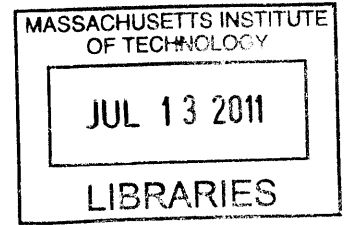# Financial Reporting Quality and the Quiet Life

by
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AUGUST 2010

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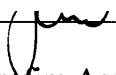Sloan School of Management, August 16, 2010

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Financial Reporting Quality and the Quiet Life

by

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Abstract

Bertrand and Mullainathan (2003) find that managers shielded from the threat of takeovers exert less effort to maximize firm value, consistent with a 'quiet life' hypothesis. I study whether the governance role of financial reporting can mitigate adverse effects arising from managerial preferences for a quiet life. I hypothesize and find evidence that after changes in the mid 1990's to Delaware's takeover protection regime, Delaware firms with higher financial reporting quality (FRQ) have better operating performance and higher capital investment intensity. Furthermore, the above relation between FRQ and performance is stronger for firms operating in less competitive industries, and firms with staggered boards. Overall, the results suggest that financial reporting can help mitigate adverse effects associated with managerial preferences for a quiet life.

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Table of Contents

1. Introduction

I hypothesize that financial reporting functioning as a governance mechanism can help mitigate agency costs associated with managerial preferences for a quiet life. Financial reporting provides a firm's owners and other monitors (e.g. boards of directors, debt holders, and analysts) with verifiable information that can be used as a direct input to evaluate firm performance. Higher quality financial reporting allows more effective monitoring and contracting by a firm's stakeholders, reducing moral hazard, shirking and wealth expropriation activities by management (e.g. Bushman and Smith, 2001; Watts 2003a). Thus, when firms obtain protection from the threat of hostile takeovers (i.e., when the potential for moral hazard increases), financial reporting can serve an amplified monitoring role to curb managerial value-decreasing actions associated with quiet life preferences.

I exploit a change in Delaware's takeover protection regime in the mid-1990s that greatly increased the ability of firms to resist hostile takeovers. In response to legal battles associated with a series of takeover contests, the Delaware Supreme Court legitimized the use of a poison pill-staggered board combination, rendering Delaware firms with staggered boards virtually immune to hostile takeovers and decreasing the effectiveness of the market for corporate control as a governance mechanism (Bebchuk et al., 2002; Rauh, 2006; Low, 2008). This setting thus provides an exogenous shock to managerial incentives to engage in 'quiet life' behavior that I use to test the governance role of financial reporting. A unique feature of the Delaware regime shift setting is that only firms incorporated in Delaware are affected by the regime shift, regardless of their state of location, which allows me to use non-Delaware firms as a control group.

I use measures of accounting conservatism to capture the quality of a firm's financial reporting. Conservatism can reduce agency costs arising from information asymmetry between managers and stockholders by enhancing the corporate governance of a firm and by increasing the quality of information available to stockholders (Watts, 2003a). Conservatism is particularly suited to mitigate agency problems arising from managerial incentives to engage in quiet life behavior because greater conservatism speeds the recognition of bad news, which in turn facilitates the monitoring and disciplining of managerial actions. I use firm-specific measures from Khan and Watts (2008) - CScore and BScore - to proxy for conservatism.

I use a differences-in-differences methodology to exploit variation in the effects of the regime shift. First, I identify a sample of firms that are incorporated in Delaware and hence, affected by the regime shift (treatment firms). I also identify two sets of control firms that are unlikely to experience changes in their incentives to engage in quiet life behavior. First, I use Delaware firms in the pre-regime shift period as a control group. An advantage of using this control group is that is that they are likely to be similar to the post-regime shift Delaware firm sample along many dimensions. Second, I use a sample of firms that are incorporated in states other than Delaware (*Non-Delaware firms*). An advantage of this control group is that it allows me to control for the effects of macro-economic shocks and/or other inter-temporal variations that occur contemporaneous to the regime shift. The differences-in-differences methodology has been widely used in recent studies that examine changes in takeover protection regimes (e.g. Bertrand and Mullainathan, 2003; Rauh, 2006; Giroud and Mueller, 2008; Low, 2008) as well as in the labor and financial economics literatures.

I test the hypothesis that greater financial reporting quality after the regime shift dampens managerial quiet life behavior and improves performance by examining differences in operating performance for the treatment and control firms. I also conduct similar tests to examine the effect of financial reporting quality on differences in capital investment and disposal activity for the treatment and control firms. I note that all empirical tests include controls for firm specific determinants of performance, capital investment and disposals, as well as controls for governance mechanisms.

My empirical results are consistent with the hypothesis that higher financial reporting quality dampens the adverse effects of managerial preferences for a quiet life. I find evidence of a positive and significant relation between conservatism and operating performance after the regime shift for Delaware firms, and the relation is significantly different from the change for non-Delaware firms. Specifically, following the regime shift and relative to non-Delaware firms, Delaware firms on average report an 8.7% decrease in operating performance. This result is concentrated in firms with low financial reporting quality – a one standard deviation increase in accounting conservatism is associated with a 17-20% increase in operating performance for Delaware firms post-regime shift. This evidence is consistent with financial reporting conservatism dampening the performance related effects of managerial quiet life behavior.

I also find evidence of a positive relation between capital investment and FRQ in the post-regime shift period. This is consistent with financial reporting playing a governance role that influences managerial real actions. First, I find that the average Delaware firm in my sample has a statistically insignificant change in investment around the regime shift. This is consistent with Bertrand and Mullainathan (2003) who argue that such evidence

8

supports managerial preferences for a quiet life – i.e. managers maintain the status quo and do not undertake effort to change existing practices. I then examine the post-regime shift effect of FRQ for Delaware firms. Results suggest that when compared to non-Delaware firms, the association between capital investment and FRQ is positive and significant in the post-regime shift period. In economic terms, a one standard deviation increase in FRQ for Delaware firms in the post-period is linked to an increase in capital investment of approximately 7%, relative to the pre-regime shift period. This result suggests that greater financial reporting quality can limit underinvestment arising from managerial preferences to engage in quiet life behavior.

I also examine the effect of FRQ on asset disposal activity around the regime shift. Quiet life preferences should result in decreased disposal activity in the post regime shift period. Financial reporting conservatism should speed the recognition of bad news arising from the retention of negative NPV assets in the post period, providing stakeholders with a timelier signal of the adverse outcomes of quiet life behavior. The empirical evidence does not provide strong support for the argument that financial reporting plays a magnified role in influencing asset disposal activity for Delaware firms in the post period.

In addition to the tests above, I identify two variables that proxy for the severity of the governance problem and predict that the effect of financial reporting on managerial behavior will be stronger when the potential for quiet life behavior is higher. First, I argue that the role of financial reporting in mitigating quiet life behavior is decreasing in market competition. Firms facing less competition have greater incentives to engage in quiet life behavior because they face less pressure to reduce slack and improve efficiency relative to firms operating in competitive environments (Giroud and Mueller, 2008). Second, I predict

and find that the post-regime shift role of financial reporting in mitigating quiet life behavior is only present for Delaware firms with relatively stronger takeover defenses. Managers of firms with stronger takeover defenses have greater incentives to engage in quiet life behavior relative to firms with weaker takeover defenses - the latter continue to be subject to disciplinary pressure from the market for corporate control post-regime shift.

Empirical findings are robust to the inclusion of controls for determinants of operating performance and capital investment, controls for alternative governance mechanisms, different subsamples, time periods, alternative econometric specifications and numerous other robustness and sensitivity tests. Overall, my results provide support for the argument that when the effectiveness of the market for corporate control diminishes, the governance role of financial reporting quality is magnified, mitigating the ability of managers to engage in behavior consistent with their preferences for a quiet life.

This paper contributes to two streams of literature. First, I contribute to a literature that examines the governance and monitoring role of financial reporting with respect to investment decisions (e.g., Bens and Monahan, 2004; Bushman et al., 2006; Biddle et al., 2009; Hope and Thomas, 2008; Beatty, Liao and Weber, 2009). Much of this literature examines a cross-sectional association between financial reporting and investment decisions, and finds that higher financial reporting quality is positively related to investment efficiency. The main challenge to this literature, however, is to identify an exogenous shock that changes managerial incentives to engage in non-value maximizing investment activities. By using changes in Delaware's takeover protection regime, I am able to address this limitation, and present results that are more consistent with a causal link between reporting quality and

investment efficiency. Furthermore, the use of non-Delaware firms as a control group allows me to control for unobservable market-wide events.

Second, I contribute to research that examines the effects of changes in takeover protection. Extant work examines managerial behavior around changes in takeover protection regimes (e.g., Bertrand and Mullainathan, 1999a,b, 2003; Cheng et al. 2004; Rauh, 2006; and Low, 2008), and stock market reactions to changes in takeover protection regimes (Hackl and Testani, 1988; Szewczyk and Tsetsekos, 1992). This literature, however, has not investigated whether the firm's financial reporting system can mitigate the adverse effects of changes in the market for corporate control. By examining whether financial reporting quality mitigates quiet life behavior, I provide evidence about cross-sectional differences in the effects of changes in takeover protection regimes.

The rest of the paper is organized as follows. In the next section, I describe the market for corporate control, and events pertinent to the Delaware takeover regime shift. Section 3 outlines the hypotheses. In Section 4, I describe the data and in Section 5, I explain the methodology used in this study. Section 6 presents empirical results and Section 7 concludes.

2. The Market for Corporate Control and Delaware's mid-1990s regime shift

2.1 The Market for Corporate Control

The market for corporate control is generally viewed as a corporate governance mechanism and is defined as "the arena in which alternative management teams compete for the right to manage corporate resources" (Jensen and Ruback, 1983). An active market for corporate control reduces stockholder-manager conflict, and along with the internal controls of a firm, is viewed as one of the most important mechanisms that discipline managerial behavior (Jensen, 1993). The threat of a takeover disciplines managerial behavior because changes in corporate control are often followed by changes in management – the new owners replace incumbent managers with their own management teams. Accordingly, incumbent managers are incentivized to reduce the risk of job loss, and accordingly, take actions that maximize stockholder value.

While an active market for corporate control can reduce stockholder-manager conflicts, there are also potential costs. The threat of takeovers may induce managers to take actions that maximize short-run performance in order to meet market expectations. Such actions may not create long-run firm value. On the other hand, limiting the threat of takeovers reduces the risk that managers focus on short-run performance. Linn and McConnell (1983) note that proponents of anti-takeover provisions argue that protection from takeovers provide two salutary effects. First, it strengthens the hand of incumbent managers in dealing with acquirers whose primary objective is to obtain the target's assets at an unreasonably low price. Second, continuity in management allows greater stability in the firm's long-term focus on profitability and firm value.

Both firm and macro-level factors affect the effectiveness of the governance role of the market for corporate control. Firms can implement anti-takeover provisions that limit a bidder's ability to obtain control of the target and/or decrease the attractiveness of the target to potential acquirers.[1] Changes in legislation can also severely restrict the market for corporate control. For example, changes in Business Combination laws in 30 states between the late 1980s and mid 1990s impose a moratorium on specific transactions between the target and a raider holding a specified threshold percentage of stock unless the board votes otherwise *before* the acquiring person becomes and interested stockholder (Bertrand and Mullainathan, 2003). Prohibited transactions include the sale of assets, mergers, and business relationships.

Another related mechanism that affects the effectiveness of the market for corporate control is a change in the judicial interpretation of existing legislation. One example is the 1995 Delaware regime shift, a setting that I exploit in this study and discuss below. It is important to note that there is a subtle but important difference between a change in judicial interpretation of existing laws (such as the Delaware regime shift) and a *change* in legislation (such as the change in business combination laws in the mid 1980s).

2.2 Delaware's mid-1990's Takeover Regime Shift

Changes in Delaware's takeover legal protection in the mid-1990s validated the use of a staggered board-poison pill combination to repel hostile takeovers. The combination gave Delaware firms an extremely potent takeover defense and made them virtually immune to hostile takeovers (e.g. Subramanian, 2004; Bebchuk and Cohen, 2005; Rauh, 2006).

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[1] An important point to emphasize is that these takeover defense mechanisms are geared towards repelling unsolicited takeover bids. In other words, targets can elect to retract takeover defenses if the takeover is deemed to be friendly or is solicited.

Furthermore, prior studies argue that the dynamics of modern takeover battles have rendered all other defenses superfluous (Daines and Klausner, 2001; Coates, 2000).

Prior to the regime shift, Delaware legal precedent restricted the ability of Delaware firms to use poison pills. For example, in *City Capital Associates v. Interco Inc (1988)* the Chancery Court of Delaware[2] ordered the target (Interco) to retract its poison pill and allow shareholders to decide whether or not to accept the acquirer's hostile bid. In such cases, a staggered board-poison pill defense is reduced to a staggered board defense, which, without a poison pill, is not considered to provide strong protection from hostile bids (Bebchuk et al., 2002).

Research examining changes in takeover protection regimes (e.g. Bertrand and Mullainathan, 2003; Giroud and Mueller, 2008) has typically focused on the changes in BC laws in the mid 1980s. Recent work has begun to focus on the mid-1990s Delaware takeover regime shift. The Delaware regime shift setting offers some advantages over the BC laws setting. First, the Delaware regime shift could be considered to be relatively more exogenous vis-a-vie the BC laws regime shift because the former occurs as the result of a change in the judicial interpretation of existing laws, whereas the latter occurs because of a change in legislation. The endogeneity concern that arises with studies using the BC laws regime shift setting is that firms expecting to have weak future performance lobby local politicians to increase takeover protection. The exogeneity of the Delaware regime shift relies on the belief that changes in judicial interpretation of existing laws are less subject to such endogenous pressures.

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[2] The Delaware Court of Chancery is a court of equity, and is one of Delaware's three constitutional courts along with the Supreme Court and the Superior Court.

Second, data availability around the Delaware regime shift is relatively greater than for the BC laws regime shift. This permits researchers to use a relatively more pertinent set of controls that sharpen the interpretability of empirical tests. In the next section I discuss the takeover defense mechanisms that are central to the Delaware regime shift.

2.3 Takeover defense mechanisms

In this section, I consider the two takeover defense mechanisms that are the foundation for the Delaware regime shift: Poison Pills and Staggered Boards. Gompers et al., (2003) identify these mechanisms as two of the most powerful anti-takeover defense mechanisms available to companies in current times.

2.3.1 Poison pills

Poison pills (also known as a shareholder rights plan) are a form of takeover defense mechanism that acts to dilute an acquirer's share in a target. They consist of stock warrants or rights that allow the holder to buy an acquirer's stock or the target's stock, or both, at a substantial discount from the market price (Bebchuk et al., 2002). The rights become exercisable in the event that any stockholder of the target firm acquires greater than some pre-specified percentage of the target's stock without the approval of the target's board of directors, and are issued to all stockholders of the target firm with the exception of the stockholder who's holdings triggered the pill.

A commonly observed variant of a poison pill is a "Flip Over" Rights Plan (Bebchuk et al., 2002).[3] Under this plan, the target firm common stockholders are given the right to buy non-voting stock in the target. The rights are not independently tradable because they are linked to the common stock. The rights are worthless at the time of issue as the exercise

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[3] Other types of poison pills include "Flip In" Rights Plans and "Poison Debt" Rights Plans. While these pills are somewhat different to "Flip Over" rights plans in their implementation, the objective of all variants of poison pills remains similar: Make a bidder's attempted acquisition of a target prohibitively costly.

price is set at a significantly higher level than the prevailing stock price. If a hostile bid is successful, the rights to purchase shares at a significant discount (up to 50%) of the prevailing market price can be exercised by all holders except the bidder. This significantly dilutes the acquirer's holdings and can make it prohibitively expensive to continue the attempted takeover. If the bid is abandoned, the target retains the option to redeem the rights for a nominal amount.

Poison pills provide a very effective defense against hostile takeovers. Bebchuk et al. (2003) note "as long as the pill remains in place, no other defensive measures are necessary because [a] bid is completely blocked". A poison pill has one main weakness: it can be redeemed at any time by the target's board. Hence, if an acquirer is able to win a proxy contest and obtain control of a target's board, the pill is virtually useless because it can be redeemed. Hence, it is critical for a target to ensure is that the pill itself is protected. One method may be to limit the speed with which an acquirer can obtain control of a target board, for instance with the use of a staggered board to limit the number of directors that can be replaced if a proxy context is lost. I discuss staggered boards in more detail next.

2.3.2 Staggered boards

Staggered boards are boards of directors in which directors are grouped into classes (typically three) and the classes are elected during successive annual meetings. In order to obtain control of the board, potential acquirers would have to win multiple proxy contests in order to obtain control of the target board. Such actions could take up to two years, which can be a prohibitively long delay (Low, 2009). Furthermore, the delay to obtain control of the board provides the target with time to implement or undertake other measures that can make the target less attractive. In contrast, 'un-staggered' boards require all directors to be

elected annually, which permits a bidder to obtain control of a board in a single proxy contest.

Proponents of staggered boards propose two nontakeover-related justifications for the use of staggered boards (Bebchuk et al., 2003). First, staggered boards facilitate the independence of outside directors. Under this argument, independent directors will be less influenced by executives if they have a term of three years instead of one year. Second, staggered boards reduce annual turnover on the board, thereby promoting board stability.

2.3.3 A staggered board – poison pill combination

The simultaneous use of both a staggered board and poison pill is viewed as an extremely effective takeover defense strategy because it requires the hostile bidder to win multiple proxy contests over a period of up to two years before obtaining control of the board and redeeming the pill. Empirical evidence provides supports for the strength of the board-pill combination: Bebchuk et al. (2002) find that not a single hostile bidder managed to win control against a target with an effective staggered board in the five year period from 1996 to 2000. Furthermore, Daines (2001) argues that Delaware's takeover friendly rules are one of the reasons why Delaware firms had higher market valuations than non-Delaware firms prior to the Delaware regime shift, and Bebchuk and Cohen (2005) find that staggered board firms typically had lower valuations than non-staggered board firms post-1995. Next, I discuss how the changes in Delaware's takeover regime affected the ability of Delaware firm managers to engage in quiet life behavior was increased as a result of changes in the validation of the use of a staggered board – poison pill combination.

