Strategic Interactions in Financial Reporting Quality

Haofei Zhang, and Yun Ma[1]

November 08, 2025

Keywords: Strategic Interaction, Financial Reporting Quality, Peer Effect, Sensitive Environment

JEL Classification Code: M41, G30, G32

1Haofei Zhang is from Ningbo University of Technology. Address: No. 201, Fenghua Road, Jiangbei District, Ningbo, Zhejiang, 315211. Email: haofei.zhang@nbut.edu.cn.
Yun Ma (corresponding author) is from College of Business and Public Management, Wenzhou-Kean University. Address: 88 Daxue Rd, Ouhai, Wenzhou, Zhejiang Province, China 325060. Email address: yunma@wku.edu.cn.

Strategic Interactions in Financial Reporting Quality

November 08, 2025

Abstract

This study examines how firms strategically interact with their peers to influence financial reporting quality (FRQ) in contexts of heightened scrutiny. Using an instrumental variable based on peer firms' residual short interest, we show that a firm's FRQ is significantly affected by peer behavior. We document an "industry spotlight effect," in which firms improve and align their FRQ when their industry faces pressure, such as during M&A deal withdrawals or peer financial distress. The evidence highlights the strategic nature of reporting adjustments and reveals how peer dynamics amplify transparency responses under high-attention environments.

Keywords: Strategic Interaction, Financial Reporting Quality, Peer Effect, Sensitive Environment

1. Introduction

Peer pressure in financial reporting decisions is widely alleged in practice. A notable example occurred in the telecom industry during the early 2000s. As documented by Horowitz (2009), once WorldCom began engaging in illegal reporting practices to boost its performance, competitors faced enormous pressure to do the same. They had to either (a) commit accounting fraud to keep pace with telecom's growth rate, or (b) be viewed as underperformers, with severe consequences. Qwest and Global Crossing ultimately chose accounting fraud, while AT&T and Sprint took actions to boost their short-term performance at the expense of long-term firm value. Gao and Zhang (2019) demonstrate that managers are more likely to manipulate financial reports if they believe their peers' reports are also likely to be manipulated. Einhorn et al. (2018) develop a theoretical model that demonstrates how managers can influence stockholders' beliefs about the value of their firm, not only by managing their own earnings reports but also by influencing rival firms' earnings reports. Together, these insights imply that firms operate in interdependent information environments, where one firm's reporting choice shifts the scrutiny, expectations, and monitoring intensity faced by others.

Despite substantial anecdotal evidence and a growing body of theoretical research emphasizing the importance of peer effects on financial reporting quality (FRQ), quantifying FRQ empirically remains challenging due to reflection and identification concerns. Related studies document strategic disclosure interdependence (e.g., Gao & Zhang, 2019; Seo, 2021) and contextual amplification in disclosure timing and content (Matsumoto et al., 2022; Truong, 2023). We build on this literature by examining peer effects specifically in FRQ and by studying when industry events intensify these interdependencies. Using residual short interest (ResSI) as a peer-level instrument, while acknowledging that both ResSI and equity shocks can embed mixtures of public and private information, we estimate how a firm strategically responds to its peers' FRQ.1 We also examine how firms react to peer information under two types of sensitive environments.

1. "Following the quality of financial reports" refers to the tendency of firms to align their financial reporting practices with those of their industry peers. This alignment can occur as firms seek to maintain credibility, enhance comparability, or respond to competitive and regulatory pressures. High-quality financial reporting is characterized by transparency, accuracy, and adherence to accounting standards, while lower-quality reporting may involve earnings management or strategic distortions.

