outsourcing proxy that measures the annual change in the number of press articles that mention the firm’s name and the word stem “outsourc” as of the beginning of the quarter over which *PerfAcc* is measured. *WFRED* is a firm-level outsourcing proxy that measures workforce reductions not explained by declining economic conditions, measured over the prior two years.

**Table 4: Panel variation in discretionary accruals among sample firms**

This table presents the results of pooled regressions of all sample firms. The dependent variable is *PerfAcc*, or the performance-matched discretionary accruals of sample firms. All standard errors are clustered at the firm level.

<b>Parameter</b>	<b>Model 1: Estimate (p-value)</b>	<b>Model 2: Estimate (p-value)</b>
<i>Intercept</i>	-0.001 (0.759)	-0.002 (0.682)
<i>Qtr4</i>	0.001 (0.876)	0.001 (0.905)
<i>MID-2004</i>	0.007 (0.326)	0.003 (0.661)
<i>CTWGiver</i>	-0.007 (0.319)	-0.006 (0.393)
<i>CTWGiver*MID-2004</i>	-0.013 (0.226)	-0.011 (0.275)
<i>OUTSOURC</i>	4.9x10 <sup>-4</sup> (0.830)	
<i>OUTSOURC*MID-2004</i>	-0.009 (0.051)	
<i>OUTSOURC*CTWGiver</i>	0.004 (0.218)	
<i>OUTSOURC*CTWGiver*MID-2004</i>	0.004 (0.634)	
<i>WFRED</i>		-2.245 (0.397)
<i>WFRED*MID-2004</i>		3.788 (0.456)
<i>WFRED*CTWGiver</i>		9.470 (0.215)
<i>WFRED*CTWGiver*MID-2004</i>		-24.853 (0.009)
N	2806	2,650
R-Sq.	0.004	0.003

The regressions include all firm-quarters that meet the data availability constraints over the *MID-2004* period (second and third calendar quarters of 2004). Benchmark periods included in the regression for the purpose of comparison include Q2'2003&Q3'2003 (*MID-2003*), Q4'2003&Q1'2004 (*2003-04*), Q4'2004&Q1'2005 (*2004-05*), and Q2'2005&Q3'2005 (*MID-2005*). All standard errors are clustered at the firm level. The explanatory variables include *CTWGiver*, *OUTSOURC* and *WFRED*. *CTWGiver* is a firm-level indicator coded "1" if the firm contributed to a congressional candidate contesting in a "closely watched race" (as defined by the Green Papers). *OUTSOURC* is a firm-level outsourcing proxy that measures the annual change in the number of press articles that mention the firm's name and the word stem "outsourc" as of the beginning of the quarter over which *PerfAcc* is measured. *WFRED* is a firm-level outsourcing proxy that measures workforce reductions not explained by declining economic conditions, measured over the prior two years.

**Table 5: Discretionary accruals and the joint effects of *OUTSOURC* and *WFRED***

This table presents the results of pooled regressions for all sample firms. The dependent variable is *PerfAcc*, or the performance-matched discretionary accruals of sample firms. All standard errors are clustered at the firm level.

Parameter	Model 1: Estimate (p-value)	Model 2: Estimate (p-value)
<i>Intercept</i>	-0.002 (0.653)	-0.002 (0.649)
<i>Qtr4</i>	0.001 (0.930)	0.001 (0.907)
<i>MID-2004</i>	0.012 (0.150)	0.012 (0.145)
<i>CTWGiver</i>	-0.006 (0.415)	-0.006 (0.432)
<i>CTWGiver*MID-2004</i>	-0.016 (0.138)	-0.016 (0.139)
<i>OUTSOURC</i>	0.002 (0.793)	0.001 (0.871)
<i>OUTSOURC*MID-2004</i>	-0.033 (0.074)	-0.034 (0.068)
<i>OUTSOURC*CTWGiver</i>	0.001 (0.949)	0.001 (0.952)
<i>OUTSOURC*CTWGiver*MID-2004</i>	0.019 (0.432)	0.021 (0.391)
<i>WFRED</i>	-2.195 (0.408)	0.103 (0.975)
<i>WFRED*MID-2004</i>	2.264 (0.657)	2.258 (0.647)
<i>WFRED*CTWGiver</i>	9.345 (0.220)	7.912 (0.299)
<i>WFRED*CTWGiver*MID-2004</i>	-22.896 (0.015)	-21.426 (0.028)
<i>OUTSOURC*WFRED</i>		-5.959 (0.188)
<i>OUTSOURC*WFRED*MID-2004</i>		-4.299 (0.629)
N	2,650	2,650
R-Sq.	0.005	0.006