2.4 The effect of the Delaware regime shift on managers' ability to engage in quiet life behavior.

Bertrand and Mullainathan (2003) find evidence that managers protected from the threat of takeovers exert less effort to maximize firm value, consistent with managerial preferences for a 'quiet life'. Such preferences are a manifestation of agency conflicts between managers and owners of a firm. Agency conflicts arise because managers and owners have diverging incentives - managers control the firm's assets but typically do not have a significant equity stake in the firm (Berle and Means, 1932; Jensen and Meckling, 1976). Hence, managers maximizing their personal welfares are sometimes inclined to take actions that are not in the best interests of shareholders (e.g. shirking or quiet life behavior). Agency conflicts cannot be fully resolved using contracts because of the substantial costs associated with writing and enforcing complete contracts (Fama and Jensen, 1993). Thus, in order to reduce conflicts, incomplete contracts are supplemented with corporate governance mechanisms such as board of directors, institutional stockholders, managerial ownership, the market for corporate control and financial reporting.

Changes in Delaware's takeover legal protection in the mid-1990s reduced the effectiveness of governance from the market for corporate control and in turn, increased agency costs and managerial incentives to engage in quiet life behavior. The regime shift increased the ability of Delaware firms to use a poison pill-staggered board combination – a nearly impenetrable defense – to block against hostile takeovers. Legal scholars and financial economists have examined the effects of the regime shift on managerial behavior. I discuss this work next.

2.5 Prior research examining the Delaware regime shift

Prior work finds that the Delaware regime shift affects managerial behavior. Rauh (2006) examines whether the regime shift affects managerial incentives to encourage

employee stock ownership. If greater employee stock ownership functions as a takeover defense mechanism, increases in takeover protection arising from the regime shift should reduce managerial incentives to encourage employee stock ownership. Rauh's results suggest that following the regime shift, the proportion of stock held by employees decrease by amounts similar to what would be expected if firms stopped making defined contribution plan contributions in employee stock.

Low (2008) examines how equity based compensation affects managerial risk-taking behavior around the Delaware regime shift. She finds that managers with low equity-based incentives decrease firm risk following changes in Delaware takeover protection regime, and the risk reductions are associated with decreases in stock prices. Furthermore, she finds some evidence that firms respond to the regime shift by increasing managerial incentives for risk taking, but does not examine if increases in managerial incentives mitigate quiet life behavior. In the next section, I turn to the role of financial reporting in mitigating the adverse effects of managerial preferences for a quiet life.

3. Hypothesis Development

In this section, I discuss the governance role of financial reporting conservatism in monitoring and disciplining managerial behavior and develop predictions about how financial reporting conservatism can mitigate adverse outcomes from managerial preferences for a quiet life.

3.1 The role of financial reporting conservatism in mitigating agency costs

The governance role of financial reporting can help mitigate agency conflicts between managers and owners of a firm. Financial reporting serves as a direct input for numerous governance mechanisms by providing those mechanisms with verifiable information about firm performance, which in turn reduces information asymmetry between managers and stakeholders of a firm. Information in financial reports enables the firm's owners and other stakeholders to monitor and evaluate both managerial performance (for example, Bushman and Indjejikian, 1993; Holmstrom and Tirole, 1993; Kanodia and Lee, 1988) and managerial decisions and strategies (Watts and Zimmerman, 1986; Bushman and Smith, 2001).

Governance from financial reporting likely operates in conjunction with other elements of a firm's corporate governance system including the market for corporate control, boards of directors, debt holders, executive compensation, and institutional investors. All these mechanisms likely rely on verifiable financial reports to either evaluate managerial/firm performance or engage in contracts with the firm.[4] Hence, I argue that

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[4] Note that boards of directors and certain groups of debtholders typically have access to non-public information about a firm (such as budgets and forecasts). While such information can help to evaluate managerial performance, the accuracy of such information is typically void of independent auditor attestation, and hence, complements verifiable financial reports.

financial reporting plays a first order role in a firm's system of corporate governance, and therefore is an important governance mechanism to examine in the extant setting.

Conservatism in financial reporting is an important characteristic of a firm's accounting practices. Watts (2003) notes that conservatism can help stakeholders reduce agency costs that arise from information asymmetry between managers and stakeholders. Conservatism achieves this by imposing an asymmetric verification requirement for the recognition and disclosure of losses vs. gains, and thus provides stakeholders with a relatively timelier signal to investigate reasons for reported losses and discontinue negative net present value projects and/or discipline managers (Ball, 2001; Watts, 2003a). [5]

Following the Delaware regime shift, the effectiveness of the governance and monitoring role of the market for corporate control in Delaware decreases substantially while other governance mechanisms still function to monitor and discipline managers. I argue that the role of financial statement information is magnified in this period as a source of information for stakeholders to monitor and discipline managers. Firms that have relatively more conservative financial statements report adverse outcomes arising from managerial preferences for a quiet life in a timelier manner, providing stakeholders with timelier information with which to monitor and discipline those managers. Furthermore, managers likely understand that the outcomes of their actions are recognized in financial reports in a timelier fashion when financial statements are conservative, which reduces managerial incentives to engage in non-value maximizing actions.

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[5] Recent work by Armstrong et al. (2009) examines the effect of the changes in BC laws on both the degree of financial statement informativeness and overall information asymmetry. Their evidence suggests that firms respond to BC laws by increasing financial statement informativeness and reducing asymmetry. They argue that their findings are "consistent with the view that external corporate governance mechanisms such as the market for corporate control (i.e., state antitakeover statutes) and financial reporting transparency are substitutes". My work is complementary to their study in that I find that the governance role of financial reporting conservatism acts to curb the adverse effects of quiet life behavior.

A natural question that arises is if managers' actions are self-dealing, then couldn't managers' merely reduce conservatism in financial reports to reduce the timeliness with which bad news is recognized. Such actions delay the recognition of bad news, masking adverse outcomes arising from quiet life behavior and the resulting adverse effects for a manager's job security and compensation. This scenario is unlikely to occur for a number of reasons including stockholder demands for conservatism and/or independent verification of financial statements by external auditors. Further, if managers change their accounting policies, auditors are typically required to disclose the nature of the change. This further restricts managerial ability to make unobservable changes in financial reports.

Based on the discussion above, I expect that financial reporting plays a pronounced governance role for Delaware firms following the regime shift. The change in the effectiveness of the market for corporate control increases the importance of the governance role of financial reporting in the post period. In this period, all Delaware firms are likely to experience declines in performance as the effects of preferences for a quiet life are realized. However, Delaware firms with higher quality financial reporting will have less ability to engage in quiet life behavior and hence will have stronger (i.e. less adverse) effects relative to Delaware firms with relatively lower quality financial reports. Turning to non-Delaware firms, as the regime shift only affects Delaware firms, non-Delaware firms do not systematically experience changes in the market for corporate control around the regime shift. Hence, while it is entirely plausible that financial reporting can also mitigate quiet life behavior for non-Delaware firms, in practice, the market for corporate control may be more effective than FRQ in governing non-Delaware firms. I remain agnostic about the role of FRQ for non-Delaware firms and draw attention to the fact that non-Delaware firms are not

affected by the regime shift and therefore should not be subject to a *change* in the role of FRQ around the regime shift for non-Delaware firms (which does not also affect Delaware firms, i.e. a market-wide effect). The discussion above leads to my first hypothesis:

H1: Following the Delaware regime shift, there is a positive relation between firm performance and financial reporting quality for Delaware firms relative to non-Delaware firms.

Next, I examine the effect of FRQ on Delaware firms' capital investment around the regime shift. Bertrand and Mullainathan (2003) find that after the passage of takeover laws in the late 1980s, firms shielded from takeovers have lower levels of plant births and deaths, consistent with managers exerting lower levels of effort with respect to their firms' capital investment activities when the threat of a takeover subsides.[6] Such managerial action/inaction can have adverse effects for both firm productivity and performance because of the resulting decreases in product quality and/or competitiveness. For example, managers may forgo investments in new technology, reduce plant and machinery maintenance, and/or shirk from the effort required to terminate or close underperforming plants.

The outcomes of managerial shirking with respect to capital investment decisions are reflected in financial reports and the timeliness with which the adverse outcomes are recognized is increasing in financial reporting conservatism. Timelier disclosure of adverse outcomes facilitates monitoring by stakeholders and boards, who likely investigate the root causes of the decrease in performance. For instance, upon obtaining reports about decreasing

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[6] Bertrand and Mullainathan (2003) examine changes in plant-level capital expenditures but do not find statistically significant results in support of the quiet life hypothesis. They note that due to data availability constraints, the sample size for those tests are "substantially smaller" than for other tests in their paper.

profitability, boards may request additional information and analysis from managers and take appropriate action to limit further losses.

Timelier monitoring by stakeholders and boards can affect capital expenditure activity. One plausible scenario is that monitors (e.g. shareholders or boards), of a firm that reports adverse changes in performance, may direct managers to increase investment in order to improve performance. Under such a scenario, I expect that subsequent to the Delaware regime shift, timelier recognition of losses results in greater capital investment expenditures. This leads to:

H2a: Following the Delaware regime shift, there is a positive relation between capital investment and financial reporting quality for Delaware firms relative to non-Delaware firms.

Next, I argue that financial reporting conservatism can mitigate quiet life behavior with respect to overinvestment. Overinvestment occurs because managers *do not* terminate value-decreasing activities in the post regime shift period. The intuition is as follows: Managers who are acting to maximize firm value would likely terminate value-destroying plants. Such activities require managerial effort, both in terms of the identification of sub-optimal plants and the logistical and administrative requirements to shut down a given plant.[7] Prior to the regime shift, all firms are disciplined to terminate value decreasing plants or operations because of the threat of the market for corporate control. Following the regime shift, managerial preferences for a quiet life results in *decreased* plant death activity for Delaware firms protected from the market for corporate control, cetirus paribus.

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[7] Upon the announcement of a plant closure, it is highly likely that managers would be confronted by aggravated employees, unions and be faced with other undesired activities such as ensuring that the plant closure is in accordance with Occupational Health and Safely regulations.

Prior work by Ball (2001) and Watts (2003) argue that the timelier recognition of losses can bring forward managerial decisions to divest value-decreasing investments. If managers understand that losses incurred from negative NPV investments will be recognized during their tenure, they are more likely to divest the investments in a timelier manner to limit the extent of the losses. Accordingly, if financial reporting plays a magnified role in the post period, I expect greater conservatism can curb the *decreased* plant death activity in the post regime shift period, i.e. conservatism is positively associated with Delaware plant-death activity in the post-regime shift period. Formally stated:

> **H2b: Following the Delaware regime shift, there is a positive relation between plant-death activity and financial reporting quality for Delaware firms relative to non-Delaware firms.**

3.2 Cross sectional predictions

In this section, I examine whether the role of financial reporting in mitigating quiet life behavior is affected by the severity of the quiet life problem. I identify two variables to proxy for the severity of the quiet life problem: the level of market competition faced by the firm and the presence of a staggered board.

First, I examine whether the positive relation between financial reporting and operating performance for Delaware firms post-regime shift is affected by product market competition. All else equal, firms operating in less competitive environments are faced with relatively less discipline from market competition, and hence managers of those firms have greater incentives to engage in quiet life behavior. On the other hand, managers of firms operating in competitive industries have limited scope to take actions consistent with

preferences for a quiet life because of pressure to reduce slack and inefficiencies. Giroud and Mueller (2008) provide some empirical evidence.[8] Using the passage of business combination laws in the late 1980's, Giroud and Mueller (2008) only observe adverse effects of managerial preferences for a quiet life for firms in less competitive industries. This leads to my third hypothesis:

H3: After the Delaware regime shift, the predicted positive relation between operating performance and financial reporting quality for Delaware firms relative to non-Delaware firms is more pronounced for firms operating in less competitive industries.

In my next set of tests, I consider that the Delaware takeover regime shift centered around the validity of the use of a staggered board-poison pill combination to repel hostile bids. Ex-post, Delaware firms with both mechanisms have the greatest protection from hostile takeovers, and incentives to lead the quiet life are expected to be strongest for managers of these firms. I expect that the governance and monitoring role of financial reporting is likely to have the greatest effect in curbing value decreasing managerial actions for firms with the strongest takeover protection mechanisms. On the other hand, in the pre-regime shift period, Delaware court rulings limited the power of firms to use the staggered board-poison pill combination to defend against hostile bids.[9]

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[8] While empirical evidence the argument that industry competition mitigates managerial slack exists, attempts to formalize the argument have met with mixed results - see Hart (1983), Scharfstein (1988) and Hermalin (1992). Holmström and Tirole (1989) conclude that "...the simple idea that product market competition reduces slack is not as easy to formalize as one might think".

[9] For instance, in Moran v. Household International Inc. (1985), the Delaware Supreme Court noted that a target's right to use a poison pill against hostile takeovers was not absolute and that the use of the pill would be subject to judicial scrutiny. Furthermore, in City Capital Associates v. Interco Inc. (1988), the Delaware Chancery Court ordered for the withdrawal of the target's poison pill, thus allowing shareholders to decide for themselves whether to accept the hostile bid.

I classify Delaware firms into two groups – those with a staggered board (*staggered board firms*) and firms without a staggered board (*non-staggered board firms*). I do not require *staggered board firms* to have poison pills in place ex-ante because the speed with which a poison pill can be implemented suggests that staggered board-only firms are similar to firms with staggered board-poison pill combination in place (Coates, 2000).[10] This leads to my final hypothesis:

H4: *Following the regime shift, the predicted positive relation between operating performance and financial reporting quality for Delaware firms is more pronounced for strong takeover defense firms.*

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[10] A limitation of my tests is the unavailability of data to differentiate between staggered board firms that do/do not have recourse to a poison pill, with the latter group having characteristics similar to '*weak takeover defense firms*'. I consider this possibility in my sensitivity tests.

4. Research Design

4.1 Empirical estimation of financial reporting quality

In this section, I focus on the empirical estimation of attributes of financial reporting quality: timely loss recognition, timely gain recognition and the overall timeliness of financial reporting. Financial reporting quality has been the subject of much examination in the accounting literature and numerous proxies that attempt to capture the attributes of financial reporting have been developed (see Dechow et al., 2009 for a summary). I focus on conservatism in financial reporting for a number of reasons. First, conservatism has been posited to have a governance role (Ball, 2001; Watts, 2003; LaFond and Roychowdhury, 2008). Second, given that quiet life behavior is expected to have adverse effects on performance, examining how the timeliness of these adverse effects are reflected in performance is a potentially interesting and natural choice of accounting property to examine. Next, I turn to my choice of conservatism measures.

I examine multiple properties of conservatism. First, I consider asymmetric timeliness of earnings with respect to bad news. Next, I consider earnings timeliness, in terms of good news timeliness as well as overall earnings timeliness. I examine the effects of timely gain recognition as well as overall timeliness of a firm's financial reporting as prior work identifies these characteristics of financial reporting conservatism as being informative to stakeholders (Ball and Shivakumar, 2006). Timely gain recognition improves the timeliness of accounting earnings and therefore is expected to make earnings a more informative measure of a borrower's performance (Ball and Shivakumar, 2006; Guay, 2006; Guay and Verrecchia, 2006). Further, timely gain recognition allows managers to bring forward earnings, which could mask the adverse effect of quiet life behavior. The overall

timeliness of a borrower's financial reporting, for both gains and losses, has been shown to be associated with the borrower's transparency (Ball et al., 2008).

I use proxies developed by Khan and Watts (2009) to measure conservatism. While a number of other conservatism measures have been discussed in the literature, the Khan and Watts proxies offer the important advantage of being firm-year measures without requiring historical time series data. This is in contrast to measures such as the Basu measure (Basu, 1997) and the Givoly and Hayn (2000) measures, all of which require the use of historical time-series data to estimate measures of conservatism. The use of such measures is problematic in my setting because the exogenous shock to firms arising from the Delaware regime shift can influence a firm's choice of reporting conservatism. Hence, the effect of any such changes in reporting conservatism around the regime shift is likely to be masked for measures that would require the use of pre-period data to estimate post-period conservatism.

The Khan and Watts (2009) firm-year measures of conservatism are linear functions of firm specific characteristics expected to vary theoretically and empirically with conservatism. The characteristics are firm size, market-to-book, and leverage. The regression model is based on the methodology in Basu (1997), which is used to provide weights used to linearly aggregate the firm-specific characteristics above into a composite conservatism index. GScore is the measure of earnings timeliness with respect to good news, CScore is the asymmetric timeliness with respect to bad news, and BScore captures the total bad news timeliness. The empirical model used to estimate GScore, CScore and BScore is as follows:

$$E_{i,t} = \beta_1 + \beta_2 D_{i,t} + R_{i,t}(\mu_1 + \mu_2 Size_{i,t} + \mu_3 M/B_{i,t} + \mu_4 Lev_{i,t}) + D_{i,t} R_{i,t}(\lambda_1 + \lambda_2 Size_{i,t} + \lambda_3 M/B_{i,t} +$$

$$\lambda_4 Lev_{i,t}) + \beta_3 Size_{i,t} + \beta_4 M/B_{i,t} + \beta_5 Lev_{i,t} + \varepsilon_{i,t} \tag{a}$$

Equation (a) is estimated using annual cross-sectional regressions, and the measures are then computed by summing the resulting coefficient estimates from equation (a):

$$GScore = \mu_{1,t} + \mu_{2,t} Size_{i,t} + \mu_{3,t} M/B_{i,t} + \mu_{4,t} Lev_{i,t} \tag{b}$$

$$CScore = \lambda_{1,t} + \lambda_{2,t} Size_{i,t} + \lambda_{3,t} M/B_{i,t} + \lambda_{4,t} Lev_{i,t} \tag{c}$$

$$BScore = GScore + CScore \tag{d}$$

The definitions of the variables used in the above model are as follows: i indexes the firm, t indexes time, E is earnings deflated by market value of equity at the end of the prior fiscal year (COMPUSTAT #18 / (#25 * #199)), R is returns, calculated by cumulating monthly returns for the 12 months starting from the fourth month after the firm's prior fiscal year end (Hayn, 1995; Basu, 1997), D is a dummy variable equal to 1 when R<0 and equal to 0 otherwise, *Size* is log of the market value of equity, i.e. Log(COMPUSTAT #25 * #199), *M/B* is measured as the market value of equity divided by the book value of equity at the end of the year (COMPUSTAT #25 * #199), and *Leverage* is the sum of long term debt and debt in current liability, deflated by market value of equity ((COMPUSTAT #9 + #34) / (#25 * #199)).

4.2 Differences in differences methodology

To conduct empirical tests, I use a differences-in-differences methodology, as used by Bertrand and Mullainathan (2003) and numerous other studies that examine the effects of changes in takeover regimes (e.g. Rauh, 2006; Giroud and Mueller, 2008; Low, 2008).