First, we examine peer effects on financial reporting quality (FRQ) when an industry peer withdraws from a merger or acquisition (M&A) event, either as the acquirer or the target. Prior studies show that target firms' FRQ significantly influences the outcomes of M&A deals. Target firms with higher FRQ command better valuations and foster more efficient capital allocation (Chen et al., 2018; McNichols & Stubben, 2015), while those with lower FRQ are more likely to see deals terminated (Skaife & Wangerin, 2013). We define the industry spotlight effect as a theoretical mechanism in which salient industry events increase collective attention and informational interdependence among firms, thereby strengthening peer alignment in FRQ. When the industry-level information environment becomes sensitive, as proxied by M&A deal withdrawals, firms may seek to align their reporting quality with peers' to mitigate perceived risk and avoid future failures. When a target withdraws from an M&A deal, other firms in the same industry may become concerned about the underlying reasons for the withdrawal and take steps to avoid similar issues. In such cases, firms become more attuned to peer performance and aim to maintain relative reporting comparability. It is important to note, however, that not every M&A withdrawal conveys industry-wide information. Many withdrawals are deal-specific and stem from regulatory objections, financing shortfalls, or governance conflicts between the transacting firms. Our empirical measure, therefore, captures the average industry response to withdrawals that are salient enough to attract broad investor and media attention, particularly large transactions or those involving prominent targets, rather than assuming that every withdrawal produces an industry-level shock.

Second, we explore how firms respond to peer FRQ when facing financial constraints, as quantified by the firm's Whited–Wu index (Whited & Wu, 2006). While the incentives to improve financial reporting quality are clear in M&A contexts, they are less straightforward when firms are financially constrained. On the one hand, the same spotlight effect described above suggests that financially constrained firms may align their FRQ with those of industry peers to reduce uncertainty and negotiate better terms for new credit or external investment (Akins, 2018). On the other hand, Kurt (2018) finds that managers may artificially enhance external perceptions of firm performance by employing upward earnings management when the firm faces financing pressure.

While financial constraints are primarily firm-specific, episodes of severe distress can also generate broader repercussions. Defaults or near-defaults within a sector often raise concerns that

other firms may share similar structural or accounting weaknesses, drawing additional investor and regulatory scrutiny to the entire industry. We therefore recognize that financial distress can occasionally act as an industry-level shock rather than a purely idiosyncratic one. In our empirical design, we capture both possibilities by examining whether peer-effect strength increases when distress becomes widespread within an industry. This refinement allows us to distinguish between firm-specific constraints and sector-level contagion effects while maintaining comparability with the M&A-withdrawal setting. Consistent with this framing, our research design orthogonalizes peer constructs to market- and industry-wide components, focusing on plausibly exogenous peer variation.

While conceptually appealing, empirically identifying peer effects is challenging due to the reflection problem (Manski, 1993). By using measures of peer firm financial reporting quality, such as industry average FRQ, or peer firm FRQ determinants as explanatory variables for individual firms' FRQ, any observed correlation between firms' FRQ and the actions or characteristics of their peers can be attributed to the endogenous formation of peer groups or omitted common factors. This complicates inference, as firms within the same peer group often share similar institutional environments and firm characteristics. As a result, a peer firm may act as a proxy for latent common factors that influence both its own FRQ and the focal firm's FRQ. The correlation between firms' FRQ and the policies or characteristics of their peers, therefore, inherently reflects endogeneity bias.

This challenge can be overcome by showing that, controlling for characteristics of their own firm, firms' behaviors are significantly correlated with exogenous characteristics of their peers. We use peer firms' residual short interest (ResSI)—that is, idiosyncratic private negative information shocks—as a possible source of exogenous variation in peer firm attributes. The motivation for this approach stems from existing research, such as Bao et al. (2019), who use residual short interest as a measure of managerial private negative information and demonstrate that managerial private information influences a firm's decision to disclose information. Importantly, we orthogonalize ResSI to both industry and market returns to mitigate the influence of public signals, recognizing that short interest can also partially respond to perceived opacity or prior reporting behavior. Indeed, idiosyncratic private negative information shocks have several desirable properties. First, shocks to different firms within a peer group are largely uncorrelated, as they capture each firm's private

information. Second, the shocks are serially uncorrelated and cross-sectionally uncorrelated, implying that firms' shocks do not forecast future shocks for themselves or for other firms. Finally, the shocks are uncorrelated with firm characteristics typically used to explain variation in FRQ. While these features do not guarantee full exogeneity, our design strengthens credibility by combining this orthogonalization with firm fixed effects and overidentification tests of instrument validity, reported in Section 3.

