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Reputation Building or Skin in the Game:

Employee Welfare's Impact on Financial Reporting Quality

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Abstract

Based on the 8271 firm-year observations from 2010 to 2016, this paper investigates the impact of employee welfare on the financial reporting quality. Financial reporting quality is measured by the degree of abnormal accruals and real activities manipulation. Due to the availability of data, the sample's year interval could not be extended to 2020, which is the same limitation shared by previous literature. The results show that employee welfare attracts attention and enhances supervision by establishing a good reputation. The enhancement of supervision ultimately improves the financial reporting quality. Further analysis shows that the positive impact of employee welfare on financial reporting quality is weakened in companies with high ownership concentration or excessive ESOP costs, suggesting that whether employee welfare can play a positive role depends on the corporate governance environment.

1. Introduction

In recent years, an increasing number of studies have examined managerial behavior from the perspective of employee relations. Unsal et al. (2017) investigated the impact of employee litigation on managerial political lobbying, indicating that management may mitigate the negative effects of poor employee relations by acquiring political resources. Conversely, management may also improve employee relations to address potential external threats, such as the risk of stock price crashes (Ben-Nasr et al.,2018) and short-selling threats (Brockman et al.,2020). Among various

corporate characteristics, the quality of financial reporting is crucial for the effectiveness of capital markets and is highly relevant to the interests of numerous information users, including investors, tax authorities, and policymakers, making it a long-standing topic of research. The quality of financial reporting often reflects the internal management activities of a company. This paper aims to explore the impact and mechanisms of high employee welfare on financial reporting quality.

Although existing research on employee relations and financial reporting quality is relatively abundant, there is currently no literature directly examining the impact of employee welfare on financial reporting quality. The relevant literature has mostly focused on the effects of employee welfare on other corporate characteristics, such as innovation (Wei et al.,2020) and the risk of stock price crashes (Ben-Nasr et al.,2018), or has concentrated on specific indicators or measures of employee welfare, such as minimum wage (Lu Yao et al.,2017) or employee stock ownership plans (Chen Dapeng et al.,2019). On one hand, these studies do not directly test the overall impact of employee welfare on financial reporting quality. On the other hand, some studies suffer from issues of external validity or omitted variable bias, reducing their applicability. As an important dimension of corporate social responsibility, employee welfare is often a means for management to coordinate employee relations. This paper studies employee relations and financial reporting quality from the perspective of corporate social responsibility, effectively filling a gap in the relevant field.

High employee welfare aligns the interests of management and ordinary employees, but it does not always indicate positive company development. Whether it fosters collaboration or leads to collusion often depends on whether the implementation of employee welfare helps establish a good reputation, thereby attracting scrutiny and enhancing oversight, or whether it becomes a means of bundling interests, prompting employees to conceal internal misconduct.

On the positive side, higher employee welfare may establish or maintain a better reputation, attracting more diligent employees while drawing increased media and public scrutiny, thereby enhancing the level of internal and external oversight. This could lead to a positive impact of employee welfare on financial reporting quality, ultimately contributing to the long-term development of the company.

Conversely, higher employee welfare may also create stronger interest bundling among employees, serving as a means for management to "appease" potential whistleblowers, which could result in more internal misconduct being concealed and ultimately distort financial information, reducing the quality of financial reporting.

This paper studies the aforementioned issues based on observational data from non-financial listed companies in the Shanghai and Shenzhen A-shares from2010 to2016. The results show that employee welfare positively impacts financial reporting quality, supporting the reputation-building hypothesis. An analysis of specific indicators of employee welfare reveals that work income and job care significantly improve financial reporting quality, while job security has no significant effect. A detailed analysis of the components of financial reporting quality indicates that employee welfare has no obvious impact on accrual earnings management, but significantly suppresses real earnings management, with an average improvement of2 units in employee welfare being able to suppress real earnings management by 1%, demonstrating a substantial economic impact. Furthermore, additional analysis reveals that in companies with excessive investment in employee stock ownership plans and high ownership concentration, the positive impact of employee welfare on financial reporting quality is weaker.

The contributions of this paper are mainly twofold: First, this is the first study to systematically investigate the relationship between employee welfare and corporate earnings management using a large sample of data from listed companies. It extends the influence of corporate social responsibility on financial reporting behavior from the perspective of employee relations, filling the gap in previous literature that lacked a detailed breakdown of corporate social responsibility (Chen Guohui et al.,2018) and enriching the literature on the economic impact of detailed indicators of corporate social responsibility. Second, this paper tests two hypotheses regarding the mechanisms through which employee welfare influences financial reporting quality. The results show that employee welfare can improve financial reporting quality by establishing a reputation, supporting a perspective that differs from previous literature related to employee welfare (Ben-Nasr et al.,2018; Chen Dapeng et al.,2019), providing research insights into the mechanisms of corporate social responsibility behavior.