For the standard differences-in-differences approach, outcomes are observed for two groups for two time periods – in this study the periods correspond to prior to and following the Delaware regime shift. One of the groups is exposed to a treatment (i.e. Delaware firms are exposed to the regime shift) in the second period but not in the first period. This group is called the treatment group. The other group, called the control group (non-Delaware firms) is not exposed to the treatment in either period. The first level of differencing compares outcomes (where outcomes in this study refer to the effect of financial reporting on operating performance or capital investment) before and after the regime shift separately for firms in the control group and the treatment group. The second difference compares changes in treatment firms relative to changes in the control group.

I estimate the following regression for Delaware firms and non-Delaware firms:

$$DEP\_VAR_{it} = \alpha_1 + \beta_1\, AFT_{it} + \beta_2\, FRQ_{it} + \beta_3\, AFT_{it} * FRQ_{it} + \beta_4 X_{it} + e \qquad (1)$$

where DEP_VAR_{it} represents a variable to capture H1, H2a or H2b. To test H1, DEP_VAR_{it} is set to ROA_{it}, calculated as income before extraordinary items scaled by total assets ((COMPUSTAT #18 / #6) x 100). To test H2a, DEP_VAR_{it} is set to $INVESTMENT_{it}$, calculated as capital expenditure (from the Statement of Cash Flows) scaled by lagged PP&E; ((COMPUSTAT #128 / #8$_{t-1}$) * 100). To test H2b, DEP_VAR_{it} is Asset Sales scaled by lagged PP&E ((COMPUSTAT #107 / #8$_{t-1}$) * 100).

In equation 1 (2), AFT is a dummy variable set to 1 if the observation is in or after 1996. FRQ represents a firms financial reporting quality, captured using CScore, BScore or GScore. CScore and BScore (GScore) are increasing (decreasing) in financial reporting

quality. X_{it} is a vector of control variables (discussed below). In all regressions, I cluster standard errors by firm and year (Petersen, 2009).

In equation (1), β_1 captures the incremental effect of the regime shift on operating performance (or capital investment) relative to pre-regime shift years. Under a quiet life hypothesis β_1 is predicted to have a negative sign, representing lower levels of operating performance (capital investment) in the post-regime shift period. A significant difference between β_1 for the Delaware and non-Delaware firm regressions is consistent with quiet life behavior. β_2 *(FRQ$_{it}$)* captures the effect of financial reporting quality on performance (capital investment) in the pre-regime shift period. If the governance role of financial reporting complements the governance from the market for corporate control, then β_2 is predicted to have a positive sign. However if financial reporting is a substitute for the market for corporate control, then β_2 may not have a positive coefficient. Next, β_3 can be interpreted as the *incremental* effect of financial reporting quality in the post-regime shift period. My central prediction is that the effect of financial reporting is greater in the post-regime shift period for Delaware relative to non-Delaware groups. Hence, I predict that the *difference* between β_3 for the Delaware and non-Delaware groups is positive.

In all econometric specifications, I attempt to control for firm, governance and other operating environment characteristics that could explain cross-sectional differences in a firm's operating performance or capital investment actions. I discuss these control variables next.

For empirical tests where ROA is the dependent variable, I include controls for firm specific and governance characteristics, as well as the information environment. Firm-specific controls include *FirmSize* (log of Market Value of Equity at year end; (Ln

(COMPUSTAT #199 * #25)), *Book to Market* (Book value of equity divided by Market Value of Equity; (COMPUSTAT #6 - #181) / (#25 * #199)), *Leverage* (Total liabilities scaled by Book Value of Equity; (COMPUSTAT #181 / (#6 - #181))), and *Firm Age* (the number of years since the firm first appeared on COMPUSTAT). I expect *Firmsize*, *Leverage* and *Firm Age* to be positively associated with performance, and *Market to Book* to be negatively associated with *ROA*.

I also control for a number of corporate governance characteristics that can influence managerial behavior. First, I control for the strength of shareholder rights at the firm level using *G-Index*, a measure developed by Gompers at al. (2003).[11] The measure is *negatively related* to the strength of shareholder rights. I expect that managerial incentives to engage in quiet life behavior are decreasing in shareholder rights, hence implying that *G-Index* has a negative relationship with performance. Next, I control for the level of blockholder monitoring using the proportion of stock held by institutions during the contemporaneous fiscal year (*InstitutionalHolding%*; with data obtained from Thomson Reuters, and measured as total stock held by institutions at fiscal year end scaled by outstanding number of shares at year end). Shleifer and Vishny (1997) suggest that institutional investors can monitor mangers, and hence act in a governance capacity. I also control for executive compensation with the proportion of outstanding stock held by the CEO at the end of the contemporanous fiscal year (*CEOStockholding%*). I use Execucomp for compensation data. Next, I use I/B/E/S to calculate the analyst following for each firm. I calculate the average number of analysts following a firm over the contemporaneous fiscal year (*AnalystFollowing*) to proxy for a firm's information environment. *AnalystFollowing* can

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[11] Data for GIndex is only available for the 1990, 1993, 1995, 1998 and 2000 fiscal years during my sample period. For years missing GIndex values, I use the most recent lagged GIndex value.

also act as a corporate governance proxy because analysts are widely viewed as external monitors of manager's actions (Hope and Thomas, 2008). I expect a positive relation between *ROA* and *InstitutionalHolding%, CEOStockholding%* and *AnalystFollowing.*

Empirical tests examining the effect of financial reporting quality on capital investment (H2a) and asset sales (H2b) also include numerous control variables. First, I discuss controls for the determinants of investment. I control for contemporaneous *Return on Equity (ROE)*, calculated as Income before Extraordinary Items scaled by Total Stockholders Equity (COMPUSTAT #18/(#6 - #181)). *ROE* captures the extent to which firms have positive NPV projects and is expected to be positively associated with capital investment and asset sales. Next, consistent with Welch and Wessels (2000), I control for changes in Inventory *(Inventory)*, calculated as the change in scaled inventory (COMPUSTAT $((\#3_t / \#6_t) - (\#3_{t-1} / \#6_{t-1}))$. Firms with unusual increases in inventory could respond by decreasing investment or shutting down plants. Alternatively, it is possible that firms might increase inventories and investment in anticipation of future demand. Hence, I do not have an ex-ante prediction for the sign on *Inventory* for tests of Investment or Asset sales. Next, I control for the firm's *Book to Market* ratio (Book value of equity divided by Market Value of Equity; (COMPUSTAT #6 - #181) / (#25 * #199)) as a proxy for the size of the firm's investment opportunity set. I expect investment and asset sales to be positively associated with the presence of growth options, and hence predict a negative coefficient on Book to Market. Next, I include a control for changes in Dividend Payouts *(Dividends)*. Decreases in investment opportunities should result in an increase in dividend payouts, i.e. there is a substitution effect between investment and dividends. Alternatively, managers could use excess free cash flow to simultaneously pay dividends and fund managerial pet

projects. This leads to a complementary relation between investment and dividends. I calculate *Dividends* as the change in Dividends Paid from t-1 to t, measured as COMPUSTAT #21$_t$/#6$_t$ - #21$_{t-1}$/#6$_{t-1}$. I also control for the size of the firm's cash holdings (*Cash*) as firms may retain greater cash reserves in anticipation of future capital expenditures. *Cash* is calculated as the scaled change in cash holdings from t-1 to t all multiplied by 100, i.e. ((COMPUSTAT #3$_t$/#6$_t$ - #3$_{t-1}$/#6$_{t-1}$)*100) I expect cash to be positively (negatively) associated with capital investment (asset sales). I also control for lagged annual stock returns (*Lag Return*) as well as *Firm Age*. These variables are expected to respectively be positively and negatively associated with both investment and disposals. Finally, I also include controls for the number of analysts following a firm (*AnalystFollowing*), as well as governance controls including *InstitutionalHolding%*, *CEOStockholding%* and *G-Index*, which are all as previously described. I expect that stronger governance is positively associated with capital expenditure as well as disposal activity in the post regime shift period.

To test Hypothesis 1-3, I pool the Delaware and non-Delaware samples and then estimate the following equation:

$DEP\_VAR_{it} = \alpha_1 + \beta_1\,AFT_{it} + \beta_2\,FRQ_{it} + \beta_3\,AFT_{it} * FRQ_{it} + \beta_4 X_{it} + \beta_5\,DEL_{it} + \beta_6\,AFT_{it} *$

$DEL_{it} + \beta_7\,FRQ_{it} * DEL_{it} + \beta_8\,AFT_{it} * FRQ_{it} * DEL_{it} + \beta_9 X_{it} * DEL_{it} + e$ (2)

where DEL_{it} is an indicator variable set to 1 if the firm is incorporated in Delaware and all other variables are as previously described. Equation (2) includes all the variables from Equation (1) with the difference being that all the variables are included a second time and interacted with DEL_{it}. The significance of the β_8 interaction coefficient term is the

estimate of the significance of the difference between the coefficients from equation (1) for the incremental governance role of financial reporting as calculated separately for Delaware and non-Delaware firms.

4.3 Measure of industry competition

For empirical tests examining whether industry competition affects the role of financial reporting quality on firm performance and capital investment, I use the Herfindahl Hirschman index (HHI) to measure industry competition, and partition firms into two groups based on the level of industry competition. The HHI is defined as the sum of squared market shares,

$$HHI_{jt} := \sum_{i=1}^{N_j} s_{ijt}^2 ,$$

where s_{ijt} is the market share of firm i in industry j in year t. Market shares are calculated using sales (#12) from Compustat. The measure is decreasing in industry competition. Consistent with Giroud and Mueller (2008), industries are determined at the 3-digit SIC code level.[12] I use the first year following the Delaware regime shift to determine the level of industry competition.[13]

4.4 Tests examining the effect of the presence of a staggered board

Tests of Hypothesis 4 are performed by estimating Equation (1) on a subsample of firms that are incorporated in Delaware. I do not examine differences between the effect of the presence of a staggered board for Delaware and non-Delaware firms as non-Delaware firms represent firms in 49 states, rendering it difficult to develop an understanding of the role of staggered boards for non-Delaware firms. A limitation of this approach is that my

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[12] Empirical results are qualitatively similar when I use 2-digit or 4-digit SIC codes as partitions. I windsorize HHI values at the 1% and 99% levels.
[13] In sensitivity tests, I use 1994 and 1995 to compute the HHI index. Reported results are unchanged using these alternate specifications.

tests will not be able to incorporate the benefits associated with the differences-in-differences design used for my other empirical tests.

5. Sample and Descriptive Statistics

5.1 Sample

I create my primary dataset by combining financial, accounting, governance and other firm and manager specific data from multiple sources. Table 1 outlines the sample selection procedure. My sample period is the five year period prior to and following the regime shift in 1995, i.e. a period of 11 years from 1990-2000. I begin with the merged CRSP/ Compustat Industrial (Annual) population and retain firms with state of incorporation data. This results in 104,260 firm year observations. I require firms to be in the dataset in the year preceding the regime shift (i.e. in 1994), a restriction that reduces the sample to 35,295 firm year observations. Consistent with prior work, I delete financial firms (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) because of variation in federal regulation that affects the corporate governance of these firms. This reduces my sample by 4,704 observations, leaving 30,591 firm-year observations.

I then retain observations for which I have CScore data. This leaves me 12,479 firm year observations[14]. Finally, I require observations to have valid data from Execucomp for CEO Stockholding data, Thomson Reuters for Institutional Holding data, I/B/E/S for analyst following data, G-Index data, obtained from Andrew Metrick's website and data from Compustat in order to calculate required financial variables.[15] After imposing these data requirements, my final sample consists of an unbalanced panel of 6,879 firm years for

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[14] Khan and Watts (2009) remove negative Book Value of Equity firms from their sample. As I restrict my sample to observations from Khan and Watts (2009), a limitation of my study is the sample is restricted to relatively healthier firms that have the incentive and ability to engage in quiet life behavior.
[15] I thank Andrew Metrick for providing G-Index data on his website: http://www.som.yale.edu/faculty/am859/.

regressions examining operating performance, and 6,241 firm year observations for regressions examining the effects of the regime shift on capital investment.[16]

5.2 Descriptive Statistics

Table 2, Panel A outlines industry membership for Delaware and Non-Delaware incorporated firms at 1994. Computers and Textile/Print/Publish firms comprise the largest groups for Delaware incorporated firms, with approximately one quarter of the total Delaware sample. Non-Delaware incorporated firms have the greatest representation in the Textiles/Print/Publish, Retail and Transportation industries, with these industries combining for nearly one quarter of the total Non-Delaware firm sample. Evidence from this table suggests that results are unlikely to be driven by industry membership.

Table 2, Panel B outlines the states in which Delaware and non-Delaware firms are headquartered. Approximately half of all Delaware firms are headquartered in one of four states: California, Illinois, New York and Texas. Non-Delaware incorporated firms appear to have greater dispersion in their choice of headquarters – no state has greater than 11% of all firms (Ohio). Evidence in Panel B suggests that there is little congruence between a firm's state of incorporation and state of location which reduces the likelihood that my empirical results are driven by effects at the state location.

Table 3 provides descriptive statistics for Delaware and non-Delaware incorporated firms as at 1994. Both groups have similar market capitalization and sales mean values. Non-Delaware firms report relatively higher average ROA and are slightly less levered than Delaware firms. Both groups of firms appear to have similar governance characteristics- analyst following, CEO stock ownership and G-Index scores are similar for both groups of

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[16] All Compustat variables are winsorized at the 1 and 99% levels.

firms. Investment is significantly different for both groups, with Delaware firms reporting higher investment levels than non-Delaware firms.

Table 4 displays correlation tables. Panel A (B) shows Spearman and Pearson correlations for tests of FRQ on performance (Investment/Asset Sales) and control variables. As expected, correlations between my measures of FRQ are significantly different than zero and positive in both Panels. Turning to Panel A, both measures of FRQ are negatively correlated with firm size, ROA, and age, and positively correlated with leverage, consistent with expectations. Firm size is positively related to analyst following, institutional holding and G-Index, and negatively related to the percentage of stock held by the CEO.

Turning to Panel B, Investment is significantly and negatively associated with both CScore and BScore. As expected, investment is negatively associated with Firm Age, Book to Market and Firm Age. Interestingly, Analyst Following, Institutional Ownership, CEO Holding are all positively and significantly associated with investment.

Turning to Asset Sales, measures of conservatism are positively associated with asset sales, consistent with timelier recognition of losses facilitating negative NPV project divestment. Firm age and Book to Market are both positively associated with divestment, consistent with firms in the steady or mature stage of their life cycle eliminating underperforming assets. Interestingly, I find that Analyst Following and Institutional Holding % are negatively associated with asset sales. One explanations is that analysts and institutional investors invest in firms with growth options, which in turn is negatively associated with asset sales.

6. Results

6.1 Main results

Table 5 presents regression results for tests of H1. The first set of tests shows the effect of the regime shift on firm behavior. The second, third and fourth set of tests show the results of whether the governance role of financial reporting in the post-regime shift period affects firm performance when the market for corporate control is no longer effective for Delaware firms. Each set of tests includes results for Delaware and non-Delaware firms separately, and then reports coefficients and t-stats for the difference between coefficients for the Delaware and non-Delaware groups.

I use return on assets (ROA) to proxy for operating performance, where ROA is Income before Extraordinary Items scaled by Total Assets. Column 1 and 2 display results for regressions examining the effect of the regime shift on firm performance for Delaware and non-Delaware firms respectively. *AFT*, the coefficient of interest, is negative and significant for both groups. Column 3 presents t-tests of differences in coefficients for the Delaware and non-Delaware regressions and the results indicate that post-regime shift, Delaware firms have significantly worse performance than non-Delaware firms. This result is consistent with a quiet life hypothesis: Delaware managers appear to take actions in the post-regime shift period that are associated with reduced performance relative to both the pre regime shift period and non-Delaware firms (which do not experience any systematic changes in takeover defenses at the same point in time). In terms of economic significance, the coefficient for AFT in column 3 implies that the drop in ROA after the regime shift is approximately 8.7% (i.e. -0.866 x 100) for Delaware firms. This represents an average

decrease in ROA from 4.8% in the pre period to 4.4% in the post period (for Delaware firms).

I find evidence that for Delaware firms post regime shift, greater asymmetric timeliness and overall timeliness (using CScore and BScore respectively) are positively and significantly associated with operating performance. First, I turn to results of tests that use CScore to measure financial reporting quality. Column 4 & 5 report results using CScore as a proxy for FRQ for Delaware and non-Delaware firms. I find evidence consistent with financial reporting quality being positively associated with performance in the post regime shift period when using either CScore, and this effect is significantly different to the effect of FRQ for non-Delaware firms.[17] I also find similar results when using BScore (Columns 10-12) to measure total news timeliness.

Next, while I find some evidence that the level of good news timeliness (using GScore to measure good news timeliness) is positively associated with performance for Delaware firms in the post-regime shift period, this effect is not significantly different to non-Delaware firms. This result coupled with the evidence above suggests that the governance role of conservatism in mitigating quiet life behavior is driven by the timely recognition of losses relative to gains, and that my results using BScore are driven by asymmetric loss recognition rather than timely gain recognition.

The role of FRQ in the pre-regime shift period on performance is captured by β_2. Ex-ante, I predict that β_2 should be > 0 ($= 0$) if FRQ and the market for corporate control are substitutes (complements) and FRQ plays (does not play) a governance role in the post period. It is also possible that β_2 is negative due to the mechanical relation between

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[17] My empirical results are qualitatively similar when I cluster standard errors at the state-of-incorporation level.

conservatism and performance: if a firm records losses in a relatively timelier manner, then it is likely to cause a more negative relation between conservatism and performance relative to another less conservative firm that does not record losses in a less timely manner. Results in Table 5 where FRQ is set to either CScore, BScore or GScore indicate that the mechanical effect appears to dominate over the governance effect of FRQ. Specifically, coefficient for β_2 is negative (and sometimes significant) for Delaware and non-Delaware firms. However, in all scenarios, none of the tests of differences between coefficients are significant, suggesting that the role of financial reporting in the pre-period is similar across groups. However, my tests are focused on the *incremental* effect of FRQ (i.e. β_2) in the post period and as such I focus on the fact that given a change in the system of corporate governance arising from the decreased effectiveness of the market for corporate control can affect the role of FRQ in the post-regime shift period.