A remaining concern is that firms' underlying business strategies may jointly influence both financial reporting practices and M&A behavior. Firms pursuing aggressive growth or innovation-oriented strategies may face different reporting incentives and deal risks than those following efficiency or cost-leadership strategies (Bentley et al., 2013; Hossain, 2021). To mitigate this potential confounding effect, our empirical design includes firm fixed effects and controls for observable firm characteristics, such as size, leverage, and market-to-book ratio, that capture much of the cross-sectional variation in strategic orientation. Moreover, by employing residual short interest as an instrumental variable, we isolate variation in peer behavior that is orthogonal to firms' strategic positioning. In robustness analyses, we further verify that our findings remain unchanged when controlling for strategic style proxies (e.g., R&D intensity, asset turnover), suggesting that shared strategic preferences do not solely drive the documented peer effects.

Another potential omitted factor is firms' embeddedness in local trust networks—commonly proxied by social capital. Prior studies show that higher levels of social capital, often measured at the county or regional level, are associated with greater trust, lower opportunism, and higher financial reporting quality (Jha & Chen, 2015; Gupta et al., 2018; Jha, 2019). Social capital may therefore generate correlated reporting outcomes across firms within the same geographic or professional network, even in the absence of direct peer influence. To mitigate this concern, we include firm- and industry-fixed effects, as well as controls for analyst coverage, institutional ownership, and firm size, which together absorb much of the variation associated with local information environments and social connectedness. While we do not explicitly measure cross-firm social capital, our robustness tests indicate that the estimated peer effects persist after accounting for these factors, suggesting that our results reflect strategic peer alignment rather than a social-capital externality.

Our empirical results show that firms' FRQ is significantly influenced by their peers. FRQ is positively related to peer firms' private negative information shocks, consistent with higher short-interest-implied bad news being associated with lower reporting quality, as measured by our |discretionary accruals| proxy. Furthermore, these inferences are robust to a host of measurement and endogeneity concerns. Importantly, the estimated effects remain consistent across alternative specifications that include industry, firm, and year fixed effects, and they remain unchanged with the inclusion of peer-level controls for industry sentiment and equity market shocks.

To address the second identification challenge —the channel through which peer effects operate —we demonstrate that, conditional on peer firms' FRQ policies, a firm's FRQ is largely insensitive to peer firms' idiosyncratic private negative information. In other words, firms' FRQ respond to peer firms' private information shocks only when corresponding changes in peer FRQ behavior accompany those shocks. Furthermore, peer firm characteristics other than their private negative information shocks are largely irrelevant for FRQ policy, both statistically and economically. This pattern suggests that the primary mechanism of influence is behavioral rather than informational: firms adjust their reporting quality in response to their peers' observed actions, not merely to unobserved signals about their peers' fundamentals.

We make several contributions. First, we provide a clear and implementable identification strategy to quantify peer effects on financial reporting quality, offering empirical support for prior theoretical models. Gao and Zhang (2019) show that managers tend to manipulate more when they believe peers' reports are also manipulated, while Einhorn et al. (2018) demonstrate that managers can shape investors' beliefs not only by managing their own earnings but also by influencing those of rival firms. By translating these theoretical predictions into an empirical framework that addresses the reflection problem, our study bridges a critical gap between theory and evidence. Second, we extend existing research on peer effects in corporate behavior by examining how information-sensitive environments amplify strategic interdependence in reporting choices. While prior studies document peer effects across financing, payout, and disclosure policies on average (Leary & Roberts, 2014; Kaustia & Rantala, 2015; Ahern & Harford, 2014; Shue, 2013; Lerner & Malmendier, 2013; Parsons et al., 2018; Grennan, 2019; Seo, 2021), we focus on FRQ as a more regulated and consequential domain of peer coordination and demonstrate that peer alignment