2. Literature Review

2.1 Financial Reporting Quality

As one of the important fields of accounting research, financial reporting quality encompasses a vast number of insightful classic literatures. Among these, the research on earnings management is the most detailed. A classic study by Dechow et al. (1995) tested the relative performance of five major models of earnings management based on various samples, including randomly selected annual observations from companies, annual observations from companies with extreme financial performance, annual observations from companies with known fixed and quantity-adjusted accrual items generated through simulations, and samples from companies accused by the Securities and Exchange Commission (SEC) of exaggerating annual earnings. The models evaluated included the Healy model, DeAngelo model, Jones model, modified Jones model, and industry model. For the randomly selected company annual observation samples, all models performed well; however, in the samples with extreme financial performance, all models excessively rejected the null hypothesis of no earnings management. Finally, among the last two samples used to detect the occurrence of Type II errors, the modified Jones model showed the best performance.

Building on the aforementioned research, Kothari et al. (2005) improved the model specification issues reflected in the samples with extreme financial performance. Unlike previous models based on time series data (the Jones model and the modified Jones model), the authors switched to estimating using industry cross-sectional data and systematically compared the Jones model, the modified Jones model, the Jones model incorporating ROA, the modified Jones model incorporating ROA, the Jones model matched by contemporaneous ROA, the modified Jones model matched by contemporaneous ROA, the Jones model matched by prior ROA, and the modified Jones model matched by prior ROA. They ultimately found that the Jones model and the modified Jones model matched by contemporaneous ROA produced the fewest Type I errors. Furthermore, the authors emphasized that models matched by ROA report “abnormal” earnings management after removing the performance factor's influence, rather than the total earnings management.

Based on the well-tested and improved earnings management models, many scholars have further studied the factors influencing financial reporting quality. Among these, corporate social

responsibility (CSR) factors have attracted considerable scholarly attention (Zhu Song,2011; Kim et al.,2012; Wang Xia et al.,2014; Chen Guohui et al.,2018). Several studies have explored earnings management issues from the perspective of overall CSR performance. For example, Chen Guohui et al. (2018) used A-share listed companies that published CSR reports from2008 to2012 as samples and studied the impact of mandatory and voluntary disclosures of CSR on corporate earnings management. The results showed that under voluntary disclosure, CSR behavior significantly suppressed real earnings management, accrual earnings management, and the occurrence of financial restatements. Under mandatory disclosure, CSR behavior had a notable suppressive effect only on real earnings management, but this effect was more significant than that in the voluntary disclosure group, with the economic impact being approximately double that of the voluntary disclosure group. However, the limitation of this type of research lies in the lack of a detailed breakdown of CSR indicators for further verification. In the various refined dimensions of CSR, there is relatively little literature focusing on the economic consequences of CSR from the perspective of employee welfare. Exploring employee welfare as part of CSR research can effectively address this gap.

2.2 Employee welfare

Previous empirical studies on employee welfare have concentrated in part on its effects on innovation, stock price crash risk, and other corporate characteristics (Wei et al.,2020; Ben-Nasr et al.,2018). Ben-Nasr et al. (2018) researched data from various countries from2008 to2014 and found that employee welfare might increase the risk of stock price crashes by inhibiting the willingness of employees to blow the whistle or facilitating managers' earnings management, thereby accumulating negative news for the company. In further research, the authors discovered that in labor-intensive companies or industries and in countries with more regulated labor markets and less competitive product markets, the extent to which employee welfare increased the risk of stock price crashes was more significant. While this article has partially examined the relationship between employee welfare and earnings management, its limitation is that the international data used mostly come from developed countries, where the four most represented developed countries account for nearly50% of the data, specifically the U.S. (13.24%), the U.K. (12.99%), Japan (14.96%), and Australia (8.25%). Data from developing countries is minimal, with Chinese

enterprise data only accounting for1.76%, thus limiting the external validity of the research conclusions. Similarly, although Wei et al. (2020) conducted their study within the context of the Chinese capital market, it was limited to manufacturing companies, thereby also suffering from inadequate external validity. Conducting research on a broader range of company samples within the Chinese context will provide a strong complement to the existing literature.