In sum, my results from Table 5 provide strong for the argument that Delaware firms with higher (lower) conservatism have stronger (weaker) performance in the post-regime shift period. In economic terms, a one standard deviation increase in CScore (BScore) results in an increase in post regime shift ROA of approximately 19% for the average Delaware firm relative to non-Delaware firms. A one standard deviation increase in CScore is associated with an increase in ROA in the post regime shift period of 11.21 * 0.08 = 0.90, or 19% (noting from Table 3 that the average pre-regime shift ROA for Delaware firms was 4.76) so 0.90 / 4.76 = 0.19. This result is consistent with financial reporting, and specifically, the timelier recognition of bad news in financial reports, playing a magnified role in the post-regime shift period when the market for corporate control is less effective in governing Delaware firms.

Controls for firm size, book to market, leverage, analyst following and institutional holdings are all significant at conventional levels. Consistent with expectations, firm size is positively associated with performance. In tests using CScore and BScore, there is a significantly greater effect of firm size on performance for Delaware firms than for non-Delaware firms. As expected, ROA is negatively related to both Book to Market and Leverage for all measures of conservatism. A negative coefficient on Book to Market is consistent with firms with greater growth opportunities reporting higher performance.

Next, I find that contrary to expectations, average analyst following is negatively related to performance for all firms using all measures of conservatism, and the differential effect between DE and non-DE firms is statistically significant at the 10% for FRQ=CScore. One possible explanation is that analysts may follow firms in more competitive industries because of economies of scale in understanding industry-wide factors that affect firm performance. Further, greater market competition is likely to be associated with lower levels of profitability which could drive the negative coefficient for *Analyst Following*. Next, I find that *Institutional Holding%* and *CEO Holding%* are both positively associated with performance for all firms, consistent with these mechanisms playing a governance role. Further, coefficients on G-Index are negative (but insignificant), consistent with managerial protection and entrenchment increasing agency costs and adversely affecting performance. This is consistent for all three measures of FRQ, a result that holds using any of my proxies for conservatism.

The adjusted R-square values are similar across tests using any of CScore, GScore or BScore to proxy for FRQ – the value is between 18% and 27%, suggesting a reasonable level of fit for the model. Overall, the results in Table 5 are consistent with hypothesis 1 and

provide support for the argument that financial reporting can play a magnified role in disciplining managerial quiet life behavior when the market for corporate control ceases to effectively function as a governance mechanism.

Table 6 presents results of estimating the effect of financial reporting on post regime shift capital expenditures. Empirical results support the thesis that financial reporting can help mitigate reductions in quiet life behavior with respect to capital investment. First, I find some evidence that Delaware firms reduce capital expenditures following the regime shift. However, this effect is not significant at conventional levels, a result consistent with the results in Bertrand and Mullainathan (2003) who do not find evidence that firms affected by changes in Business Combination takeover laws reduce capital investment. However, using plant level data, Bertrand and Mullainathan (2003) find evidence of managerial *inaction*, manifested though decreases in both plant births and deaths for firms affected by the Business Combination laws. The second, third and fourth set of tests examine whether capital investment activities are affected by FRQ for Delaware and non-Delaware firms and provide t-tests of the differences between the groups. In each set of tests, FRQ is set to be CScore, BScore and GScore respectively. A positive coefficient for *AFT*FRQ* is consistent with the hypothesis that higher financial reporting quality is associated with higher levels of capital expenditures post-regime shift.

For tests using all three FRQ proxies, I find evidence consistent with H2: the coefficient on *AFT*FRQ* is positive both for Delaware firms and significantly greater when compared to non-Delaware firms: t-tests of differences of coefficients are significant at the 5% level or better. Existing literature on the governance role of conservatism with respect to investment suggests both an ex-ante and ex-post role (e.g., Ball, 2001, Watts, 2003). Ex-

ante, conservatism limits managerial investment in negative NPV projects because the losses are more likely to be recorded during the manager's tenure. In an ex-post setting, Ball and Shivakumar (2005) argue that under conservative accounting, managers have incentives to act quickly to limit economic losses from poorly performing projects because without such action, the losses would grow and also be recognized during the manager's tenure. I argue that through an indirect effect, conservatism can also affects capital expenditures: As previously discussed, conservatism speeds the recognition of adverse performance effects of quiet life behavior. It is possible that the monitoring actions (by boards and/or stockholders) arising from the signal of adverse performance can induce managers to undertake greater levels of investment as a response to adverse performance. The results in Table 6 are consistent with this argument.

In terms of economic significance, a one standard deviation increase in CScore is associated with a 7% reduction in underinvestment that arise from managerial preferences for a quiet life. This is determined as follows: The standard deviation for Delaware firms CScore value is 0.08 (from Table 3). A one standard deviation increase in CScore is associated with an increase in investment in the post regime shift period of 6.63 * 0.08 = 0.53, or 7.2% (noting that the average pre-regime shift investment for Delaware firms was 7.27: i.e. 0.53 / 7.27 = 0.097).

Next, I discuss results for control variables. For all tests, *ROE* is negatively associated with capital expenditure, inconsistent with expectations. However this result is insignificant at conventional levels. The change in inventory *(Inventory)* is negative and significant for all tests of FRQ on Investment. In addition, this result is significantly different for Delaware firms than for non-Delaware firms. I also find as expected, a negative

relation between firm age and capital investment. This is consistent with firms spending proportionally less on investment over time. Next, Book to Market is also negatively related to Investment, consistent with growth firms having greater levels of investment. I find no significant relation between the change in Dividends (*Dividends)* and investment for all tests of Delaware and non-Delaware groups. Cash Holdings are positively and significantly associated with investment in all reported tests, and this effect is significantly different between Delaware and non-Delaware firms for all tests. *G-Index* is positively associated with Investment suggesting that greater managerial power results in higher levels of investment, consistent with an empire-building story. Similarly, less monitoring by analysts also results in greater levels of capital investment. I also find that neither the level of institutional holdings nor CEO Holding % appears to significantly affect capital investment. In summary, the results in Table 6 provide further evidence that financial reporting can play a magnified governance role in disciplining managerial behavior when other governance mechanisms such as the market for corporate control demonstrate a reduced ability to discipline managerial behavior.

Table 7 displays results for tests of hypothesis 2b, which predicts that greater conservatism should curb Delaware firms' quiet life behavior with respect to asset sales in the post-regime shift period. The overall evidence provides some support for the prediction above. Panel 1-3 show results for tests of the differences in disposal activity around the regime shift. First, Panel 1 (2) displays results for Delaware firms (non-Delaware firms) and Panel 3 provides t-tests of the differences between coefficients in Panels 1 and 2. In the post-period, Delaware firms experience a small (but insignificant) in their asset sale behavior relative to the pre-period whereas non-Delaware firms have a significant and positive

increase in asset sales relative to the pre-period. The difference between Delaware and non-Delaware firms is negative and significant at the 10% level, but this result is driven by the non-DE firms. A possible explanation is that the disciplinary role of the market for corporate control in the pre-period has reduced the presence of negative NPV projects in the post period. Panels 4-12 provide results of the effect of financial reporting conservatism characteristic on disposal activity and the incremental effect in the post-regime shift period. For tests using CScore, the coefficient for *AFT* in Column 4 (Delaware firms) is positive and significant at 10% using a one tailed test. This implies that FRQ has a significant positive impact on asset disposals, consistent with arguments in Ball (2001) and Watts (2003). This result however, is not significantly different to non-Delaware firms. The coefficient for *AFT*FRQ* is also positive and significant at the 10% level for a one-sided test, suggesting that FRQ has a significantly greater effect on asset disposal activity in the post period. This result holds for both Delaware and non-Delaware firms, which suggests that the incremental role of FRQ in the post period is an economy-wide effect. I find similar empirical results to those discussed above when using BScore instead of CScore. For tests using GScore to measure FRQ, I expect that the timelier recognition of good news should be negatively related to asset disposal activity. All else equal, greater good news timeliness should increase the ability of mangers to mask poor performance. Results for *AFT*FRQ* in column 7 are consistent with this expectation. However, the effect of GScore in the post-period is significantly greater for non-Delaware firms than for Delaware firms, contrary to expectations.

Table 8 and 9 provide results for hypotheses 3 and 4, which examine whether the relation between financial reporting quality and firm performance varies with the severity of

managerial incentives to engage in quiet life behavior. Table 8 provides results from tests of my third hypothesis which predicts that the governance role of FRQ will play a greater disciplinary role for firms subject to less competitive pressure. I partitions firms by the level of product market competition, with competition determined using the HHI at the 4-digit SIC code level. The HHI is calculated out of sample, using the entire population of Compustat firms. Observations are ranked into deciles based on the level of industry competition as at 1996 and the top and bottom four deciles are partitioned into two groups: a high industry competition group and a low industry competition group. Panel A (B) displays results of tests for firms operating in high and low competition industries where FRQ is set to CScore (BScore). Turning to control variables, ROE, Inventory, Book to Market, Dividends and Cash Holdings appear to affect disposal activity.

Evidence from Table 8, Panel A provide evidence that the governance role of financial reporting is magnified in the post-period for Delaware firms operating in less competitive environments. This effect is significantly greater for Delaware firms in the post period. In Panel A, the coefficients for a t-test of the difference between the coefficients for *AFT*FRQ* for Delaware and non-Delaware firms are positive and significant at the 5% level, consistent with the argument that Delaware firms operating in less competitive industries and with relatively greater asymmetric timeliness and have better performance in the post regime shift period relative to non-Delaware firms. In Panel B, results are similar to those in Panel A when I replace CScore with BScore. T-tests of the difference between *AFT*FRQ* for Delaware and non-Delaware firms are insignificant for tests using both CScore and BScore. R-squared values for all tests across the partitions are similar, ranging from 0.15 to 0.26. In summary, my results suggest that the governance role of financial

reporting has the greatest effect on performance for firms that are not subject to high levels of product market competition. For firms subject to competition, financial reporting does not play a magnified governance role in the post period, but instead, can act in conjunction with competition to discipline managerial actions.

Results in Table 9 provide evidence in support of Hypothesis 4: the governance role of financial reporting is magnified for Delaware firms with staggered boards, i.e. when managers are less subject to takeover threats. Panel A provide results for tests examining the effect of FRQ on performance for Delaware firms with a staggered board, and Panel B provide results for Delaware firms without a staggered board. While coefficients for *AFT*FRQ* in Panel A and B are significant and positive for both CScore and BScore, the coefficients in Panel A are statistically stronger. It is possible the results in Table 9 are overstated because of the inability to use a non-Delaware control group to account for any macroeconomic shocks or inter-temporal shocks.

6.2 Sensitivity tests and robustness checks

6.2.1 Alternative sample period: late-1980s multi-state adoption of antitakeover laws

My primary empirical results for the effect of FRQ on performance and capital expenditures are qualitatively similar when I replicate my tests using the Bertrand and Mullainathan (2003) sample period and setting as displayed in Table 10. BM use exogenous variation in governance in the form of business combination laws enacted in the late-1980s by 30 states on a state-by-state basis. The Business Combination laws impose a moratorium on a number of transactions including mergers and asset sales between a large shareholder and the firm for a period from three to five years after a shareholder's stake has passed a certain threshold. The passage of Business Combination laws in the late-1980s and the mid-

1990s Delaware regime shift differ in that the Delaware regime shift refers to a change in the judicial interpretation of *existing* legislation, whereas the Business Combination laws refer to a *change* in legislation. This difference suggests at least two potential benefits of focusing on the Delaware regime shift setting.

First, the prevalence of data available in machine readable form is greater in the period surrounding the Delaware regime shift than for the sample period in the Bertrand and Mullainathan setting. Specifically, a number of control variables used in my main tests are not available for the entire Bertrand and Mullainathan sample period. Specifically, CEO Stockholding % is not available prior to 1990, G-Index is not available before 1990 and Institutional Holding% is not available prior to 1980. A second benefit of using the Delaware regime shift setting is that the possibility that the change in the market for corporate control arises endogenously due to lobbying by a coalition of firms. I discuss this issue further in Section 6.4.1.

6.2.2 Ex-ante managerial entrenchment

In this section, I consider the possibility that managerial entrenchment affects the effectiveness of the governance role of financial reporting. On the one hand, entrenched Delaware managers may not adjust their behavior *following* the regime shift as they are already leading the quiet life *prior* to the regime shift. Hence, for such firms, it is possible that the governance role of financial reporting does not play a magnified around the regime shift. Under this argument, I expect that β_3 from Equation (1) would be less pronounced for entrenched Delaware firms. An alternative argument is that the governance role of financial reporting is greater when managers are more entrenched, and even more so when the market

for corporate control is less effective. Under this argument, I expect β_3 to be greater for entrenched Delaware firms relative to other Delaware firms.

I measure the level of managerial entrenchment using the Entrenchment Index (E-Index) developed in Bebchuk and Cohen (2009). The index identifies a subset of measures from the Gompers et al. (2003) G-Index measure of corporate governance that are expected to have the greatest effect on the level of managerial entrenchment. I partition sample firms into two groups - High and Low Entrenchment based on the mean E-Index score from Bebchuk and Cohen (2009).

Table 11 displays the results from empirical tests with firms partitioned by low and high entrenchment. Panel A (B) displays results for tests where CScore (BScore) proxy for FRQ. The collective evidence suggests that the governance role of financial reporting does not have a significant effect in mitigating quiet life behavior for entrenched Delaware managers. First, I find that entrenched Delaware firms do not display a significant decrease in performance following the regime shift (relative to non-Delaware firms). I interpret this as evidence that the increased protection from takeovers arising from the regime shift does not increase the incentives for Delaware managers to engage in quiet life behavior incremental to their quiet life incentives *prior to* the regime shift. Hence, if the regime shift does not influence managerial behavior because managers are entrenched ex-ante and already engaging in quiet life behavior, it is not clear that the governance role of financial reporting should play a magnified role in the post period. Consistent with this, I find that the financial reporting only plays a governance role in the post period for firms that engage in quiet life behavior as a result of the regime shift – i.e. non-entrenched Delaware firms. For these firms, the evidence in Panel A and B indicates that there is a positive association

between conservatism and performance in the post period, and that this effect is significantly different for Delaware firms relative to non-Delaware firms. For tests in Panel A (B) using CScore (BScore) the coefficient on FRQ * AFT is significant at the 1% level.

6.2.3 Post-regime shift roles of other governance mechanisms

In this section, I consider the possibility that multiple governance mechanisms (i.e. mechanisms in addition to or other than financial reporting) play an increased governance role in the post-regime shift period. In other words, it is possible that my primary empirical specification suffers from an omitted correlated variable problem in the form of an alternative governance mechanism that is correlated with financial reporting and plays an increased governance role in the post regime shift period. I examine this possible issue by adding controls that allow my governance control and information environment variables to play an incremental role in the post regime shift period. Specifically, I interact Institutional Holding percentage, CEO stockholding %, G-Index and Analyst following with AFT_{it} and include each of the interaction terms in my main empirical specification in addition to the un-interacted variables.

Table 12 summarizes the results. First, I find evidence that CEO Holdings *(AFT*CEO Holding %)* and G-Index *(AFT*G-Index)* have statistically significant magnified governance roles in the post period. Interestingly, I find that the proportion of stock held by institutional investors and the analyst following for a firm do not have a significant incremental governance role in the pre and post period. Turning to the role of financial reporting, the evidence in Table 12 suggests that financial reporting is still positively and significantly associated with performance after controlling for the possible increased governance role of various governance mechanisms in the post regime shift period. These

results are robust to the use of either CScore or BScore to measure FRQ. The coefficient on *AFT * FRQ* is 11.82 (12.56) for Delaware firms for CScore (BScore) with a t-statistic of 2.06 (2.48). Importantly, when compared to non-Delaware firms, I find significant differences between the coefficients on *AFT * FRQ* at the 5% level or better using both CScore and BScore to measure *FRQ*.

6.2.4 Staggered boards without recourse to a poison pill

Table 13 presents results of tests of FRQ on performance after excluding firms without a poison pill. Ceteris paribus, firms with a staggered board but *without recourse to a poison pill* have weaker takeover defenses relative to firms with a staggered board-poison pill combination: if a hostile bidder wins the first proxy contest to replace a third of a target's staggered board, the acquirer will inevitably win a subsequent proxy contest and obtain control of the board. Hence, upon losing the first proxy contest, the remaining incumbent directors typically resign, and cede control to the hostile bidder (Bebchuk et al., 2002). Ideally, I would like to identify firms without recourse to a poison pill and remove these firms from the Delaware sample. However, data limitations limit my ability to distinguish between firms without recourse to a poison pill and firms that have access to a poison pill but do not preemptively maintain one.[18] In other words, removing firms based on the lack of poison pill may have the unintended consequence of removing observations that are valuable to my tests – a case of 'throwing the baby out with the bathwater'. I acknowledge this inability to differentiate between non-poison pill firms as a limitation of the set of tests below. The evidence in Table 15 is consistent with my main findings in Table

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[18] Note that a poison pill can be implemented in under 24 hours in the event that a firm is the subject of a takeover attempt. Hence, it is not imperative for firms to preemptively maintain a poison pill.

5, i.e. that greater financial reporting quality plays a magnified governance role in the post regime shift period for Delaware.

6.2.5 Differential effects of staggered board establishment in the charter or the bylaws

In this section, I discuss results of tests that examine whether firms with staggered boards established in a firm's charter have greater quiet life incentives than do firms with staggered boards established through the bylaws. Shareholders cannot amend charter-based staggered boards whereas they can amend or dismantled bylaws-based staggered boards. Hence, as shareholders may amend their company's bylaws, bylaws-based staggered boards do not provide boards with the same protection from removal by determined shareholders that is provided by charter-based staggered boards (Bebchuk and Cohen, 2002). Empirical evidence suggests that the presence of charter-based (bylaws-based) staggered boards is associated with greater (smaller) decreases in firm value (Bebchuk and Cohen, 2002).

I reperform my main tests after excluding all firms with bylaws-based staggered boards.[19] The evidence in Table 14 is consistent with my primary results. I find evidence that the subsample of charter-based staggered board firms engage in quiet life behavior as there is less risk of shareholders dismantling the staggered board. While these results are statistically stronger than those in my primary tests, the results are not economically different to my main tests.