intensifies during high-scrutiny settings, such as M&A withdrawals and financial distress. Third, by employing peer firms' residual short interest (ResSI) as an instrumental variable, we address endogeneity concerns that have historically limited causal inference in studies of financial reporting interdependence. We complement this design with diagnostic tests, including first-stage F-statistics and overidentification tests, to assess the instrument's strength and validity. Finally, our findings carry meaningful implications for regulators, investors, and corporate managers. For regulators, the results highlight that transparency improvements observed during "spotlight" periods may reflect strategic conformity rather than permanent transparency gains, warranting context-specific oversight. For investors, the results indicate that temporary increases in FRQ alignment can mask underlying heterogeneity in firm fundamentals. For managers, our evidence suggests that aligning with peers under high scrutiny may enhance perceived legitimacy but also increase the risk of herd-driven reporting behavior. Taken together, these insights refine our understanding of how competitive and informational pressures jointly shape financial transparency and corporate accountability.

The rest of the paper is structured as follows: Section 2 reviews the relevant literature and develops our hypotheses; Section 3 describes the data and methodology used in our empirical analysis; Section 4 presents the main results on peer effects in financial reporting quality; Section 5 presents robustness checks; Section 6 concludes with a discussion of the implications for regulators, investors, and corporate managers.

2. Literature Review and Hypotheses

2.1. Literature

Financial reporting quality (FRQ) differs conceptually from disclosure behavior and earnings management, though the three are closely related. FRQ reflects the faithful representation and comparability of reported outcomes; disclosure behavior concerns the timing and scope of voluntary information release; and earnings management captures the use of accounting discretion within accepted boundaries. Peer effects can operate across these dimensions, but their mechanisms differ. Prior research documents peer contagion in voluntary disclosure (Shue, 2013; Seo, 2021; Truong,

2023), compensation and governance choices (Grennan, 2019), and financing or investment policies (Leary & Roberts, 2014; Kaustia & Rantala, 2015). Our study extends this line of inquiry by focusing specifically on FRQ, the quality rather than the quantity or timing of information, and by analyzing how inter-firm interactions evolve under information-sensitive conditions

Studies show a strong relationship between firms' financial reporting quality and the outcome of M&A deals. Deals with targets that have low-quality financial reporting are more likely to be terminated, presumably due to breaches of Generally Accepted Accounting Principles (GAAP) (Skaife & Wangerin, 2013). Similarly, better accounting quality increases the likelihood that an M&A deal will be completed and accelerates its resolution (Marquardt & Zur, 2015). Additionally, Skaife and Wangerin (2013) show that targets involved in failed deals are more likely to restate their financial statements soon after termination. Acquirers make more profitable acquisition decisions when target financial statements are comparable, even after controlling for accrual quality (Chen et al., 2018). More generally, McNichols and Stubben (2015) find that higher-quality target information increases acquirer announcement returns, consistent with the notion that accurate accounting information improves valuation precision. A related study finds that bidders share information risk with target shareholders by paying for poor-quality targets with equity rather than cash (Raman et al., 2013). The breakdown of a high-profile M&A deal may cast a temporary "spotlight" on other firms in the same industry, inviting broader investor and regulatory scrutiny, though smaller or idiosyncratic withdrawals may not. Using a natural experiment that exploits exogenous reductions in analyst coverage from brokerage-house mergers, Irani and Oesch (2013) show that lower coverage deteriorates FRQ, particularly for firms with weak shareholder rights. These studies collectively imply that salient industry events heighten implicit monitoring and can amplify cross-firm conformity in financial reporting practices.

These results suggest that M&A transactions involving targets with poor accounting quality are more costly, inefficient, and risky than transactions involving high-quality, comparable targets. Thus, acquirers are likely to favor targets with higher and more comparable FRQ. Consequently, if firms aspire to become viable acquisition candidates, they have incentives both to improve FRQ and to match peers' reporting quality—particularly after a deal termination within their industry. We extend this logic by arguing that M&A withdrawals act as focal events that update managerial beliefs

about acceptable reporting behavior, thereby reinforcing peer alignment. Our empirical analysis tests whether such events trigger measurable convergence in FRQ among industry peers.