Another portion of the literature focuses on the impact of specific indicators or measures of employee welfare on financial reporting quality (Lu Yao et al.,2017; Chen Dapeng et al.,2019). Chen Dapeng et al. (2019) found that employee stock ownership plans significantly increase a firm's level of accrual earnings management, with a10% increase in employee stock ownership leading to an average increase of0.012 in accrual earnings management, which is about five times the mean or1/8 of the standard deviation. Furthermore, firms with employee stock ownership plans had an average increase of0.008 in accrual earnings management compared to those without such plans, roughly equivalent to three times the mean and1/11 of the standard deviation. Additional analysis revealed that corporate capital feature characteristics, such as the funding source of employee stock ownership plans and ownership concentration, as well as asset feature characteristics like transparency of corporate assets, and labor feature characteristics like the relative importance of employees, have moderating effects on employee welfare. However, these studies often fail to control for the effects of other employee welfare measures. If firms reduce other benefits in the process of enhancing one type of employee welfare, the estimates of the impact of employee welfare in these studies will be biased, while using a more comprehensive employee welfare indicator will help alleviate this issue.

Currently, no literature has directly examined the role of overall CSR performance related to employee welfare in financial reporting quality. Based on the various inadequacies in previous literature discussed above, this study empirically examines the impact of employee welfare on financial reporting quality in non-financial A-share listed companies from2010 to2016, using financial data and corporate social responsibility data from Hexun, in order to supplement and expand the existing literature.

2.3 Hypothesis Development

Regarding whether employee welfare improves or lowers financial reporting quality, past theories and empirical results support two opposing hypotheses. According to stakeholder theory, corporate decisions should consider the interests of all stakeholders. A company's stakeholders include any group or individual that can significantly influence or be influenced by the company. In addition to traditional capital market stakeholders within the company (such as shareholders and creditors), stakeholders also include product market stakeholders (such as customers, suppliers, distributors, and the community), stakeholders within the organization (such as employees and internal management), as well as the government. Managers are required to balance the demands of various stakeholders and maximize the utility function of all stakeholders.

Corporate social responsibility (CSR) behavior helps establish or maintain a company's reputation, thereby influencing stakeholders' evaluations of the company (Fombrun and Shanley,1990). From the perspective of stakeholders within the organization, employee welfare is one of the company policies most valued by workers. Therefore, companies that emphasize employee welfare often enjoy a good reputation (Turban and Greening,1997). Conversely, if a company fails to adequately consider employee interests and adopts measures that reduce employee welfare, such as layoffs, it will lower employee satisfaction and damage the company's reputation (Flanagan and O'Shaughnessy,2005), which can also negatively impact financial performance.

Establishing a company's reputation through higher employee welfare not only attracts external talent (Bhattacharya et al.,2008) but also enhances the organizational commitment of current employees (Brammer et al.,2007; Turker,2009), thereby promoting efficiency in labor output across departments. For the accounting and internal audit departments, improved labor output efficiency can lead to higher quality control activities and internal supervision (Cao et al.,2012). On the other hand, current employees may also reduce their misconduct to maintain the company's reputation, thus improving the internal environment of the company. For example, analysts working in reputable institutions will avoid issuing overly optimistic forecasts to protect the company's reputation (Xu and Tang,2012). Additionally, a good reputation may attract public and media attention, thereby increasing external oversight (Cao et al.,2012). These factors enhance the company's internal control levels, thereby promoting improvements in financial reporting quality.

In summary, higher employee welfare will ultimately have a positive effect on financial reporting quality. Therefore, this paper proposes the following hypothesis:

H1a: Employee welfare positively affects financial reporting quality by establishing a good reputation.

Additionally, an alternative explanation is that a company's ample economic resources positively influence both employee welfare and financial reporting quality, resulting in a positive correlation between the two. Following the approach of Kim et al. (2012), this paper controls for the company's return on total assets and whether it is listed in Fortune magazine's "Most Admired Companies in China" to mitigate this issue.

However, from the perspective of agency theory, CSR behavior may still be opportunistically used to conceal internal misconduct. The research by Hemingway and Maclagan (2004) mentions that concealing corporate misconduct may be one of the motivations for CSR, leading opportunistic managers to disguise financial manipulation under the guise of CSR. For instance, Petrovits (2006) found that companies strategically use charitable programs to manipulate earnings to achieve their financial goals. Furthermore, the research by Prior et al. (2008) confirms that sudden improvements in CSR may be associated with earnings management and other behaviors detrimental to company value, potentially exacerbating the negative impact of such behaviors on corporate returns.

From the perspective of employee welfare, overly generous welfare programs may become a means of interest bundling, reducing the likelihood of employees discovering and reporting potential misconduct by management (Ben-Nasr et al.,2018). In other words, conflicts of interest with management, which may lead to employee dissatisfaction, are likely to encourage employees to expose management's wrongdoings. For example, according to a report by China Securities Journal, the exposure of Changsheng Biotechnology's vaccine fraud in2018 was due to internal job adjustments affecting employee welfare, leading affected employees to report externally. Similarly, a report by Phoenix Network noted that in early2021, an employee from Deloitte Huayong Accounting Firm reported internal non-compliance issues to the Securities Regulatory Commission due to dissatisfaction with the partners' actions. Previous studies have also confirmed that layoffs

and downsizing (Dyck et al.,2010; Bowen et al.,2010) encourage employees to report misconduct. Additionally, the findings of Rothschild and Miethe (1999) indicate that in bureaucratic and undemocratic work environments, employees are more inclined to expose management's wrongdoings.