6.2.6 Alternative measure of executive compensation

Table 15 outlines the empirical results after replacing *CEOHolding%* with an alternate measure of executive compensation that incorporates 1) CEO stockholding and 2) total number of options held by the CEO; with both amounts scaled by the total number of

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[19] I obtain data to differentiate charter-based and bylaws-based staggered boards from Lucian Bebchuk's website: http://www.law.harvard.edu/faculty/bebchuk/data.shtml.

outstanding shares. Cheng et al (2006) find evidence that managers subject to protection from takeovers divest their stock holdings ex-post. Hence, using both stock and option holdings (*CEOHolding%_2*) may more effectively measure CEO stock-related incentives relative to a measure that only incorporates the total percentage of outstanding stock held by the CEO: *CEOHolding%.*

The evidence in Table 15 suggests that that my primary results are robust to the alternate measure of executive compensation. The coefficient on FRQ * AFT is positive and significant at the 5% level using either CScore or BScore to measure FRQ. Further, the role of FRQ is significantly greater for Delaware firms than for other firms: the t-statistic is 2.42 (2.49) when I use CScore (BScore) to measure FRQ. The coefficient for *CEOHolding%_2* using the alternate measure discussed above is also positive and significant for both Delaware and non-Delaware firms, consistent with the results for CEOHolding% in my primary results in Table 5.

6.2.7 Effect of firms located in California

Approximately 19% of all Delaware incorporated firms in the sample are *headquartered* in California. To limit the possibility that state-level effects that only affect firms headquartered in California drive my results, I rerun my tests after excluding California firms from the sample. Empirical results displayed in Table 16 suggest that my primary results are qualitatively similar when after excluding California firms. The role of financial reporting in the post regime shift period is positive and significant at the 5% level or better using both CScore and BScore, and this effect is significantly greater for Delaware firms relative to other firms.

6.3 Additional Issues

6.3.1 Exogeneity of regime shift

An implicit assumption throughout this paper is that the regime shift is a shock to Delaware firms that is exogenous in nature. To the best of my knowledge, there is no evidence examining the validity of this assumption. Hence, I cannot rule out the possibility that that the regime shift is a response to the political context and specifically, lobbying actions by economic players in Delaware. However, this is unlikely for a number of reasons. First, it would require that lobbying activities influenced the judicial decisions made by the Delaware Supreme Court. Given the independent nature of the judicial process, this is unlikely. Furthermore, it would likely be more costly for lobbyists to focus their efforts on influencing the Delaware Supreme Court judicial body to change their interpretation of existing laws as opposed to lobbying lawmakers to amend existing takeover protection laws.

Second, given that approximately 50% of US firms choose to incorporate in Delaware (Daines, 2001), it seems unlikely that a small coalition of firms in Delaware would be able to lobby a majority of Delaware Supreme Court judges and influence the interpretation of existing laws.

6.3.2 Changes in reported state of incorporation

I consider the possibility that my results are driven by firms that anticipate poor future performance and amend their state of incorporation to Delaware post-regime shift to obtain takeover protection. Ideally, I would examine firm-level state of incorporation data over time to identify firms that change their state of incorporation. However, COMPUSTAT files only provide firms' present state of incorporation. Romano (1993) suggests that changes in state of incorporation are quite rare. Bertrand and Mullainathan (2003) select 200

random firms from their sample only find three firms that change their state of incorporation. They also find that none of the changes were timed to take advantage of changes in takeover protection laws – all the changes preceded changes in legislation by a number of years.

6.3.3 Post regime-shift enactment of staggered boards

It is possible that the presence of quiet life behavior in Delaware post-regime shift is driven by Delaware firms that implement staggered boards after 1995 in order to exploit the benefits of regime shift. This argument, however does not affect the role of financial reporting in reducing quiet life behavior once Delaware firms have implemented staggered boards. I examine whether firms switch their board structure (from a non-staggered board to a staggered-board) in the post-regime shift period and find that 12 firms implement staggered boards in that period. This represents approximately 2% of my sample of unique Delaware firms and hence is unlikely to be driving my results.

7. Conclusion

I exploit changes in Delaware's takeover protection regime to examine whether the governance role of financial reporting can mitigate the adverse effects that arise from managerial preferences for a quiet life. I hypothesize that higher financial reporting quality mitigates managerial value decreasing actions associated with a quiet life. In addition, I also examine whether the governance role of FRQ is greater for firms for whom the severity of the quiet life problem is greater.

I use a differences-in-differences methodology which allows me to examine the role of financial reporting prior to and following the regime shift while controlling for both aggregate market-wide effects and any Delaware-specific shocks. A key advantage of my study is the identification of an exogenous shock that affects managerial incentives to engage in non-value maximizing behavior, which in turn, allows me to present results that are more consistent with a causal link between reporting quality and investment efficiency.

I use measures of financial reporting conservatism from Khan and Watts (2009) to proxy for FRQ. Results from empirical tests are consistent with the hypothesis that greater FRQ mitigates adverse effects arising from managerial preferences for a quiet life. I also find evidence that the role of financial reporting in mitigating quiet life behavior is only present for firms with staggered boards and for firms operating in less competitive environments. Empirical results are robust to the inclusion of a number of controls as well as to numerous other sensitivity and robustness tests.

Appendix A: Variable Definitions

AFT	Dummy that takes the value of 1 for the years 1996 and onwards and 0 otherwise.
FRQ	A firm's financial reporting quality (FRQ) proxied for using a measure of asymmetric timeliness, discussed below.
FRQ = BScore	Estimated based on the Khan and Watt (2009) model.
FRQ = CScore	Estimated based on the Khan and Watt (2009) model.
FRQ = GScore	Estimated based on the Khan and Watt (2009) model.
Market Cap	The firm's market capitalization at year end (#199 * #25).
Total Assets ($m)	Total Assets (#6).
Sales ($m)	Total Sales (#12).
ROA	Return on Assets multiplied by 100; measured as Income before Extraordinary Items / Assets - (#18 / #6) * 100
Book to Market	The firm's investment opportunity set measured as (#6 - #181) / (#25 * #199).
Leverage	Total Debt / Equity measured as (#181 / (#6 - #181)).
Firm Size	Log of the year end market value of equity measured as Ln(#199*#25).
Analyst Following	Average number of analysts following the firm at year end.
Institutional Holding %	Percentage of outstanding stock held by institutional investors.
CEO Stockholding %	Percentage of outstanding stock held by the CEO.
G-Index	Governance Index score from Gompers, Ishii and Metrick (2003).
Firm Age	Number of years since the firm first appeared on Compustat.
Investment	Capital Investment (from the Statement of Cash Flows) scaled by lagged PP&E all multiplied by 100, and calculated as (#128 / #8$_{t-1}$) * 100.
Disposals	Asset Sales (from the statement of Cash Flows) scaled by lagged PP&E all multiplied by 100, and calculated as (#107 / #8$_{t-1}$) * 100.
ROE	Return on Equity measured as #18 / (#6 - #181).
Inventory	Change in inventory measured as change in (#3 / #6) from t-1 to t and scaled by 100.
Dividends	Dividends ($m) scaled by total assets, measured as (#21 / #6).
Cash	Change in cash holdings measured as change in (#1 / #6) from t-1 to t.
Lag Return	Prior fiscal year stock return.

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Table 1 - Sample Selection Procedure

Description of the process used to obtain at the final sample for the period from 1990 to 2000 inclusive.

	Firm-year observations
Total Compustat population	121,181
Compustat population with state of incorporation data	104,260
Retain firms that exist in the year preceding the regime shift	35,295
Retain non-financial and utilities firms	30,591
Retain firms with CScore data	12,479
Retain firms with all required data	6,879

Table 2. Industry membership and State of Location

Panel A reports sample observations in 1994 by two-digit SIC industry code. Firms are classified as being incorporated either in Delaware or Non-Delaware states. Panel B reports Location of headquarters by state for Delaware and Non-Delaware incorporated firms as at 1994.

Panel A: Industry membership

SIC Industry Name	Non-Delaware Incorporated firms		Delaware Incorporated firms	
	#	%	#	%
Not assigned	2	0.6%	3	0.7%
Mining/Construction	6	1.9%	12	2.8%
Food	9	2.9%	22	5.1%
Textiles/Print/Publish	45	14.4%	40	9.3%
Chemicals	14	4.5%	32	7.4%
Pharmaceuticals	13	4.2%	13	3.0%
Extractive	7	2.2%	29	6.7%
Manf:Rubber/glass/etc	12	3.8%	7	1.6%
Manf:Metal	22	7.0%	21	4.9%
Manf:Machinery	16	5.1%	17	3.9%
Manf:ElectricalEqpt	13	4.2%	18	4.2%
Manf:TransportEqpt	16	5.1%	23	5.3%
Manf:Instruments	16	5.1%	23	5.3%
Manf:Misc.	4	1.3%	3	0.7%
Computers	19	6.1%	62	14.4%
Transportation	27	8.6%	26	6.0%
Retail:Wholesale	20	6.4%	12	2.8%
Retail:Misc.	28	8.9%	30	7.0%
Retail:Restaurant	6	1.9%	4	0.9%
Services	18	5.8%	34	7.9%
Total	**313**	**100%**	**431**	**100%**

Panel B: State of location for Delaware and non-Delaware incorporated firms.

State of location		Non-Delaware Incorporated firms		Delaware Incorporated firms	
		#	%	#	%
Alabama	AL	2	0.6%	3	0.7%
Alaska	AK	0	0.0%	0	0.0%
Arizona	AZ	2	0.6%	2	0.5%
Arkansas	AR	2	0.6%	4	0.9%
California	CA	21	6.7%	80	18.6%
Colorado	CO	2	0.6%	9	2.1%
Connecticut	CT	8	2.6%	15	3.5%
Delaware	DE	0	0.0%	3	0.7%
District of Columbia	DC	0	0.0%	3	0.7%
Florida	FL	8	2.6%	5	1.2%
Georgia	GA	13	4.2%	9	2.1%
Hawaii	HI	1	0.3%	0	0.0%
Idaho	ID	1	0.3%	4	0.9%
Illinois	IL	12	3.8%	40	9.3%
Indiana	IN	5	1.6%	2	0.5%
Iowa	IA	4	1.3%	2	0.5%
Kansas	KS	0	0.0%	2	0.5%
Kentucky	KY	2	0.6%	3	0.7%
Louisiana	LA	2	0.6%	2	0.5%
Maine	ME	1	0.3%	0	0.0%
Maryland	MD	2	0.6%	4	0.9%
Massachusetts	MA	16	5.1%	21	4.9%
Michigan	MI	13	4.2%	10	2.3%
Minnesota	MN	13	4.2%	15	3.5%
Mississippi	MS	0	0.0%	1	0.2%
Missouri	MO	8	2.6%	10	2.3%
Montana	MT	0	0.0%	0	0.0%
Nebraska	NE	2	0.6%	2	0.5%
Nevada	NV	4	1.3%	0	0.0%
New Hampshire	NH	0	0.0%	2	0.5%
New Jersey	NJ	10	3.2%	13	3.0%
New Mexico	NM	0	0.0%	0	0.0%
New York	NY	25	8.0%	35	8.1%
North Carolina	NC	10	3.2%	9	2.1%
North Dakota	ND	0	0.0%	0	0.0%
Ohio	OH	35	11.2%	14	3.2%
Oklahoma	OK	0	0.0%	3	0.7%
Oregon	OR	6	1.9%	2	0.5%
Pennsylvania	PA	21	6.7%	20	4.6%
Rhode Island	RI	4	1.3%	1	0.2%
South Carolina	SC	6	1.9%	1	0.2%
South Dakota	SD	0	0.0%	1	0.2%
Tennessee	TN	7	2.2%	6	1.4%
Texas	TX	21	6.7%	51	11.8%
Utah	UT	1	0.3%	2	0.5%
Vermont	VT	0	0.0%	0	0.0%
Virginia	VA	7	2.2%	7	1.6%
Washington	WA	5	1.6%	5	1.2%
West Virginia	WV	0	0.0%	0	0.0%
Wisconsin	WI	10	3.2%	6	1.4%
Wyoming	WY	1	0.3%	2	0.5%
Totals		313	100.0%	431	100.0%

Table 3. Descriptive Statistics

Descriptive statistics for Delaware and Non-Delaware incorporated firms as at 1994. The t-test tests for differences between the means for Delaware and non-Delaware firms. The difference-in-means t-tests assume unequal variances between groups when a test of equal variance is rejected at the 10% level. ***, **, and * indicate significance at the 0.01, 0.05, and 0.10 level or better, respectively.

| | Non-Delaware Incorporated firms | | | | Delaware Incorporated firms | | | | |
	N	Mean	Med.	S.D.	N	Mean	Med.	S.D.	t-test
Market Cap ($m)	313	2021.97	1115.63	2520.72	430	2436.67	1122.62	3314.77	
Total Assets ($m)	313	2351.30	1074.70	3291.21	430	2987.94	1184.20	5254.67	**
Sales ($m)	313	2697.28	1228.22	3387.17	430	2977.55	1373.12	4409.19	
Book to Market	313	0.528	0.47	0.27	430	0.524	0.47	0.31	
Return on Assets	313	5.843	5.99	5.72	430	4.762	4.98	7.34	*
Leverage	313	1.470	1.19	1.17	430	1.863	1.33	2.19	
Analyst Following	313	10.590	10.00	8.06	430	11.283	9.92	8.94	
Institutional Holding %	313	0.466	0.52	0.25	430	0.480	0.54	0.25	
CEO Stockholding %	313	0.031	0.00	0.07	430	0.026	0.00	0.06	
G-Index	313	9.740	10.00	2.80	430	9.306	9.00	2.93	**
Firm Age	313	29.294	31.00	11.63	430	25.844	27.00	13.91	***
CScore	313	0.018	0.01	0.08	430	0.017	0.01	0.08	
BScore	313	0.062	0.05	0.08	430	0.058	0.06	0.08	
Investment	290	7.012	6.090	4.833	398	7.266	6.224	5.100	**
Asset Disposals	182	0.437	0.078	1.208	257	0.566	0.114	1.258	
ROE	290	0.118	0.13	0.14	398	0.099	0.12	0.22	
Inventory	290	-0.070	0.00	2.76	398	-0.058	0.00	2.90	***
Dividends	290	0.021	0.02	0.02	398	0.014	0.01	0.02	
Cash	290	-0.007	0.00	0.05	398	-0.002	0.00	0.06	
Lag Return	290	0.204	0.16	0.36	398	0.240	0.14	0.45	

Table 4. Correlation Tables

Correlation tables for independent variables used in multivariate tests. Panel A includes variables used to test H1, and Panel B includes variables used to test H2a and H2b. Spearman correlations reported above the diagonal and Pearson correlations below the diagonal. All variables defined in Appendix A.

Panel A – Variables for tests of H1

	ROA	CScore	BScore	Firm Size	Book to Market	Leverage	Analyst Following	Inst'l Holding %	CEO Stock holding %	G-Index	Firm Age
ROA	1	-0.377	-0.388	0.282	-0.376	-0.327	0.181	0.131	0.110	-0.027	-0.018
	0	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	0.004	0.024
CScore	-0.297	1	0.949	-0.842	0.572	0.104	-0.473	-0.197	0.236	-0.123	-0.217
	<.0001	0	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001
BScore	-0.284	0.935	1	-0.821	0.603	0.097	-0.453	-0.218	0.207	-0.095	-0.200
	<.0001	<.0001	0	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001
Firm Size	0.305	-0.823	-0.767	1	-0.398	0.138	0.569	0.273	-0.331	0.132	0.363
	<.0001	<.0001	<.0001	0	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001
Book to Market	-0.152	0.577	0.558	-0.373	1	0.171	-0.169	-0.006	0.025	0.022	0.114
	<.0001	<.0001	<.0001	<.0001	0	<.0001	<.0001	0.428	0.014	0.019	<.0001
Leverage	-0.016	0.067	0.071	-0.003	0.001	1	0.043	0.017	-0.187	0.179	0.310
	0.046	<.0001	<.0001	0.711	0.878	0	<.0001	0.033	<.0001	<.0001	<.0001
Analyst Following	0.174	-0.500	-0.449	0.641	-0.174	0.003	1	0.608	-0.186	0.096	0.181
	<.0001	<.0001	<.0001	<.0001	<.0001	0.662	0	<.0001	<.0001	<.0001	<.0001
Inst'l Holding %	0.168	-0.184	-0.194	0.243	-0.036	0.006	0.449	1	-0.078	0.112	0.169
	<.0001	<.0001	<.0001	<.0001	<.0001	0.467	<.0001	0	<.0001	<.0001	<.0001
CEO Stock holding %	0.100	0.115	0.101	-0.156	0.008	-0.017	-0.127	-0.094	1	-0.188	-0.289
	<.0001	<.0001	<.0001	<.0001	0.434	0.100	<.0001	<.0001	0	<.0001	<.0001
G-Index	0.001	-0.116	-0.089	0.113	-0.011	0.009	0.099	0.092	-0.219	1	0.358
	0.929	<.0001	<.0001	<.0001	0.221	0.350	<.0001	<.0001	<.0001	0	<.0001
Firm Age	0.069	-0.210	-0.181	0.379	0.069	0.012	0.231	0.153	-0.186	0.352	1
	<.0001	<.0001	<.0001	<.0001	<.0001	0.117	<.0001	<.0001	<.0001	<.0001	0