Beyond M&A settings, financial constraints can also shape peer interdependence. Greater financial constraints have been shown to induce upward earnings management when raising equity (Kurt, 2018), whereas stronger analyst coverage reduces managerial discretion (Lin & Wang, 2023). We build on this work by examining whether constrained firms exhibit stronger sensitivity to peer FRQ as they seek to signal creditworthiness and reduce financing uncertainty. When distress becomes pervasive — e.g., multiple firms within an industry approaching covenant violations — the ensuing scrutiny can mimic a sector-wide spotlight akin to that created by M&A withdrawals. FRQ also influences firms' perceived risk profiles among outside investors. Poor FRQ can increase arbitrage risk by elevating uncertainty and holding costs (Bushee et al., 2019), while deteriorating earnings quality raises idiosyncratic volatility via forecast dispersion (Rajgopal & Venkatachalam, 2011). Conversely, higher FRQ reduces disagreement among credit rating agencies (Akins, 2018) and improves investment efficiency (Alhadi et al., 2021). These findings underscore that FRQ improvements serve not only valuation accuracy but also reputation and capital-access objectives—both of which are shaped by peer benchmarking.

Thus, improving financial reporting quality and comparability can also attract investors even when a full acquisition is not feasible or desirable. This provides an additional incentive to enhance FRQ, particularly when firms seek external financing or credibility in capital markets. The same mechanism can be observed through peer effects during sensitive periods. Seo (2021) provides evidence of peer influence in voluntary disclosure decisions, showing that firms respond to peer management forecasts. Our study extends this literature by focusing on FRQ, a more foundational and regulated dimension of financial communication that underpins overall disclosure credibility. Recent studies, such as Matsumoto et al. (2022) and Truong (2023), further demonstrate that peer effects manifest across multiple facets of corporate transparency, including geographic proximity and disclosure timing. While our analysis centers on industry-level FRQ alignment, these studies collectively highlight that peer-driven strategic behavior is a pervasive force shaping firms' information environments.

2.2. Hypotheses

Building on prior theoretical frameworks, we conceptualize peer influences in FRQ as emerging from three interrelated mechanisms: competitive signaling, market discipline, and reputational learning. Competitive signaling suggests that managers benchmark their reporting practices against those of peers to maintain perceived performance parity in competitive industries. Market discipline implies that investors and analysts evaluate firms relative to peer norms, rewarding those that align with industry transparency standards and penalizing outliers. Reputational learning occurs when firms observe the consequences of peers' reporting failures or scrutiny events and proactively adjust their own FRQ to mitigate similar risks. Together, these mechanisms link peer FRQ, managerial incentives, and information asymmetry, establishing an economic rationale for strategic interaction in financial reporting.

Under this framework, the "spotlight effect" operates as a reinforcing mechanism through heightened external attention. When salient industry events, such as M&A withdrawals or widespread financial distress, draw investor, media, or regulatory focus, the resulting scrutiny increases the cost of deviation from peer norms. Managers respond strategically by aligning their FRQs with those of their peers to reduce perceived risk and information asymmetry. This theoretical delineation clarifies that the spotlight effect primarily operates through investor and regulatory monitoring channels rather than purely through statistical correlation.

H1 (Peer Interdependence Hypothesis). Peers' reporting behavior systematically influences firms' financial reporting quality through competitive signaling, market discipline, and reputational learning.

H2 (Spotlight Amplification Hypothesis). The strength of peer interdependence in FRQ increases when industry-wide scrutiny intensifies, such as following M&A deal withdrawals or periods of financial distress, because heightened monitoring amplifies managerial incentives to conform to peer reporting standards.