The regressions include all firm-quarters that meet the data availability constraints over the *MID-2004* period (second and third calendar quarters of 2004). Benchmark periods included in the regression for the purpose of comparison include Q2'2003&Q3'2003 (*MID-2003*), Q4'2003&Q1'2004 (*2003-04*), Q4'2004&Q1'2005 (*2004-05*), and Q2'2005&Q3'2005 (*MID-2005*). All standard errors are clustered at the firm level. The explanatory variables include *CTWGiver*, *OUTSOURC* and *WFRED*. *CTWGiver* is a firm-level indicator coded "1" if the firm contributed to a congressional candidate contesting in a "closely watched race" (as defined by the Green Papers). *OUTSOURC* is a firm-level outsourcing proxy that measures the annual change in the number of press articles that mention the firm's name and the word stem

“outsourc” as of the beginning of the quarter over which *PerfAcc* is measured. *WFRED* is a firm-level outsourcing proxy that measures workforce reductions not explained by declining economic conditions, measured over the prior two years.

**Table 6: Panel variation in discretionary accruals using alternate definitions of *OUTSOURC* and *WFRED***

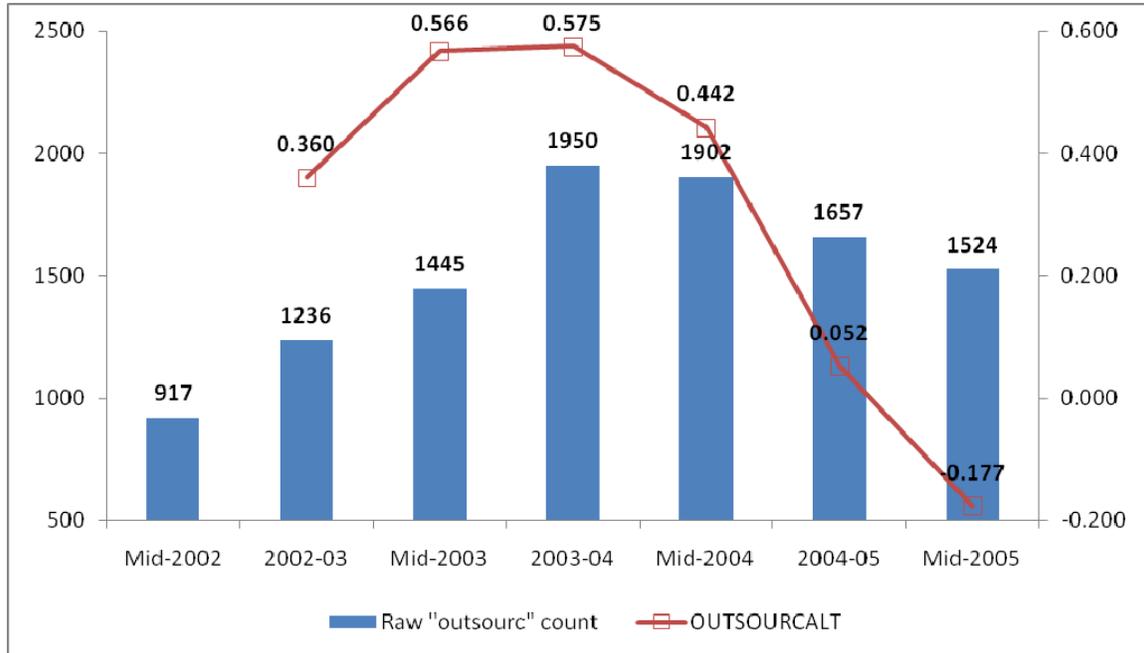
This table presents the results of a pooled regression of all sample firms. The dependent variable is *PerfAcc*, or the performance-matched discretionary accruals of sample firms. All standard errors are clustered at the firm level.