PANEL B – Variables for tests of H2a and H2b

	Asset Sales	Investment	CScore	BScore	ROE	Inventory	Firm Age	Book to Market	Dividends	Cash	Lagged Return	Analyst Following	Inst'l Holding %	CEO Holding %	G-Index
Asset Sales	1	0.255	-0.112	-0.111	0.035	0.011	-0.116	-0.110	-0.033	-0.126	0.111	0.114	0.013	0.030	-0.042
	0	<.0001	<.0001	<.0001	<.0001	0.170	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	0.104	0.004	<.0001
Investment	0.255	1	0.078	0.069	-0.036	0.003	0.048	0.068	-0.044	0.033	-0.067	-0.018	-0.026	0.015	0.000
	<.0001	0	<.0001	<.0001	0.000	0.738	<.0001	<.0001	<.0001	0.000	<.0001	0.056	0.005	0.198	0.999
CScore	-0.112	0.078	1	0.935	-0.293	-0.009	-0.210	0.577	-0.312	0.002	-0.204	-0.500	-0.184	0.115	-0.116
	<.0001	<.0001	0	<.0001	<.0001	0.306	<.0001	<.0001	<.0001	0.821	<.0001	<.0001	<.0001	<.0001	<.0001
BScore	-0.111	0.069	0.935	1	-0.293	-0.002	-0.181	0.558	-0.278	0.004	-0.198	-0.449	-0.194	0.101	-0.089
	<.0001	<.0001	<.0001	1	<.0001	0.860	<.0001	<.0001	<.0001	0.660	<.0001	<.0001	<.0001	<.0001	<.0001
ROE	0.035	-0.036	-0.293	-0.293	1	-0.006	0.104	-0.204	0.220	0.031	0.131	0.134	0.117	0.024	0.033
	<.0001	0.000	<.0001	<.0001	0	0.467	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	0.016	0.001
Inventory	0.011	0.003	-0.009	-0.002	-0.006	1	-0.002	0.017	0.007	-0.348	-0.006	-0.003	0.000	0.003	-0.011
	0.170	0.738	0.306	0.860	0.467	0	0.802	0.032	0.356	<.0001	0.437	0.666	0.966	0.778	0.235
Firm Age	-0.116	0.048	-0.210	-0.181	0.104	-0.002	1	0.069	0.368	0.030	-0.111	0.231	0.153	-0.186	0.352
	<.0001	<.0001	<.0001	<.0001	<.0001	0.802	0	<.0001	<.0001	0.000	<.0001	<.0001	<.0001	<.0001	<.0001
Book to Market	-0.110	0.068	0.577	0.558	-0.204	0.017	0.069	1	-0.160	-0.004	-0.232	-0.174	-0.036	0.008	-0.011
	<.0001	<.0001	<.0001	<.0001	<.0001	0.032	<.0001	0	<.0001	0.575	<.0001	<.0001	<.0001	0.434	0.221
Dividends	-0.033	-0.044	-0.312	-0.278	0.220	0.007	0.368	-0.160	1	-0.010	-0.049	0.212	0.034	-0.055	0.122
	<.0001	<.0001	<.0001	<.0001	<.0001	0.356	<.0001	<.0001	0	0.200	<.0001	<.0001	<.0001	<.0001	<.0001
Cash	-0.126	0.033	0.002	0.004	0.031	-0.348	0.030	-0.004	-0.010	1	-0.019	-0.001	0.003	0.001	0.013
	<.0001	0.000	0.821	0.660	<.0001	<.0001	0.000	0.575	0.200	0	0.016	0.929	0.753	0.953	0.178
Lagged Return	0.111	-0.067	-0.204	-0.198	0.131	-0.006	-0.111	-0.232	-0.049	-0.019	1	0.030	0.034	0.033	-0.033
	<.0001	<.0001	<.0001	<.0001	<.0001	0.437	<.0001	<.0001	<.0001	0.016	0	0.000	<.0001	0.001	0.001
Analyst Following	0.114	-0.018	-0.500	-0.449	0.134	-0.003	0.231	-0.174	0.212	-0.001	0.030	1	0.449	-0.127	0.099
	<.0001	0.056	<.0001	<.0001	<.0001	0.666	<.0001	<.0001	<.0001	0.929	0.000	0	<.0001	<.0001	<.0001
Inst'l Holding %	0.013	-0.026	-0.184	-0.194	0.117	0.000	0.153	-0.036	0.034	0.003	0.034	0.449	1	-0.094	0.092
	0.104	0.005	<.0001	<.0001	<.0001	0.966	<.0001	<.0001	<.0001	0.753	<.0001	<.0001	0	<.0001	<.0001
CEO Holding %	0.030	0.015	0.115	0.101	0.024	0.003	-0.186	0.008	-0.055	0.001	0.033	-0.127	-0.094	1	-0.219
	0.004	0.198	<.0001	<.0001	0.016	0.778	<.0001	0.434	<.0001	0.953	0.001	<.0001	<.0001	0	<.0001
G-Index	-0.042	0.000	-0.116	-0.089	0.033	-0.011	0.352	-0.011	0.122	0.013	-0.033	0.099	0.092	-0.219	1
	<.0001	0.999	<.0001	<.0001	0.001	0.235	<.0001	0.221	<.0001	0.178	0.001	<.0001	<.0001	<.0001	0

Table 5: The effect of Financial Reporting Quality on ROA

This table reports regressions of Financial Reporting Quality (FRQ) on Return on Assets (ROA) around the mid-1990s Delaware takeover regime shift. All variables are defined in the Appendix. Standard errors are clustered by firm and year. t-stats are reported in italics. All tests include firm and year fixed effects. Values in bold indicate significance at the 10% level or better.

Dependent variable: ROA	Pred Sign	MAIN EFFECT			FRQ = CSCORE		
		DE firms	Non-DE firms	Difference in Coefficients	DE firms	Non-DE firms	Difference in Coefficients
AFT	-	**-1.67**	**-0.80**	**-0.87**	**-1.39**	-0.51	**-0.88**
		-3.14	*-1.74*	*-1.94*	*-2.89*	*-1.13*	*-2.06*
FRQ	+				**-10.51**	-5.40	-5.12
					-3.02	*-0.72*	*-0.74*
AFT*FRQ	+				**11.38**	0.17	**11.21**
					2.20	*0.03*	*2.49*
Firm Size	+/-	**2.08**	**1.20**	**0.88**	**1.59**	0.43	**1.16**
		6.43	*3.90*	*2.42*	*4.43*	*1.01*	*2.64*
Book to Market	-	**-1.83**	**-4.96**	**3.13**	**-2.91**	**-5.75**	**2.83**
		-1.74	*-4.50*	*2.65*	*-3.78*	*-5.22*	*2.44*
Leverage	-	**0.00**	**-0.01**	0.01	**-0.84**	**-1.33**	0.49
		-3.10	*-1.73*	*1.16*	*-5.12*	*-4.92*	*1.78*
Analyst Following	+	**-0.10**	**-0.07**	-0.03	**-0.12**	-0.04	-0.07
		-2.76	*-1.65*	*-0.62*	*-3.36*	*-1.02*	*-1.70*
Inst'l Holding %	+	**6.03**	**3.00**	**3.03**	**4.66**	**1.41**	**3.25**
		6.19	*3.29*	*2.53*	*4.12*	*1.77*	*2.65*
CEO Holding %	+	**14.99**	**15.00**	-0.02	**13.08**	**10.07**	3.01
		3.70	*4.09*	*0.00*	*3.69*	*3.38*	*0.67*
G-Index	-	-0.09	-0.05	-0.04	-0.02	-0.05	0.03
		-1.15	*-0.40*	*-0.35*	*-0.36*	*-0.74*	*0.30*
Firm Age	+	-0.02	-0.01	-0.01	0.01	**0.04**	-0.03
		-1.21	*-0.57*	*-0.22*	*0.43*	*2.39*	*-1.44*
Intercept	+/-	**-9.93**	-0.37	**-9.56**	-4.51	**6.92**	-11.43
		-3.01	*-0.12*	*-2.60*	*-1.30*	*6.92*	*2.14*
N		3967	2912	6879	3967	2912	6879
Adjusted R²		0.14	0.18	0.16	0.19	0.27	0.22

Dependent variable: ROA	Pred Sign	FRQ = GSCORE			FRQ = BSCORE		
		DE firms	Non-DE firms	Difference in Coefficients	DE firms	Non-DE firms	Difference in Coefficients
AFT	-	-2.43	-1.39	-1.04	-2.04	-0.53	-1.51
		-2.89	-1.25	-1.47	-4.45	-1.05	-2.92
FRQ	+	-34.32	-24.30	-10.03	-17.03	-7.76	-9.27
		-5.54	-1.99	-1.01	-5.11	-1.30	-1.20
AFT*FRQ	+	18.37	6.28	12.09	11.18	-2.19	13.37
		1.99	0.38	0.97	2.59	-0.61	2.73
Firm Size	+/-	1.78	0.74	1.04	1.38	0.31	1.07
		6.15	3.05	3.02	4.05	0.85	2.60
Book to Market	-	-3.00	-5.96	2.95	-2.48	-5.58	3.10
		-3.68	-5.56	2.55	-3.43	-5.12	2.66
Leverage	-	-0.90	-1.41	0.51	-0.82	-1.31	0.49
		-5.13	-5.76	2.12	-5.18	-5.15	1.87
Analyst Following	-	-0.11	-0.05	-0.07	-0.12	-0.04	-0.07
		-3.38	-1.17	-1.54	-3.39	-1.02	-1.72
Inst'l Holding %	+	4.67	1.45	3.22	4.62	1.38	3.24
		4.15	1.89	2.60	4.11	1.75	2.63
CEO Holding %	+	12.78	10.04	2.74	12.96	10.16	2.80
		3.55	3.33	0.61	3.71	3.50	0.64
G-Index	-	-0.03	-0.04	0.02	-0.02	-0.05	0.03
		-0.38	-0.60	0.17	-0.29	-0.73	0.34
Firm Age	+	0.01	0.04	-0.03	0.01	0.04	-0.03
		0.47	2.39	-1.42	0.41	2.45	-1.50
Intercept	+/-	-4.26	6.00	-10.26	-2.21	8.13	-10.34
		-1.43	2.62	-3.03	-0.66	2.70	-2.66
N		3967	2912	6879	3967	2912	6879
Adjusted R²		0.19	0.25	0.22	0.19	0.27	0.22

Table 6: The effect of Financial Reporting Quality on Capital Investment

This table reports regressions of Financial Reporting Quality (FRQ) on Capital Investment around the mid-1990s Delaware takeover regime shift. All variables are defined in the Appendix. Standard errors are clustered by firm and year. t-stats are reported in italics. All tests include firm and year fixed effects. Values in bold indicate significance at the 10% level or better.

Dependent variable: Disposals	Pred Sign	MAIN EFFECT			FRQ = CSCORE		
		DE firms	Non-DE firms	Difference in Coefficients	DE firms	Non-DE firms	Difference in Coefficients
AFT	-	-0.01	-0.23	0.22	0.06	-0.13	0.19
		-0.03	*-0.77*	*0.92*	*0.17*	*-0.44*	*0.69*
FRQ	+				-0.59	1.04	-1.63
					-0.21	*0.41*	*-0.43*
AFT*FRQ	+				**4.34**	-2.29	**6.63**
					2.02	*-1.33*	*2.25*
ROE	+/-	-0.75	0.20	-0.95	-0.18	0.65	-0.83
		-1.80	*0.45*	*-1.53*	*-0.31*	*1.25*	*-1.07*
Inventory	+	-0.06	-0.02	-0.04	-0.07	0.01	**-0.08**
		-1.04	*-0.48*	*-0.68*	*-1.27*	*0.37*	*-1.67*
Firm Age	-	**-0.03**	**-0.03**	0.00	**-0.03**	**-0.04**	0.01
		-2.76	*-2.28*	*-0.10*	*-2.27*	*-2.09*	*0.31*
Book to Market	-	-0.38	**-0.77**	0.40	-0.13	**-0.67**	0.54
		-1.17	*-2.78*	*0.89*	*-0.29*	*-2.16*	*1.03*
Dividends	+	-12.60	-9.14	-3.46	-15.15	-14.87	-0.28
		-1.62	*-0.94*	*-0.28*	*-1.65*	*-1.45*	*-0.02*
Cash	+	**-11.10**	**-7.60**	**-3.50**	**-11.35**	**-6.20**	**-5.15**
		-5.26	*-4.51*	*-2.33*	*-5.40*	*-6.20*	*-4.64*
G-Index	-	**0.90**	**0.64**	0.26	**1.21**	**0.59**	0.62
		3.21	*2.20*	*0.63*	*5.00*	*1.70*	*1.40*
Lag Return	+	**0.11**	**0.06**	0.05	**0.14**	**0.06**	**0.07**
		5.63	*2.89*	*1.69*	*5.80*	*2.37*	*2.13*
Analyst Following	+/-	-0.96	-1.14	0.18	-1.23	-1.23	0.00
		-1.69	*-1.55*	*0.20*	*-2.15*	*-0.01*	*0.00*
Inst'l Holding %	+/-	**-3.74**	1.50	**-5.23**	-2.62	3.73	-6.35
		-1.49	*0.53*	*-1.47*	*-1.03*	*0.04*	*-1.61*
CEO Holding %	+/-	-0.01	-0.11	0.10	-0.04	-0.12	0.08
		-0.15	*-1.52*	*1.06*	*-0.60*	*0.00*	*0.81*
Intercept		**8.00**	**9.25**	-1.25	**7.60**	**9.55**	-1.94
		11.73	*9.12*	*-1.03*	*10.17*	*0.10*	*-1.39*
N		3895	2820	6715	3895	2820	6715
Adjusted R²		0.06	0.05	0.06	0.07	0.06	0.07

Dependent variable: Investment	Pred Sign	FRQ = GSCORE			FRQ = BSCORE		
		DE firms	Non-DE firms	Difference in Coefficients	DE firms	Non-DE firms	Difference in Coefficients
AFT	-	-0.14	-0.17	0.03	-0.16	-0.10	-0.06
		-0.24	-0.30	0.10	-0.41	-0.31	-0.20
FRQ	+	-2.81	2.69	-5.50	-0.82	0.74	-1.56
		-0.34	0.33	-5.98	-0.29	0.36	-0.46
AFT*FRQ	+	9.46	0.81	8.64	5.86	-1.48	7.34
		0.76	0.09	1.42	2.22	-0.92	2.43
ROE	+/-	-0.23	0.68	-0.91	-0.15	0.66	-0.80
		-0.39	1.31	-1.14	-0.24	1.29	-1.02
Inventory	+	-0.07	0.01	-0.09	-0.07	0.01	-0.09
		-1.36	0.36	-1.76	-1.30	0.37	-1.69
Firm Age	-	-0.03	-0.04	0.00	-0.03	-0.04	0.01
		-2.59	-2.14	0.17	-2.25	-2.09	0.32
Book to Market	-	0.10	-0.70	0.80	-0.16	-0.70	0.54
		0.28	-2.37	1.67	-0.37	-2.38	1.08
Dividends	+	-14.83	-15.21	0.37	-15.00	-15.01	0.01
		-1.60	-1.48	0.03	-1.64	-1.45	0.00
Cash	+	-11.40	-6.28	-5.12	-11.40	-6.19	-5.21
		-5.50	-6.06	-4.89	-5.56	-6.22	-5.03
G-Index	-	1.14	0.58	0.56	1.20	0.59	0.61
		5.04	1.64	1.40	4.75	1.72	1.37
Lag Return	+	0.13	0.06	0.07	0.14	0.06	0.08
		5.96	2.56	2.13	5.92	2.46	2.18
Analyst Following	+/-	-1.13	-1.22	0.10	-1.26	-1.23	-0.03
		-1.91	-1.62	0.10	-2.18	-1.64	-0.03
Inst'l Holding %	+/-	-2.53	3.69	-6.22	-2.64	3.71	-6.35
		-0.98	1.07	-1.58	-1.03	1.08	-1.61
CEO Holding %	+/-	-0.04	-0.12	0.08	-0.04	-0.12	0.08
		-0.64	-1.52	0.80	-0.61	-1.50	0.80
Intercept		7.76	9.46	-1.71	7.65	9.52	-1.87
		9.77	7.74	-1.27	9.78	8.20	-1.32
N		3895	2820	6715	3895	2820	6715
Adjusted R²		0.07	0.06	0.07	0.07	0.06	0.07

Table 7: The effect of Financial Reporting Quality on Asset Sales

This table reports regressions of Financial Reporting Quality (FRQ) on Asset Sales around the mid-1990s Delaware takeover regime shift. All variables are defined in the Appendix. Standard errors are clustered by firm and year. t-stats are reported in italics. All tests include firm and year fixed effects. Values in bold indicate significance at the 10% level or better.

Dependent variable: Disposals	Pred Sign	MAIN EFFECT			FRQ = CSCORE		
		DE firms	Non-DE firms	Difference in Coefficients	DE firms	Non-DE firms	Difference in Coefficients
AFT	-	0.05	**0.19**	-0.14	0.01	**0.13**	-0.13
		0.84	*3.91*	*-1.92*	*0.09*	*2.54*	*-1.65*
FRQ	+				1.42	**1.44**	-0.02
					1.61	*1.95*	*-0.02*
AFT*FRQ	+				1.07	**1.23**	-0.16
					1.56	*1.74*	*-0.18*
ROE	+/-	-0.09	0.55	-0.63	-0.17	0.45	-0.62
		-0.50	*2.37*	*-2.48*	*-0.90*	*2.46*	*-2.88*
Inventory	+	**0.02**	0.00	0.02	0.02	0.01	0.01
		2.70	*1.03*	*1.55*	*2.00*	*0.76*	*0.97*
Firm Age	-	**0.01**	0.01	0.00	0.01	0.01	0.00
		2.13	*1.45*	*-0.02*	*1.91*	*1.23*	*-0.05*
Book to Market	-	**0.18**	0.16	0.02	0.09	0.06	0.03
		2.19	*1.23*	*0.14*	*0.68*	*0.62*	*0.18*
Dividends	+	**-5.89**	**-6.68**	0.79	-6.53	-5.75	-0.78
		-2.80	*-2.09*	*0.22*	*-2.36*	*-1.92*	*-0.19*
Cash	+	1.72	0.49	**1.23**	1.58	0.73	0.85
		3.87	*1.28*	*1.99*	*4.47*	*1.40*	*1.21*
G-Index	-	**-0.16**	-0.22	0.06	-0.04	-0.09	0.05
		-2.11	*-1.63*	*0.33*	*-0.56*	*-0.64*	*0.24*
Lag Return	+	0.00	0.00	-0.01	0.00	**0.02**	-0.01
		-0.90	*0.71*	*-1.14*	*0.64*	*2.12*	*-1.30*
Analyst Following	+/-	-0.14	-0.04	-0.11	-0.12	-0.06	-0.06
		-0.88	*-0.18*	*-0.40*	*-0.67*	*0.00*	*-0.23*
Inst'l Holding %	+/-	-0.33	0.99	-1.32	-0.30	1.74	-2.04
		-0.71	*0.94*	*-1.10*	*-0.63*	*0.02*	*-1.32*
CEO Holding %	+/-	0.02	**-0.047**	**0.07**	0.03	-0.04	**0.07**
		1.24	*-1.69*	*2.11*	*1.46*	*0.00*	*1.86*
Intercept		0.38	**0.66**	-0.28	0.22	0.45	-0.23
		2.09	*1.78*	*-0.70*	*1.30*	*0.00*	*-0.52*
N		2696	2001	4697	2696	2001	4697
Adjusted R²		0.03	0.03	0.03	0.03	0.04	0.04