Based on the above facts and research findings, generous employee welfare helps alleviate conflicts between management and employees, bundling the interests of both parties and leading to the concealment of internal misconduct by employees. With the threat of external reporting diminished, management's concerns about earnings manipulation are reduced, making high employee welfare a form of agency cost, ultimately resulting in lower financial reporting quality. Therefore, this paper proposes the following hypothesis:

H1b: Employee welfare negatively affects financial reporting quality by strengthening interest bundling.

3. Research Design

3.1 Sample Selection and Data Sources

Due to the fact that data on corporate social responsibility reports for listed companies in China began in2010, and considering data availability and quality, this paper uses all A-share listed companies from2010 to2016 as the initial sample. During the calculation of accrual earnings management and real earnings management, any samples with fewer than10 observations were removed. Additionally, the following types of companies were excluded:1) companies in the financial industry;2) companies in the real estate industry;3) companies with special treatment (ST), *ST, as well as those that are suspended or delisted. After these exclusions, samples with missing or invalid data for the variables involved in each model were removed, resulting in a final sample of8,271 observations. Data on employee welfare is sourced from Hexun’s corporate social responsibility reports of Chinese listed companies, while the external evaluation variable is derived from Fortune magazine's list of "Most Admired Companies in China." Data related to employee stock ownership plans comes from the Wind database, and all other data is obtained from the CSMAR database. Furthermore, to mitigate the impact of outliers, all continuous variables in this

paper are winsorized at the1st and99th percentiles.

3.2 Dependent Variables

This paper references existing literature (Dou et al.,2018) and uses four common measurement methods for accrual earnings management and real earnings management to construct a comprehensive measurement index. The results from the four measurements are ranked separately within each year, and then assigned values from0 to9, with each10% interval representing a corresponding result. For instance, if a company's abnormal accrual level in a particular year exceeds less than10% of the observations, that company's abnormal accrual level will be assigned a value of0. The assigned results are then divided by9 to ensure that the absolute values of the four measurement results lie between0 and1. Subsequently, these values are multiplied by -1, so that larger measurement values represent higher financial reporting quality. Finally, the average of the four measurement methods produces the comprehensive measurement index for financial reporting quality. The specific calculation processes for the four measurement methods are as follows:

(i) The first measurement method involves abnormal accruals (ABSKLW) and uses the modified Jones model (Kothari et al.,2005), as shown in Model (1):

$$\frac{TAC_{i,t}}{TA_{i,t-1}} = \alpha_0 + \alpha_1 \frac{1}{TA_{i,t-1}} + \alpha_2 \frac{\Delta Sales_{i,t}}{TA_{i,t-1}} + \alpha_3 \frac{PPE_{i,t}}{TA_{i,t-1}} + \alpha_4 ROA_{i,t} + \varepsilon_{i,t} \quad (1)$$

where I represents the listed company and t represents the year. Total accruals (TAC) are defined as "operating profit minus cash flow from operating activities," TA is total assets, ΔSales is the change in operating income, PPE is fixed assets, and ROA is return on assets, calculated as current year net profit divided by previous year total assets. Using the industry classification guidelines published by the China Securities Regulatory Commission in2012, the model (1) estimates the discretionary accrual earnings of each enterprise by the residual ϵ on an industry basis annually, and the absolute value of ϵ measures the degree of earnings management. All continuous variables in the model underwent two-tailed 1% winsorization; the same applies below.

(ii) The second measurement method involves abnormal accruals, using the adjusted Dechow-Dichev model (Ball and Shivakumar,2006), as shown in Model (2):

$$\frac{WC_{i,t}}{TA_{i,t-1}} = \alpha_0 + \alpha_1 \frac{OCF_{i,t-1}}{TA_{i,t-1}} + \alpha_2 \frac{OCF_{i,t}}{TA_{i,t-1}} + \alpha_3 \frac{OCF_{i,t+1}}{TA_{i,t-1}} + \alpha_4 DOCF_{i,t} + \alpha_5 DOCF_{i,t} \times \frac{OCF_{i,t}}{TA_{i,t-1}} + \varepsilon_{i,t} \quad (2)$$

where i represents the listed company, t represents the year, total accruals (WC) are defined as "operating profit before depreciation minus cash flow from operating activities," TA is total assets, OCF is net cash flow from operating activities, and DOCF is a binary variable that equals1 when OCF is negative. Similarly, the model (2) estimates the discretionary accrual earnings of each enterprise annually on an industry basis, with the absolute value of ϵ again measuring the degree of earnings management.