Parameter	Model 1: Estimate (p-value)	Model 2: Estimate (p-value)
<i>Intercept</i>	5.8x10 <sup>-5</sup> (0.989)	-0.002 (0.720)
<i>Qtr4</i>	0.001 (0.931)	0.002 (0.752)
<i>MID-2004</i>	2.9x10 <sup>-5</sup> (0.997)	2.1x10 <sup>-4</sup> (0.976)
<i>CTWGiver</i>	-0.006 (0.375)	-0.007 (0.318)
<i>CTWGiver*MID-2004</i>	-0.009 (0.368)	-0.006 (0.516)
<i>OUTSOURC<sub>ALT</sub></i>	-0.002 (0.100)	
<i>OUTSOURC<sub>ALT</sub>*MID-2004</i>	0.005 (0.359)	
<i>OUTSOURC<sub>ALT</sub>*CTWGiver</i>	0.003 (0.232)	
<i>OUTSOURC<sub>ALT</sub>*CTWGiver*MID-2004</i>	-0.001 (0.849)	
<i>WFRED<sub>ALT</sub></i>		-0.353 (0.898)
<i>WFRED<sub>ALT</sub>*MID-2004</i>		13.025 (0.032)
<i>WFRED<sub>ALT</sub>*CTWGiver</i>		6.177 (0.503)
<i>WFRED<sub>ALT</sub>*CTWGiver*MID-2004</i>		-41.760 (0.004)
N	2806	2,650
R-Sq.	0.002	0.006

The regressions include all firm-quarters that meet the data availability constraints over the *MID-2004* period (second and third calendar quarters of 2004). Benchmark periods included in the regression for the purpose of comparison include Q2'2003&Q3'2003 (*MID-2003*), Q4'2003&Q1'2004 (*2003-04*), Q4'2004&Q1'2005 (*2004-05*), and Q2'2005&Q3'2005 (*MID-2005*). All standard errors are clustered at the firm level. The explanatory variables include *CTWGiver*, *OUTSOURC<sub>ALT</sub>* and *WFRED<sub>ALT</sub>*. *CTWGiver* is a firm-level indicator coded "1" if the firm contributed to a congressional candidate contesting in a "closely watched race" (as defined by the Green Papers). *OUTSOURC<sub>ALT</sub>* is a firm-level outsourcing proxy that measures the annual change in the number of press articles that mention the firm's name and the word stem "outsourc" as of the end of the quarter over which *PerfAcc* is measured. *WFRED<sub>ALT</sub>* is a firm-level outsourcing proxy that measures workforce reductions not explained by declining economic conditions, measured over the current and prior year.

**Figure 1: Time-series of raw “outsourc” count and  $OUTSOURC_{ALT}$**

Figure 1 plots the raw count of the total number of outsourcing-related press articles for the sample of 283 donor firms in each two-quarter period, as well as the corresponding mean  $OUTSOURC_{ALT}$  measure.



Raw “outsourc” count represents the number of press mentions of the firm’s name and the word stem “outsourc” in each two-quarter period.  $OUTSOURC_{ALT}$  is a firm-level outsourcing proxy that measures the annual change in the number of press articles that mention the firm’s name and the word stem “outsourc” as of the end of the quarter over which  $PerfAcc$  (performance-matched discretionary accruals) is measured. *MID-2002* is Q2’2002&Q3’2002; *2002-03* is Q4’2002&Q1’2003; *MID-2003* is Q2’2003&Q3’2003; *2003-04* is Q4’2003&Q1’2004; *MID-2004* is Q2’2004&Q3’2004; *2004-05* is Q4’2004&Q1’2005; and *MID-2005* is Q2’2005&Q3’2005.