3. Data and Variable Construction

In this section, we describe our data sources, outline the construction of our main variables,

and present our main empirical models. Our sample includes publicly listed American firms for the period 1973-2019. This sample window is intentionally selected for three reasons. First, it ensures consistent availability and quality of short interest data and financial reporting variables across all firms in the peer group, especially for constructing the residual short interest instrument following Bao et al. (2019). Second, the post-2019 period coincides with significant changes in disclosure regulations (e.g., Regulation S-K modernization, COVID-related disclosure interventions), which may confound our analysis of baseline peer effects and introduce time-varying noise. Third, we ensure that firms have at least a full year of lagged variables and lookahead windows (e.g., future restatements or FRQ outcomes), which would not be feasible for recent years.

Financial reporting data are from Compustat, and price and return data are from CRSP. We winsorize all our data at the $1st$ and $99th$ percentiles to mitigate the influence of extreme observations. To account for structural shifts in accounting regimes, we include decade fixed effects and indicator variables for key institutional transitions, including the Sarbanes–Oxley Act of 2002 and PCAOB oversight. Results remain robust when excluding pre-1990 observations or restricting the sample to post-SOX years. Our main independent variable is the firm's residual short interest (ResSI), calculated using Equation (1):

$$SI_{i,t} = \alpha + \beta_1 IO_{i,t} + \beta_2 CONVERT_{i,t} + \beta_3 TREND_t + \varepsilon_{i,t} \quad (1)$$

where *i* and *t* represent firm and quarter, respectively. *SI* is the short-interest ratio (raw short interest divided by total shares outstanding, from CRSP). *IO* is institutional ownership, capturing the supply of lendable shares; *CONVERT* is an indicator for convertible-bond hedging activity; and *TREND* controls for market-wide institutional factors. The regression uses 567,081 firm-quarter observations. Residual short interest (ResSI) is the estimated residuals from the regression. We report first-stage F-statistics exceeding 20 across all specifications, alleviating concerns about weak instruments. Hansen J-tests indicate that ResSI is uncorrelated with the structural error term, supporting the exclusion restriction. Instrument exogeneity is further reinforced by controlling for peer fundamentals, institutional ownership, and market-wide sentiment.

The main dependent variable is firm-quarterly FRQ, computed using the Jones Model with Ball's revision (Jones, 1991; Ball & Shivakumar, 2006). Higher values of our FRQ proxy—absolute discretionary accruals—indicate lower reporting quality. This specification adds controls for cash

flow, an indicator of negative cash flow, and their interaction. Following Dechow et al. (1995), we use the absolute value of discretionary accruals from the modified Jones model as our primary proxy for FRQ. To ensure robustness, we re-estimate all key tests using alternative measures, including accruals quality (Francis et al., 2005), accrual persistence, and earnings smoothness, and find qualitatively similar results.

Industries are defined by 1-, 2-, and 3-digit SIC codes (SIC1, SIC2, SIC3) and by the Fama–French 12-industry classifications. Our main regression model is specified in Equation (2):

$$FRQ_{i,t+1} = \alpha + \beta_1 ResSI_{i,t} + \beta_2 Controls_{i,t} + \nu_i + \gamma_t + \varepsilon_{i,t} \quad (2)$$

We examine how firm FRQ responds to residual short interest, with t + 1 timing to mitigate reverse-causality concerns. Control variables include firm size, book-to-market ratio, return on assets, and institutional ownership. We also control for quarter and firm fixed effects.

In addition to this baseline regression, we further examine how firm FRQ is influenced by its peers and how a sensitive environment moderates this effect:

$$FRQ_{i,t+1} = \alpha + \beta_1 ResSI_{i,t} + \beta_2 Event_{i,t} + \beta_3 ResSI_{i,t} + \beta_3 ResSI_{i,t} * Event_{i,t} + \beta_4 Controls_{i,t} + \nu_i + \gamma_t + \varepsilon_{i,t} \quad (3)$$

We classify an industry-quarter as "sensitive" if at least one M&A withdrawal occurs within the top quartile of deal value or is covered by major financial media (Factiva). This approach distinguishes economically significant withdrawals from routine terminations. We examine withdrawals by acquirers, by targets, and by either party, excluding event firms themselves.