(iii) Real activity manipulation involves three main methods. Following the methods cited in existing literature (Roychowdhury,2006; Zang,2012; Dou et al.,2018), this paper constructs the third (RM1) and fourth (RM2) measurement methods. The third measurement method requires the results from Models (3) and (4):

$$\frac{PROD_{i,t}}{TA_{i,t-1}} = \alpha_0 + \alpha_1 \frac{1}{TA_{i,t-1}} + \alpha_2 \frac{Sales_{i,t}}{TA_{i,t-1}} + \alpha_3 \frac{\Delta Sales_{i,t}}{TA_{i,t-1}} + \alpha_4 \frac{\Delta Sales_{i,t-1}}{TA_{i,t-1}} + \varepsilon_{i,t} \quad (3)$$

$$\frac{DISX_{i,t}}{TA_{i,t-1}} = \alpha_0 + \alpha_1 \frac{1}{TA_{i,t-1}} + \alpha_2 \frac{Sales_{i,t-1}}{TA_{i,t-1}} + \varepsilon_{i,t} \quad (4)$$

where PROD represents the cost of goods sold, measured by the cost of sales plus inventory changes. TA is total assets, and Sales is operating income, while ΔSales refers to the change in sales revenue. DISX represents discretionary expenses, which is the sum of administrative and selling expenses. Regression analysis is conducted on Models (3) and (4) on an industry basis annually to obtain two residuals ϵ, referred to as the extent of production cost manipulation (EM_PROD) and the extent of discretionary expense manipulation (EM_DISX). RM1 is then calculated as follows:

$$RM1 = -EM\_DISX + EM\_PROD \quad (5)$$

(iv) The fourth measurement method (RM2) calculates the level of real earnings manipulation based on the results from Models (4) and (6), with Model (6) defined as follows:

(6)

$$\frac{OCF_{i,t}}{TA_{i,t-1}} = \alpha_0 + \alpha_1 \frac{1}{TA_{i,t-1}} + \alpha_2 \frac{Sales_{i,t}}{TA_{i,t-1}} + \alpha_3 \frac{\Delta Sales_{i,t}}{TA_{i,t-1}} + \varepsilon_{i,t}$$

where OCF is net cash flow from operating activities, Sales is operating income, and ΔSales is the change in operating income. The residual ϵϵ obtained from the annual regression on an industry basis represents the degree of sales manipulation (EM_CFO). RM2 is calculated based on the extent of sales manipulation and discretionary expense manipulation.

$$RM2 = -EM\_DISX - EM\_CFO \quad (7)$$

3.3 Independent Variables

This paper draws on the measurement approach used by Wei et al. (2020) for employee welfare in China's manufacturing industry and constructs a measure of employee welfare using employee-related data from Hexun's corporate social responsibility report database for Chinese listed companies. The employee responsibility score constitutes15% of the overall corporate social responsibility score on Hexun. The employee responsibility score is further divided into seven sub-projects: average employee income (4%), employee training (1%), safety inspections (2%), safety training (3%), awareness of employee welfare (1%), number of welfare visits (2%), and welfare funds (2%).

The employee welfare indicator constructed in this paper is the sum of scores from five sub-projects: average employee income (4%), safety inspections (2%), safety training (3%), number of welfare visits (2%), and welfare funds (2%). The reasons for excluding employee training (1%) and awareness of employee welfare (1%) are that these two sub-projects have a significant number of missing values, and failing to exclude them poses a risk of sample selection bias. Moreover, the weight of these two sub-projects is relatively small (1%), and excluding them will not significantly impact the accuracy of the employee welfare measurement.

3.4 Model Specification

To test the aforementioned hypotheses, this paper constructs the following model to examine the impact of employee welfare on financial reporting quality:

$$FRQ_{i,t} = \alpha_0 + \alpha_1 EW_{i,t} + \alpha_2 Size_{i,t-1} + \alpha_3 MB_{i,t-1} + \alpha_4 ROA_{i,t} + \alpha_5 Big4_{i,t} + \alpha_6 LEV_{i,t-1} + \alpha_7 EO_{i,t} + \alpha_8 RD_{i,t} + \alpha_9 Firmage_{i,t} + \alpha_{10} Admired_{i,t} + \alpha_{11} Indep_{i,t} + \alpha_{12} Top1_{i,t} + \alpha_{13} Dual_{i,t} + \sum Industry + \sum Year + \varepsilon_{i,t} \quad (8)$$

（8）

In this model, the dependent variable is financial reporting quality (FRQ), and the independent variable is employee welfare (EW). If hypothesis H1 is valid, the coefficient of EW in model (8) should be significantly positive. Conversely, if hypothesis H2 is valid, the coefficient should be significantly negative.