Dependent variable: Disposals	Pred Sign	FRQ = GSCORE			FRQ = BSCORE		
		DE firms	Non-DE firms	Difference in Coefficients	DE firms	Non-DE firms	Difference in Coefficients
AFT	-	0.05	**0.27**	**-0.21**	0.01	0.15	-0.13
		0.58	**5.29**	**-4.09**	0.18	**3.50**	-1.56
FRQ	+	**-1.14**	0.14	**-1.28**	1.08	**1.12**	-0.04
		-2.50	0.38	**-1.72**	1.17	**1.93**	-0.04
AFT*FRQ	+	-1.60	**-2.72**	**1.12**	0.93	1.07	-0.15
		-0.96	**-2.35**	1.67	1.12	1.38	-0.15
ROE	+/-	-0.25	**0.36**	**-0.61**	-0.18	**0.45**	**-0.63**
		-1.27	**2.12**	**-2.83**	-0.92	**2.40**	**-2.86**
Inventory	+	**0.02**	0.00	0.02	**0.02**	0.01	0.01
		1.98	0.65	1.06	**1.96**	0.77	0.93
Firm Age	-	0.01	0.01	0.00	**0.01**	0.01	0.00
		1.60	0.96	0.01	**1.83**	1.12	-0.02
Book to Market	-	**0.25**	**0.24**	0.02	0.13	0.12	0.01
		1.95	**2.58**	0.11	0.96	1.41	0.06
Dividends	+	**-7.03**	**-5.75**	-1.28	**-6.38**	**-5.63**	-0.75
		-2.48	**-1.90**	-0.31	**-2.31**	**-1.90**	-0.19
Cash	+	**1.66**	**0.81**	0.84	**1.56**	0.70	0.86
		4.50	**1.68**	1.20	**4.46**	1.36	1.23
G-Index	-	-0.07	-0.12	0.05	-0.06	-0.10	0.04
		-1.00	-0.90	0.28	-0.74	-0.76	0.21
Lag Return	+	0.00	0.01	-0.01	0.00	**0.014**	-0.01
		-0.52	1.49	-1.43	0.34	**2.01**	-1.38
Analyst Following	+/-	-0.06	-0.02	-0.03	-0.11	-0.05	-0.06
		-0.30	-0.11	-0.13	-0.56	-0.23	-0.21
Inst'l Holding %	+/-	-0.25	1.76	-2.00	-0.27	1.73	-1.99
		-0.51	1.18	-1.30	-0.56	1.16	-1.30
CEO Holding %	+/-	0.03	-0.04	**0.07**	0.03	-0.04	**0.07**
		1.53	-1.36	**1.92**	1.45	-1.36	**1.88**
Intercept		**0.33**	0.54	-0.21	0.19	0.41	-0.23
		2.16	1.33	-0.49	1.03	1.01	-0.52
N		2696	2001	4697	2696	2001	4697
Adjusted R²		0.03	0.04	0.03	0.03	0.04	0.03

Table 8: Industry competition - subsample analysis

This table examines the effect of Financial Reporting Quality (FRQ) on ROA around the mid-1990s Delaware takeover regime shift, with sample firms partitioned by industry competition. Panel A presents results for FRQ set as CScore and Panel B presents results for FRQ set as BScore. All variables are defined in the Appendix. Standard errors are clustered by firm and year. t-stats are reported in italics. Values in bold indicate significance at the 10% level or better. All regressions include firm and year fixed effects.

Panel A: FRQ = Cscore

Dependent variable: Invest	Pred Sign	HIGH COMPETITION			LOW COMPETITION		
		DE firms	Non-DE firms	Difference in Coefficients	DE firms	Non-DE firms	Difference in Coefficients
AFT	-	**-2.11**	-0.76	-1.35	**-0.88**	-0.44	-0.44
		-2.87	*-1.08*	*-2.13*	*-1.68*	*-1.02*	*-0.86*
FRQ	+	**-17.34**	0.10	-17.45	-0.63	**-11.39**	10.76
		-3.52	*0.01*	*-1.91*	*-0.13*	*-2.29*	*2.20*
AFT*FRQ	+	9.91	2.53	7.38	**10.86**	0.88	9.97
		1.14	*0.39*	*0.80*	*2.34*	*0.17*	*2.56*
Firm Size	+/-	**1.91**	0.70	1.20	**1.56**	0.15	1.41
		2.62	*0.91*	*1.37*	*4.59*	*0.55*	*4.08*
Book to Market	-	-2.02	**-6.09**	4.07	**-3.77**	**-5.68**	1.91
		-1.36	*-3.40*	*2.15*	*-5.42*	*-6.32*	*1.95*
Leverage	-	**-0.54**	**-1.74**	1.20	**-1.37**	**-1.02**	-0.35
		-3.36	*-4.24*	*2.72*	*-7.21*	*-5.14*	*-1.74*
Analyst Following	+	**-0.16**	0.00	**-0.16**	**-0.09**	-0.09	0.00
		-2.87	*0.03*	*-2.20*	*-2.28*	*-1.93*	*0.03*
Inst'l Holding %	+	**5.19**	1.20	**3.99**	**4.20**	1.42	2.78
		2.89	*0.92*	*2.02*	*3.91*	*1.74*	*2.19*
CEO Holding %	+	**16.71**	**11.47**	5.24	**9.29**	**9.79**	-0.50
		2.88	*1.95*	*0.74*	*2.46*	*2.95*	*-0.10*
G-Index	-	0.00	-0.05	0.05	-0.06	-0.07	0.01
		0.04	*-0.34*	*0.29*	*-0.88*	*-0.85*	*0.06*
Firm Age	+	0.00	**0.07**	-0.07	0.01	0.00	0.01
		0.07	*2.53*	*-2.12*	*0.42*	*0.09*	*0.27*
Intercept	+/-	-7.51	4.03	-11.53	-2.90	**10.17**	-13.08
		-1.09	*0.69*	*-1.57*	*-1.09*	*10.17*	*4.93*
N		2089	1596	3685	2089	1596	3685
Adjusted R²		0.16	0.22	0.18	0.26	0.36	0.29

Panel B: FRQ = Bscore

Dependent variable: Invest	Pred Sign	HIGH COMPETITION			LOW COMPETITION		
		DE firms	Non-DE firms	Difference in Coefficients	DE firms	Non-DE firms	Difference in Coefficients
AFT	-	**-3.02**	-0.82	**-2.20**	**-1.25**	-0.52	-0.73
		-4.00	*-1.07*	*-2.93*	*-2.29*	*-1.03*	*-1.20*
FRQ	+	**-21.18**	-5.20	-15.98	**-10.69**	**-12.00**	1.31
		-4.36	*-0.49*	*-1.34*	*-2.76*	*-2.96*	*0.26*
AFT*FRQ	+	12.43	1.67	10.76	**9.82**	-2.47	**12.29**
		1.60	*0.28*	*1.21*	*2.74*	*-0.91*	*3.39*
Firm Size	+/-	**1.89**	0.49	**1.40**	1.16	0.08	1.08
		2.68	*0.68*	*1.66*	*3.81*	*0.30*	*3.23*
Book to Market	-	-1.73	**-5.81**	4.07	-3.17	-5.61	2.44
		-1.19	*-3.43*	*2.18*	*-4.73*	*-6.16*	*2.55*
Leverage	-	**-0.54**	**-1.72**	1.18	**-1.29**	**-1.00**	-0.29
		-3.53	*-4.58*	*2.88*	*-7.43*	*-5.38*	*-1.51*
Analyst Following	+	**-0.16**	0.00	**-0.17**	**-0.08**	-0.08	0.00
		-2.95	*0.03*	*-2.27*	*-2.17*	*-1.85*	*-0.02*
Inst'l Holding %	+	**5.14**	1.14	**4.00**	**4.13**	1.36	**2.77**
		2.90	*0.87*	*2.04*	*3.78*	*1.69*	*2.14*
CEO Holding %	+	**16.61**	**11.33**	5.28	**9.40**	**9.96**	-0.56
		2.86	*1.92*	*0.74*	*2.55*	*3.10*	*-0.11*
G-Index	-	0.01	-0.04	0.06	-0.06	-0.07	0.00
		0.12	*-0.33*	*0.34*	*-0.90*	*-0.83*	*0.04*
Firm Age	+	0.00	**0.08**	**-0.08**	0.01	0.00	0.01
		0.04	*2.57*	*-2.19*	*0.45*	*0.16*	*0.24*
Intercept	+/-	-6.33	5.78	-12.11	0.36	**11.23**	-10.87
		-0.94	*0.96*	*-1.62*	*0.14*	*5.47*	*-3.62*
N		2089	1596	3685	2089	1596	3685
Adjusted R²		0.16	0.22	0.19	0.26	0.36	0.30

Table 9: Takeover Defenses - Effect of Financial Reporting Quality on ROA

This table examines the effect of Financial Reporting Quality (FRQ) on ROA around the mid-1990s Delaware takeover regime shift, with sample firms partitioned by the level of takeover defenses. The sample is restricted to firms incorporated in Delaware. All variables are defined in the Appendix. Standard errors are clustered by firm and year. t-stats are reported in italics. Values in bold indicate significance at the 10% level or better. All regressions include firm and year fixed effects.

Panel A: High Takeover Defense Firms

Dependent variable: ROA	Pred Sign	FRQ = CSCORE	FRQ = BSCORE
		DE firms	DE firms
AFT	-	-0.94	-1.46
		-1.99	*-3.12*
FRQ	+	-4.87	-12.33
		-0.92	*-4.25*
AFT*FRQ	+	14.67	12.56
		2.37	*2.83*
Firm Size	+/-	1.09	0.79
		2.91	*2.84*
Book to Market	-	-4.45	-3.85
		-7.38	*-6.90*
Leverage	-	-0.81	-0.77
		-4.91	*-5.00*
Analyst Following	+	-0.09	-0.09
		-2.46	*-2.42*
Inst'l Holding %	+	2.91	2.86
		2.93	*2.84*
CEO Stockholding %	+	18.53	18.57
		3.95	*4.03*
G-Index	-	-0.11	-0.10
		-1.43	*-1.37*
Firm Age	+	0.04	0.04
		2.03	*2.01*
Intercept	+/-	0.16	2.76
		0.05	*1.08*
N		1987	1987
Adjusted R^2		0.20	0.20

Panel B: Low Takeover Defense Firms

Dependent variable: ROA	Pred Sign	FRQ = CSCORE DE firms	FRQ = BSCORE DE firms
AFT	-	-2.12	-3.06
		-2.64	*-3.47*
FRQ	+	-14.67	-20.52
		-2.93	*-3.40*
AFT*FRQ	+	13.98	15.81
		1.72	*1.99*
Firm Size	+/-	2.12	2.01
		3.14	*2.99*
Book to Market	-	-2.69	-2.24
		-2.25	*-1.88*
Leverage	-	-0.82	-0.80
		-3.28	*-3.41*
Analyst Following	+	-0.11	-0.11
		-1.84	*-1.92*
Inst'l Holding %	+	5.17	5.14
		2.77	2.77
CEO Stockholding %	+	8.43	8.17
		1.38	*1.35*
G-Index	-	-0.05	-0.05
		-0.30	*-0.29*
Firm Age	+	-0.04	-0.04
		-1.48	*-1.46*
Intercept	+/-	-7.34	-5.55
		-1.10	*-0.83*
N		1374	1374
Adjusted R^2		0.238	0.243

Table 10: Bertrand and Mullainathan (2003) setting replication

This table examines the effect of Financial Reporting Quality (FRQ) on Operating Performance (Panel A) and Capital Investment (Panel B) using the passage of Business Combination laws as used in Bertrand and Mullainathan (2003). All variables are defined in the Appendix. Standard errors are clustered by firm and year. t-stats are reported in italics. Intercepts are excluded. Values in bold indicate significance at the 10% level or better. All tests include firm and year fixed effects.

Panel A - Operating Performance

Dependent variable: ROA	Pred Sign	Main Effect	FRQ = CSCORE	FRQ = GSCORE	FRQ = BSCORE
AFT	-	-0.50	-0.79	-0.77	-0.59
		-2.00	*-2.66*	*-2.93*	*-2.09*
FRQ	+		-5.29	4.53	0.48
			-6.44	*2.36*	*0.65*
AFT*FRQ	+		3.14	5.26	2.63
			2.65	*1.34*	*2.55*
Firm Size	+/-	5.13	4.96	5.13	3.24
		14.61	*14.78*	*14.42*	*20.24*
Book to Market	-	0.97	1.16	0.96	-1.29
		2.78	*3.19*	*2.72*	*-6.82*
Leverage	-	0.00	0.00	0.00	-22.46
		-1.22	*-1.19*	*-1.14*	*-18.60*
Analyst Following	+	-0.24	-0.23	-0.24	-0.13
		-7.26	*-7.46*	*-7.31*	*-6.39*
Institutional Holding %	+	1.09	1.18	1.01	0.23
		2.74	*3.08*	*2.55*	*0.63*
Firm Age	+	1.25	1.25	1.29	1.45
		1.84	*1.84*	*1.91*	*3.08*
N		40642	40642	40642	40642
Adjusted R²		0.667	0.668	0.614	0.645

Panel B - Capital Expenditure

Dependent variable: CapEx	Pred Sign	Main Effect	FRQ = CSCORE	FRQ = GSCORE	FRQ = BSCORE
AFT	-	0.00	0.00	0.00	0.00
		-0.16	*-0.90*	*0.34*	*-1.00*
FRQ	+		-0.03	0.00	-0.03
			-5.83	*0.30*	*-6.26*
AFT*FRQ	+		0.01	-0.02	0.01
			2.35	*-1.01*	*1.84*
Return on Equity	+/-	0.01	0.01	0.01	0.01
		9.87	*9.10*	*9.93*	*9.19*
Inventory	-	0.00	0.00	0.00	0.00
		-16.84	*-17.20*	*-16.74*	*-17.17*
Firm Age	-	0.00	0.00	0.00	0.00
		-0.94	*-0.99*	*-0.93*	*-1.01*
Market to Book	+	-0.02	-0.01	-0.02	-0.01
		-14.88	*-13.26*	*-14.87*	*-12.82*
Dividends	+	0.15	0.14	0.15	0.14
		2.65	*2.35*	*2.64*	*2.31*
Cash Holdings	+	-0.16	-0.16	-0.16	-0.16
		-29.00	*-28.96*	*-28.89*	*-28.88*
Lagged Stock Return	-	0.01	0.01	0.01	0.01
		12.90	*12.79*	*12.84*	*12.79*
Analyst Following	+	0.00	0.00	0.00	0.00
		1.37	*1.18*	*1.39*	*1.05*
Institutional Holding %	+/-	0.01	0.01	0.01	0.01
		6.18	*6.42*	*6.28*	*6.51*
N		28378	28378	28378	28378
Adjusted R^2		0.59	0.59	0.501	0.50

Table 11: Managerial Entrenchment - subsample analysis

This table examines the effect of Financial Reporting Quality (FRQ) on ROA around the mid-1990s Delaware takeover regime shift, with sample firms partitioned using the Entrenchment index (E-Index) from Bebchuk and Cohen (2005). Panel A displays tests where FRQ = CScore, and Panel B displays tests where FRQ = BScore. All variables are defined in the Appendix. Standard errors are clustered by firm and year. t-stats are reported in italics. Values in bold indicate significance at the 10% level or better. All tests include firm and year fixed effects.

Panel A: FRQ = CScore

Dependent variable: ROA	Pred Sign	LOW ENTRENCHMENT			HIGH ENTRENCHMENT		
		DE firms	Non-DE firms	Difference in Coefficients	DE firms	Non-DE firms	Difference in Coefficients
AFT	-	**-1.64**	0.01	**-1.64**	-0.78	-1.29	0.51
		-2.88	*0.02*	*-2.98*	*-1.32*	*-2.53*	*0.88*
FRQ	+	**-9.57**	-0.68	-8.89	-9.12	**-14.41**	5.29
		-2.72	*-0.08*	*-0.99*	*-1.56*	*-1.72*	*0.83*
AFT*FRQ	+	**16.56**	1.87	**14.68**	0.03	4.95	-4.92
		2.40	*0.26*	*2.85*	*0.00*	*0.89*	*-0.86*
Firm Size	+/-	**1.54**	0.18	**1.36**	**1.83**	**1.08**	0.75
		3.29	*0.35*	*2.06*	*3.70*	*1.88*	*1.33*
Book to Market	-	**-3.99**	**-6.73**	2.74	-1.21	**-4.13**	2.92
		-4.60	*-6.43*	*2.05*	*-1.12*	*-2.92*	*1.83*
Leverage	-	**-0.75**	**-1.55**	0.79	**-1.10**	**-0.91**	-0.18
		-3.99	*-5.30*	*2.57*	*-8.50*	*-2.75*	*-0.55*
Analyst Following	+	**-0.09**	-0.02	-0.07	**-0.16**	-0.09	-0.08
		-2.41	*-0.80*	*-1.64*	*-2.66*	*-1.16*	*-0.84*
Inst'l Holding %	+	**4.39**	1.25	**3.15**	**5.21**	1.08	**4.13**
		3.24	*1.54*	*2.13*	*3.39*	*0.82*	*2.39*
CEO Holding %	+	**11.46**	**7.13**	4.33	**15.43**	**16.98**	-1.55
		2.41	*2.07*	*0.70*	*3.18*	*3.74*	*-0.24*
G-Index	-	-0.07	-0.10	0.03	-0.01	0.08	-0.09
		-0.71	*-1.29*	*0.25*	*-0.09*	*0.59*	*-0.48*
Firm Age	+	0.01	0.02	-0.02	0.01	0.03	-0.01
		0.52	*1.22*	*-0.59*	*0.64*	*1.25*	*-0.46*
Intercept	+/-	-3.58	**10.09**	**-13.66**	**-6.58**	0.84	-7.42
		-0.76	*2.68*	*-2.29*	*-1.85*	*0.84*	*-1.56*
N		1352	1104	2456	1352	1104	2456
Adjusted R²		0.19	0.31	0.23	0.20	0.25	0.22

Panel B: FRQ = BScore

Dependent variable: ROA	Pred Sign	LOW ENTRENCHMENT			HIGH ENTRENCHMENT		
		DE firms	Non-DE firms	Difference in Coefficients	DE firms	Non-DE firms	Difference in Coefficients
AFT	-	**-2.40**	0.21	**-2.60**	**-1.15**	**-1.95**	0.80
		-4.21	*0.36*	*-3.82*	*-1.98*	*-3.34*	*1.17*
FRQ	+	**-17.09**	-3.29	-13.80	**-13.76**	**-20.02**	6.26
		-4.68	*-0.47*	*-1.44*	*-2.99*	*-3.05*	*0.97*
AFT*FRQ	+	**15.63**	-2.56	**18.19**	0.67	5.45	-4.79
		2.69	*-0.44*	*2.94*	*0.14*	*1.26*	*-0.88*
Firm Size	+/-	**1.27**	-0.02	**1.29**	**1.72**	**0.94**	0.78
		2.85	*-0.05*	*2.12*	*3.64*	*1.71*	*1.34*
Book to Market	-	**-3.39**	**-6.49**	**3.10**	-1.04	**-3.96**	**2.91**
		-3.97	*-5.95*	*2.24*	*-1.02*	*-3.14*	*1.99*
Leverage	-	**-0.72**	**-1.51**	0.79	**-1.08**	**-0.91**	-0.18
		-3.96	*-5.39*	*2.64*	*-8.52*	*-2.82*	*-0.55*
Analyst Following	+	-0.09	-0.02	-0.07	-0.17	-0.09	-0.08
		-2.42	*-0.73*	*-1.67*	*-2.76*	*-1.25*	*-0.86*
Inst'l Holding %	+	**4.34**	1.21	**3.14**	**5.21**	1.05	**4.16**
		3.18	*1.50*	*2.09*	*3.42*	*0.81*	*2.41*
CEO Holding %	+	**11.33**	**7.33**	4.00	**15.40**	**16.98**	-1.59
		2.42	*2.19*	*0.66*	*3.14*	*3.72*	*-0.24*
G-Index	-	-0.07	-0.10	0.04	0.00	0.09	-0.09
		-0.66	*-1.30*	*0.29*	*0.00*	*0.67*	*-0.47*
Firm Age	+	0.01	0.03	-0.02	0.01	0.03	-0.01
		0.52	*1.29*	*-0.64*	*0.64*	*1.26*	*-0.47*
Intercept	+/-	-1.00	**11.51**	**-12.51**	-5.11	2.91	-8.02
		-0.22	*3.31*	*-2.12*	*-1.42*	*0.64*	*-1.55*
N		1352	1104	2456	1352	1104	2456
Adjusted R²		0.19	0.31	0.23	0.20	0.26	0.22

Table 12: Post-Regime Shift role of Governance Mechanisms

This table examines the effect of Financial Reporting Quality (FRQ) on ROA around the mid-1990s Delaware takeover regime shift, and includes control variables to allow the role of governance and information environment variables to vary in the post regime shift period. All variables are defined in the Appendix. Standard errors are clustered by firm and year. t-stats are reported in italics. Values in bold indicate significance at the 10% level or better. All regressions include firm and year fixed effects.