To exclude the effects of other factors, this paper references previous research (Kim et al.,2012; Wei et al.,2020) and includes the following control variables in the model: Firm Size (Size): The natural logarithm of total assets at year-end; Market-to-Book Ratio (MB): Calculated as the market capitalization divided by the book value of equity; Return on Assets (ROA): According to Kim et al. (2012), calculated as net profit for the current year divided by total assets at the end of the previous year; Big Four Audits (Big4): A dummy variable that takes the value of1 if the company was audited by one of the Big Four accounting firms in the current year, and0 otherwise; Leverage (LEV): Calculated as non-current liabilities divided by total assets; Equity Offering (EO): A dummy variable that takes the value of1 if the company issued new shares during the year, and0 otherwise; Research and Development Intensity (RD): The percentage of R&D expenditure in relation to operating revenue, ranging from 0 to100; Firm Age (Firmage): Calculated as the number of years since the company was established, plus 1, and then taking the natural logarithm; External Evaluation (Admired): Following Kim et al. (2012), this variable takes the value of1 if the company is listed in Fortune's "Most Admired Companies in China" list, and0 otherwise; Proportion of Independent Directors (Indep): The number of independent directors divided by the total number of directors; Top Shareholder Ownership Ratio (Top1): The number of shares held by the largest shareholder divided by the total number of shares; Dual Role (Dual): A dummy variable that takes the value of1 if the chairman also serves as the general manager, and0 otherwise; State-Owned Enterprise (SOE): A dummy variable that takes the value of1 if the company is state-owned; otherwise, it takes the value of 0; To control for industry fixed effects and year fixed effects, this study also includes dummy variables for industry (Industry) and year (Year).

4. Main Test

4.1 Descriptive Statistics

Table1 presents the descriptive statistics for the main variables. The average financial reporting quality (FRQ) is -0.492, which is close to the median, indicating a relatively uniform distribution among the samples. Moreover, there is a significant difference between the minimum and maximum values, which provides good differentiation and a solid research background for this study. The average employee welfare (EW) is2.857, with a standard deviation of3.067 exceeding the mean, suggesting considerable variation in employee welfare across different companies. The maximum value of13.000 indicates that some companies provide excess employee benefits, making it highly relevant to explore the impact of employee welfare on financial reporting information. Lastly, the results for control variables such as firm size (Size) and market-to-book ratio (MB) are consistent with previous research.

Table1: Descriptive Statistics for Main

Variables	N	Mean	St.Er	Min	Median	Max
FRQ	8271	-0.492	0.183	-0.917	-0.472	-0.111
EW	8271	2.857	3.067	-0.160	1.670	13.000
Size	8271	21.877	1.205	19.907	21.674	25.940
MB	8271	2.358	1.971	0.202	1.787	10.326
ROA	8271	0.043	0.055	-0.158	0.038	0.210
Big4	8271	0.052	0.221	0.000	0.000	1.000
LEV	8271	0.114	0.142	0.000	0.048	0.626
EO	8271	0.187	0.390	0.000	0.000	1.000
Indep	8271	0.374	0.054	0.333	0.333	0.571
Dual	8271	0.272	0.445	0.000	0.000	1.000
SOE	8271	0.341	0.474	0.000	0.000	1.000
Top1	8271	0.347	0.146	0.232	0.331	0.730
Firmage	8271	2.722	0.359	1.792	2.773	3.434
Admired	8271	0.017	0.129	0.000	0.000	1.000
RD	8271	4.308	4.366	0.030	3.390	25.940

4.2 Baseline Results

Table2 reports the regression results on the impact of employee welfare on financial reporting quality. Part (1) presents the clustered regression results at the company level without controlling

for year fixed effects. Part (2) controls for both industry and year fixed effects, again using clustered regression at the company level. Part (3) conducts a dual-cluster effect regression controlling for both industry and year effects. The coefficients for employee welfare (EW) in all three parts are significant at the5% level, with coefficients of0.002. This indicates that, all else being equal, the reputational effects of high employee welfare are significantly positive and positively influence financial reporting quality, supporting the previously proposed hypothesis H1.

Table2: Regression Results of Employee Welfare and Financial Reporting Quality

	(1)	(2)	(3)
Variables	FRQ	FRQ	FRQ
EW	0.002**	0.002**	0.002**
	(2.10)	(2.28)	(2.04)
Size	0.007**	0.007*	0.007**
	(2.15)	(1.80)	(2.19)
MB	-0.003**	-0.003*	-0.003
	(-2.12)	(-1.69)	(-1.26)
ROA	0.792***	0.797***	0.797***
	(17.31)	(17.15)	(13.88)
Big4	0.018	0.018	0.018*
	(1.34)	(1.34)	(1.66)
LEV	-0.017	-0.015	-0.015
	(-0.71)	(-0.65)	(-0.66)
EO	-0.012**	-0.012**	-0.012***
	(-2.44)	(-2.51)	(-2.72)
Indep	0.006	0.004	0.004
	(0.13)	(0.07)	(0.08)
Dual	0.002	0.002	0.002
	(0.35)	(0.35)	(0.41)
SOE	-0.016**	-0.015*	-0.015**
	(-2.04)	(-1.92)	(-2.08)
Top1	0.003	0.003	0.003
	(0.14)	(0.13)	(0.15)
Firmage	0.009	0.007	0.007
	(1.06)	(0.76)	(0.81)
Admired	0.012	0.013	0.013
	(0.44)	(0.45)	(0.47)
RD	0.010***	0.010***	0.010***
	(11.52)	(11.31)	(12.13)
Constant	-0.742***	-0.757***	-0.717***
	(-9.44)	(-8.69)	(-8.04)
Year	No	Yes	Yes
Ind.	Yes	Yes	Yes
Obs.	8271	8271	8271

Adj. R2	0.113	0.114	0.114

4.2 Analysis for Specific Dimensions of Employee Welfare

To analyze in more detail the impact of specific dimensions of employee welfare on financial reporting quality, this study classifies the five sub-projects into three categories based on Hexun's classification for further research. These categories are: Work Income (Income), which includes the sub-project of average employee income.

Work Safety (Safety), which encompasses the sub-projects of safety inspections and safety training; Work Care (Condolence), which includes the sub-projects of number of welfare visits and welfare funds. The score for each category is obtained by summing the scores of the included sub-projects, with clustered regression conducted at the company level.

Table3 reports the regression results. Both Work Income and Work Care have a significant positive impact on financial reporting quality at the10% level, while Work Safety does not have a significant effect on financial reporting quality. A possible explanation for this is that excessive focus on work safety may lead to employee annoyance. Consequently, management that is concerned with maintaining a positive reputation may not prioritize this dimension when considering employee welfare.

Table3: Impact of Specific Dimensions of Employee Welfare on Financial Reporting Quality

	(1)	(2)	(3)
Variables	FRQ	FRQ	FRQ
Income	0.005*		
	(1.79)		
Safety		0.002	
		(1.58)	
Condolence			0.004*
			(1.71)
Size	0.008**	0.008**	0.008**
	(2.04)	(2.04)	(2.03)
MB	-0.003	-0.003*	-0.003*
	(-1.61)	(-1.67)	(-1.65)
ROA	0.793***	0.804***	0.804***
	(16.93)	(17.39)	(17.43)
Big4	0.018	0.019	0.019
	(1.33)	(1.41)	(1.41)

LEV	-0.014	-0.016	-0.016
	(-0.60)	(-0.69)	(-0.69)
EO	-0.012**	-0.012**	-0.012**
	(-2.48)	(-2.48)	(-2.50)
Indep	0.004	0.004	0.004
	(0.09)	(0.09)	(0.08)
Dual	0.002	0.002	0.002
	(0.38)	(0.32)	(0.32)
SOE	-0.014*	-0.014*	-0.014*
	(-1.86)	(-1.83)	(-1.84)
Top1	0.002	0.002	0.002
	(0.11)	(0.11)	(0.11)
Firmage	0.008	0.007	0.007
	(0.82)	(0.78)	(0.79)
Admired	0.012	0.012	0.013
	(0.44)	(0.44)	(0.45)
RD	0.009***	0.010***	0.010***
	(11.15)	(11.42)	(11.41)
Constant	-0.735***	-0.733***	-0.733***
	(-7.71)	(-7.64)	(-7.65)
Year	Yes	Yes	Yes
Ind.	Yes	Yes	Yes
Obs.	8271	8271	8271
Adj. R2	0.114	0.113	0.113

4.3 Analysis for Specific Dimensions of Financial Reporting Quality

To further investigate how specific dimensions of financial reporting quality are influenced by employee welfare, this study analyzes the situation from two aspects: abnormal accruals and real activity manipulation. Table4 reports the analysis results. Parts (1) to (4) correspond to the four measurement methods mentioned in the variable definitions. After calculating the results for each method, the results are normalized and positively adjusted, meaning that the absolute values are scaled between0 and1, and multiplied by -1 so that larger results represent higher financial reporting quality. Additionally, since there is a substitution relationship between accrual earnings management and real earnings manipulation, the regression for abnormal accruals controls for the level of real activity manipulation, and vice versa. All four indicators are subjected to clustered regression at the company level.

The analysis shows that at the1% significance level, companies with higher employee welfare

exhibit lower levels of real activity manipulation; however, the impact of employee welfare on abnormal accruals is not significant. This differs from previous research findings (Ben-Nasr and Ghouma,2018). The reason may lie in the fact that, for accrual activity manipulation, employees may find it difficult to discern, and even if they do notice it, they may struggle to identify which accounting standards or laws management has violated. Therefore, management engaging in accrual activity manipulation does not need to enhance employee welfare to make employees "complicit."