Dependent variable: ROA	Pred Sign	FRQ = CSCORE			FRQ = BSCORE		
		DE firms	Non-DE firms	Difference in Coefficients	DE firms	Non-DE firms	Difference in Coefficients
AFT	-	**-4.241**	-1.731	-2.51	**-4.60**	**-2.01**	-2.59
		-2.89	*-1.46*	*-1.36*	*-3.10*	*-1.74*	*-1.42*
FRQ	+	**-10.33**	-5.03	-5.30	**-15.68**	-8.45	-7.23
		-2.95	*-0.66*	*-0.80*	*-5.63*	*-1.49*	*-1.04*
AFT*FRQ	+	**11.82**	-0.98	**12.80**	**12.56**	-0.36	**12.92**
		2.06	*-0.13*	*2.29*	*2.48*	*-0.06*	*2.17*
Firm Size	+/-	1.60	0.46	1.14	1.48	0.37	1.10
		4.35	*1.06*	*2.56*	*4.14*	*0.97*	*2.54*
Book to Market	-	-2.93	-5.68	2.75	-2.61	-5.54	2.93
		-3.86	*-5.23*	*2.38*	*-3.77*	*-5.29*	*2.59*
Leverage	-	-0.85	-1.33	0.48	-0.85	-1.31	0.46
		-5.27	*-4.94*	*1.77*	*-5.36*	*-5.06*	*1.74*
Analyst Following	+	-0.12	-0.03	-0.09	-0.12	-0.03	-0.09
		-3.37	*-0.66*	*-2.09*	*-3.51*	*-0.72*	*-2.04*
Inst'l Holding %	+	4.63	1.64	2.99	4.55	1.65	2.89
		3.12	*1.65*	*1.72*	*3.02*	*1.69*	*1.64*
CEO Holding %	+	7.59	9.49	-1.90	7.36	9.54	-2.18
		1.75	*2.45*	*-0.33*	*1.75*	*2.58*	*-0.39*
G-Index	-	-0.17	-0.15	-0.03	-0.16	-0.15	-0.01
		-2.10	*-1.86*	*-0.22*	*-1.95*	*-1.89*	*-0.10*
Firm Age	+	0.00	**0.03**	-0.03	0.01	**0.03**	-0.03
		0.36	*2.19*	*-1.33*	*0.36*	*2.25*	*-1.37*
AFT*Analyst Following	+	0.01	-0.04	0.05	0.01	-0.04	0.05
		0.30	*-0.66*	*0.78*	*0.30*	*-0.65*	*0.73*
AFT*Inst Holding %	+	-0.07	-0.44	0.37	0.01	-0.48	0.50
		-0.05	*-0.39*	*0.20*	*0.01*	*-0.44*	*0.27*
AFT*CEO Holding %	+	**9.99**	0.67	9.32	**10.17**	0.64	9.53
		2.31	*0.19*	*1.71*	*2.36*	*0.18*	*1.78*
AFT*G-Index	-	0.27	0.19	0.08	0.27	0.20	0.07
		3.14	*1.98*	*0.61*	*3.00*	*2.05*	*0.52*
Intercept	+/-	-2.90	**7.48**	-10.37	-1.26	**8.57**	-9.83
		-0.79	*2.44*	*-2.65*	*-0.35*	*8.57*	*-2.49*
N		3967	2912	6879	3967	2912	6879
Adjusted R²		0.19	0.27	0.22	0.19	0.27	0.22

Table 13: Exclusion of firms without recourse to a Poison Pill

This table examines the effect of Financial Reporting Quality (FRQ) on ROA around the mid-1990s Delaware takeover regime shift after excluding firms without poison pills in place as at 1995. All variables are defined in the Appendix. Standard errors are clustered by firm and year. t-stats are reported in italics. Values in bold indicate significance at the 10% level or better. All regressions include firm and year fixed effects.

Dependent variable: ROA	Pred Sign	FRQ = CSCORE			FRQ = BSCORE		
		DE firms	Non-DE firms	Difference in Coefficients	DE firms	Non-DE firms	Difference in Coefficients
AFT	-	**-1.57**	**-0.88**	-0.69	**-2.22**	**-0.90**	-1.32
		-3.05	*-2.15*	*-1.52*	*-4.46*	*-1.85*	*-2.15*
FRQ	+	**-9.59**	-3.87	-5.72	**-15.94**	-5.63	-10.31
		-2.24	*-0.44*	*-0.61*	*-2.97*	*-0.79*	*-0.99*
AFT*FRQ	+	**11.23**	1.26	9.96	**11.15**	-0.90	12.05
		1.95	*0.25*	*1.76*	*2.14*	*-0.23*	*1.91*
Firm Size	+/-	**2.16**	**0.83**	1.33	**1.94**	**0.73**	1.22
		5.82	*1.84*	*2.65*	*5.29*	*1.85*	*2.62*
Book to Market	-	**-2.18**	**-5.12**	2.94	**-1.83**	**-5.00**	3.17
		-2.40	*-4.31*	*2.45*	*-2.10*	*-4.36*	*2.71*
Leverage	-	**-1.09**	**-1.33**	0.23	**-1.06**	**-1.30**	0.24
		-6.57	*-4.02*	*0.63*	*-6.59*	*-4.06*	*0.65*
Analyst Following	+	**-0.18**	-0.06	-0.13	**-0.18**	-0.06	-0.13
		-5.10	*-1.17*	*-2.47*	*-5.07*	*-1.17*	*-2.46*
Inst'l Holding %	+	**6.23**	1.51	4.71	**6.19**	1.49	4.71
		4.52	*1.51*	*3.12*	*4.54*	*1.50*	*3.12*
CEO Holding %	+	**17.95**	**16.20**	1.74	**17.77**	**16.19**	1.58
		3.62	*4.06*	*0.29*	*3.60*	*4.05*	*0.27*
G-Index	-	-0.02	-0.04	0.02	-0.01	-0.04	0.02
		-0.27	*-0.36*	*0.13*	*-0.20*	*-0.37*	*0.19*
Firm Age	+	-0.01	**0.05**	-0.05	-0.01	0.05	-0.06
		-0.49	*2.33*	*-2.07*	*-0.52*	*2.32*	*-2.08*
Intercept	+/-	**-8.47**	3.35	-11.82	**-6.14**	4.38	-10.52
		-2.32	*0.98*	*-2.75*	*-1.70*	*4.38*	*1.33*
N		2657	2006	4663	2657	2006	4663
Adjusted R²		0.21	0.25	0.23	0.21	0.25	0.23

Table 14: Charter-Based Staggered Board Firms

This table examines the effect of Financial Reporting Quality (FRQ) on ROA around the mid-1990s Delaware takeover regime shift, after removing Bylaws-based Staggered Board firms from the sample. All variables are defined in the Appendix. Standard errors are clustered by firm and year. t-stats are reported in italics. Values in bold indicate significance at the 10% level or better. All regressions include firm and year fixed effects.

Dependent variable: ROA	Pred Sign	FRQ = CSCORE			FRQ = BSCORE		
		DE firms	Non-DE firms	Difference in Coefficients	DE firms	Non-DE firms	Difference in Coefficients
AFT	-	**-1.40**	-0.49	**-0.90**	**-2.05**	-0.51	**-1.54**
		-2.89	*-1.09*	*-2.17*	*-4.46*	*-1.00*	*-3.05*
FRQ	+	**-10.53**	-5.35	-5.18	**-17.03**	-7.70	-9.33
		-3.02	*-0.72*	*-0.75*	*-5.11*	*-1.29*	*-1.20*
AFT*FRQ	+	**11.46**	0.02	**11.44**	**11.25**	-2.35	**13.60**
		2.21	*0.00*	*2.55*	*2.60*	*-0.65*	*2.78*
Firm Size	+/-	**1.60**	0.43	**1.17**	**1.39**	0.31	**1.08**
		4.46	*1.00*	*2.66*	*4.08*	*0.84*	*2.62*
Book to Market	-	**-2.91**	**-5.74**	**2.83**	**-2.47**	**-5.57**	**3.10**
		-3.77	*-5.22*	*2.43*	*-3.42*	*-5.11*	*2.66*
Leverage	-	**-0.84**	**-1.33**	0.49	**-0.82**	**-1.31**	0.49
		-5.12	*-4.90*	*1.77*	*-5.17*	*-5.13*	*1.86*
Analyst Following	+	**-0.12**	-0.04	-0.07	**-0.12**	-0.04	-0.08
		-3.39	*-1.03*	*-1.71*	*-3.42*	*-1.03*	*-1.72*
Inst'l Holding %	+	**4.68**	**1.39**	**3.28**	**4.63**	**1.36**	**3.27**
		4.14	*1.75*	*2.69*	*4.13*	*1.73*	*2.67*
CEO Holding %	+	**13.10**	**10.09**	3.01	**12.99**	**10.18**	2.81
		3.69	*3.37*	*0.67*	*3.71*	*3.50*	*0.64*
G-Index	-	-0.02	-0.05	0.03	-0.02	-0.05	0.03
		-0.33	*-0.73*	*0.31*	*-0.26*	*-0.72*	*0.36*
Firm Age	+	0.01	**0.04**	-0.03	0.01	**0.04**	-0.03
		0.40	*2.39*	*-1.46*	*0.39*	*2.45*	*-1.51*
Intercept	+/-	-4.59	**6.92**	**-11.51**	-2.29	**8.13**	**-10.42**
		-1.33	*2.13*	*-2.96*	*-0.69*	*8.13*	*2.68*
N		3952	2892	6844	3952	2892	6844
Adjusted R²		0.18	0.27	0.21	0.19	0.27	0.22

Table 15: Alternative compensation proxy in tests of ROA

This table examines the effect of Financial Reporting Quality (FRQ) on ROA around the mid-1990s Delaware takeover regime shift, using an alternative proxy for CEO Holding % that incorporates both CEO stock and CEO option holdings. All variables are defined in the Appendix. Standard errors are clustered by firm and year. t-stats are reported in italics. Values in bold indicate significance at the 10% level or better. All regressions include firm and year fixed effects.

Dependent variable: ROA	Pred Sign	FRQ = CSCORE			FRQ = BSCORE		
		DE firms	Non-DE firms	Difference in Coefficients	DE firms	Non-DE firms	Difference in Coefficients
AFT	-	**-1.47**	-0.60	**-0.86**	**-2.12**	-0.63	**-1.49**
		-3.01	*-1.30*	*-1.98*	*-4.53*	*-1.22*	*-2.80*
FRQ	+	**-10.44**	-5.41	-5.03	**-16.79**	-7.70	-9.08
		-2.99	*-0.72*	*-0.72*	*-4.99*	*-1.29*	*-1.16*
AFT*FRQ	+	**11.38**	0.40	**10.97**	**11.24**	-1.94	**13.18**
		2.22	*0.08*	*2.42*	*2.62*	*-0.54*	*2.69*
Firm Size	+/-	**1.63**	0.48	**1.15**	**1.42**	0.36	**1.06**
		4.53	*1.10*	*2.55*	*4.13*	*0.96*	*2.53*
Book to Market	-	**-2.87**	**-5.70**	**2.83**	**-2.45**	**-5.54**	**3.09**
		-3.72	*-5.15*	*2.41*	*-3.38*	*-5.05*	*2.63*
Leverage	-	**-0.84**	**-1.33**	**0.49**	**-0.82**	**-1.31**	**0.49**
		-4.98	*-4.92*	*1.77*	*-5.03*	*-5.16*	*1.86*
Analyst Following	+	**-0.11**	-0.05	-0.07	**-0.11**	-0.04	-0.07
		-3.31	*-1.10*	*-1.53*	*-3.35*	*-1.10*	*-1.55*
Inst'l Holding %	+	**4.69**	**1.39**	**3.30**	**4.65**	**1.36**	**3.29**
		4.08	*1.77*	*2.68*	*4.06*	*1.75*	*2.66*
CEO Holding %	+	**14.54**	**9.73**	4.80	**14.37**	**9.80**	4.57
		4.31	*3.37*	*1.08*	*4.31*	*3.48*	*1.05*
G-Index	-	-0.02	-0.06	0.04	-0.02	-0.06	0.04
		-0.29	*-0.81*	*0.40*	*-0.22*	*-0.80*	*0.45*
Firm Age	+	0.01	**0.04**	-0.03	0.01	**0.04**	-0.03
		0.50	*2.48*	*-1.45*	*0.49*	*2.54*	*-1.50*
Intercept	+/-	-5.05	**6.59**	**-11.65**	-2.80	**7.79**	**-10.59**
		-1.44	*2.00*	*-2.91*	*-0.82*	*7.79*	*2.53*
N		3955	2880	6835	3955	2880	6835
Adjusted R²		0.19	0.26	0.21	0.19	0.27	0.22

Table 16: Removal of California Firms

This table examines the effect of Financial Reporting Quality (FRQ) on ROA around the mid-1990s Delaware takeover regime shift, after excluding firms headquartered in California. All variables are defined in the Appendix. Standard errors are clustered by firm and year. t-stats are reported in italics. Values in bold indicate significance at the 10% level or better. All regressions include firm and year fixed effects.

Dependent variable: ROA	Pred Sign	FRQ = CSCORE			FRQ = BSCORE		
		DE firms	Non-DE firms	Difference in Coefficients	DE firms	Non-DE firms	Difference in Coefficients
AFT	-	**-1.39**	-0.39	**-1.00**	-2.04	-0.42	**-1.62**
		-2.89	*-0.92*	*-2.56*	*-4.45*	*-0.85*	*-3.30*
FRQ	+	**-10.51**	-5.25	-5.26	**-17.03**	-7.32	-9.71
		-3.02	*-0.71*	*-0.77*	*-5.11*	*-1.24*	*-1.26*
AFT*FRQ	+	**11.38**	0.54	**10.83**	**11.18**	-1.69	**12.87**
		2.20	*0.11*	*2.36*	*2.59*	*-0.47*	*2.61*
Firm Size	+/-	**1.59**	0.41	**1.18**	**1.38**	0.30	**1.08**
		4.43	*1.01*	*2.72*	*4.05*	*0.86*	*2.64*
Book to Market	-	**-2.91**	**-5.68**	**2.76**	**-2.48**	**-5.52**	**3.04**
		-3.78	*-5.28*	*2.41*	*-3.43*	*-5.23*	*2.68*
Leverage	-	**-0.84**	**-1.29**	0.44	**-0.82**	**-1.27**	0.45
		-5.12	*-4.84*	*1.63*	*-5.18*	*-5.05*	*1.72*
Analyst Following	+	**-0.12**	-0.03	**-0.08**	**-0.12**	-0.03	**-0.08**
		-3.36	*-0.77*	*-1.85*	*-3.39*	*-0.77*	*-1.86*
Inst'l Holding %	+	**4.66**	1.23	**3.43**	**4.62**	1.20	**3.42**
		4.12	*1.48*	*2.81*	*4.11*	*1.46*	*2.78*
CEO Holding %	+	**13.08**	**9.93**	3.15	**12.96**	**10.01**	2.95
		3.69	*3.35*	*0.69*	*3.71*	*3.47*	*0.66*
G-Index	-	-0.02	-0.04	0.02	-0.02	-0.04	0.02
		-0.36	*-0.68*	*0.22*	*-0.29*	*-0.67*	*0.27*
Firm Age	+	0.01	**0.03**	-0.02	0.01	**0.03**	-0.03
		0.43	*2.01*	*-1.16*	*0.41*	*2.07*	*-1.21*
Intercept	+/-	-4.51	**6.96**	**-11.47**	-2.21	**8.07**	**-10.28**
		-1.30	*2.37*	*-3.06*	*-0.66*	*8.07*	*2.88*
N		3967	2829	6796	3967	2829	6796
Adjusted R²		0.19	0.27	0.22	0.19	0.28	0.22