On the other hand, real activity manipulation deviates from optimal business decisions and may negatively impact the company's future cash flows, which is detrimental to the long-term development of the company and undermines the fundamental interests of employees. As a result, employees are more likely to supervise and expose such behaviors rather than assist in concealing them. Thus, the bundling effect of employee welfare is weakened in the context of real activity manipulation, reflecting more of a reputational building effect. Considering the above discussion, the insignificant results in parts (1) and (2) are likely due to the interplay of two competing theories, warranting further research.

Table4: Impact of Employee Welfare on Specific Dimensions of Financial Reporting Quality

	(1)	(2)	(3)	(4)
Variables	KLWSCORE	DDSCORE	RM1SCORE	RM2SCORE
EW	-0.001	-0.001	0.005***	0.005***
	(-0.94)	(-0.53)	(3.06)	(3.53)
RM1SCORE	0.033*	-0.001		
	(1.81)	(-0.04)		
RM2SCORE	-0.001	-0.033*		
	(-0.03)	(-1.68)		
KLWSCORE			0.031***	0.022*
			(2.73)	(1.80)
DDSCORE			-0.023*	-0.032**
			(-1.86)	(-2.46)
Size	0.017***	0.001	0.007	0.001
	(3.05)	(0.20)	(1.06)	(0.21)
MB	-0.005*	-0.024***	0.011***	0.004
	(-1.82)	(-7.80)	(3.21)	(1.35)
ROA	-0.290***	-0.131	1.754***	1.885***
	(-3.62)	(-1.29)	(20.25)	(24.21)
Big4	0.007	-0.014	0.005	0.076***
	(0.36)	(-0.64)	(0.21)	(3.08)
LEV	0.005	-0.059	-0.068	0.056
	(0.13)	(-1.40)	(-1.62)	(1.37)

EO	-0.005	0.000	-0.024***	-0.021***
	(-0.59)	(0.05)	(-3.11)	(-2.61)
Indep	-0.125*	0.081	0.070	0.005
	(-1.73)	(1.03)	(0.77)	(0.06)
Dual	0.000	0.003	0.006	0.000
	(0.01)	(0.27)	(0.54)	(0.04)
SOE	0.007	-0.002	-0.032**	-0.034***
	(0.70)	(-0.15)	(-2.21)	(-2.62)
Top1	-0.033	0.017	-0.007	0.036
	(-1.12)	(0.51)	(-0.19)	(1.00)
Firmage	-0.016	-0.008	0.037**	0.017
	(-1.28)	(-0.58)	(2.11)	(1.07)
Admired	0.050*	-0.010	0.034	-0.018
	(1.74)	(-0.26)	(0.66)	(-0.36)
RD	0.003***	0.004***	0.017***	0.014***
	(2.58)	(3.35)	(10.09)	(9.68)
Constant	-0.714***	-0.274	-1.023***	-0.839***
	(-5.51)	(-1.64)	(-5.40)	(-4.11)
Year	Yes	Yes	Yes	Yes
Ind.	Yes	Yes	Yes	Yes
Obs.	8271	8271	8271	8271
Adj. R2	0.021	0.048	0.188	0.179

5.Conclusion

This study empirically examines how employee welfare affects financial reporting quality. Using observational data from A-share listed companies in Shanghai and Shenzhen from2010 to2016, the research finds that employee welfare generally has a positive impact on financial reporting quality; however, the impact of job security items is not significant. Mechanistically, employee welfare primarily suppresses real earnings management behaviors within firms, while it does not have a significant suppressive effect on accrual earnings management. Furthermore, the study shows that investment in employee stock ownership plans and the shareholding ratio of the largest shareholder play important moderating roles in the relationship between employee welfare and financial reporting quality. Specifically, in companies that excessively invest in employee stock ownership plans and in publicly listed companies with a high shareholding ratio of the largest shareholder, the positive impact of employee welfare on financial reporting quality is weakened, reflecting that some employee welfare measures still have a strong interest-binding effect. Finally, the conclusions of this study remain robust even after controlling for endogeneity issues and substituting the measurement methods for explanatory and dependent variables.

The conclusions of this study have certain implications. First, high employee welfare is generally a good signal; the government can provide policy support to companies that actively assume social responsibilities and offer higher employee welfare. On the other hand, investors and auditors should be aware of the risks hidden behind excessively high or inappropriate employee welfare measures. Specifically, they can comprehensively evaluate the governance situation of target companies by combining indicators such as ownership concentration and the scale of funds in employee stock ownership plans, remaining vigilant against potential fraud scandals.

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