We also consider whether a firm's WW-index affects its response to peer FRQ. The WW index quantifies financial constraints as:

$$WW = 0.625 - 0.091CF - 0.062DIVPOS + 0.021TLTD - 0.044LNTA + 0.102ISG - 0.035SG \quad (4)$$

where $TLTD$ is the ratio of the long-term debt to total assets; $DIVPOS$ is an indicator that takes the value of one if the firm pays cash dividends; SG is firm sales growth; $LNTA$ is the natural log of total assets; ISG is the firm's three-digit industry sales growth measured by percentage change in sales; and CF is the ratio of cash flow to total assets $\frac{IB + DP}{AT}$. Note that the WW-index calculated here is negative; we add the constant 0.652 from Whited and Wu (2006) to make it positive. We also set the missing values for IB and DP to 0 and find that the results qualitatively remain the same. Additionally, as several firms report missing sales in some quarters, which is necessary for generating the WW-

index, we also fill in missing values with 0s.[2]

This analysis aims to complement our studies of failed mergers and acquisitions (M&A) deals by focusing on the sensitive environment surrounding the firm itself. We examine how a firm's WW-index affects its FRQ and its cross-effects. Here, the sensitive environment is defined by a high WW-index, that is, when the firm faces financial constraints.

We also aim to quantify the strategic interaction in peers' financial report quality. We use the average peer short interest residual as the instrumental variable for the average peer FRQ, and then examine how its peers' average FRQ influences a firm's FRQ. We estimate the following regression:

$$FRQ_{i,t} = \alpha + \beta_1 \overline{FRQ_{-i,t}} + \beta_2 Controls_{i,t} + \nu_i + \gamma_t + \varepsilon_{i,t} \quad (5)$$

Although short interest and equity issuance reflect investor sentiment and managerial expectations, our identification strategy mitigates endogeneity in two ways. First, we use residual short interest and residual equity issuance shocks (EQS), orthogonalized to firm and market fundamentals as in Bao et al. (2019). These residuals capture variation not explained by contemporaneous performance, valuation, or liquidity. Second, we instrument peer FRQ using peer-level averages of these residuals, which vary across industries and over time but remain plausibly exogenous to any single firm's reporting decisions. This design reduces correlated-shock bias and limits simultaneity between a firm's FRQ and its peers'.

Together, these design choices attenuate—but do not entirely eliminate—the possibility of contemporaneous reflection, which we further address in Section 5 through robustness tests using lagged peer variables and alternative specifications.

4. Results

4.1. Descriptive Statistics

Table 1 reports summary statistics for the main variables used in our empirical analysis. We present results across different industry classifications to ensure the robustness of our peer construction. Our main dependent variable, Financial Reporting Quality (FRQ), is proxied by the absolute value of discretionary accruals, estimated using a modified Jones model by industry-year,

[2] Table with and without the zero imputation are provided in the online appendix

with higher values indicating lower reporting quality. For example, under the Fama-French 12 industry classification, the mean FRQ is 0.098, with a 90th percentile of 0.112, suggesting meaningful variation across firms.

Our key instrumental variable, Residual Short Interest (ResSI), captures deviations from expected short interest adjusted for firm-level fundamentals. The ResSI variable is effectively centered around zero across all classification methods. For instance, under the Fama-French 12 scheme, the mean ResSI is approximately zero with a standard deviation of 0.044. These properties indicate a well-balanced and symmetric distribution, supporting its use for instrumentation. We also construct peer-level ResSI measures to capture strategic peer effects, which exhibit similar dispersion and symmetry.

In addition to short interest proxies, we incorporate Equity Shock (EQS) variables that measure quarterly unexpected returns by industry. These variables display substantial cross-sectional variation, with mean values close to zero. All EQS values are winsorized at the 1st and 99th percentiles to mitigate the influence of extreme observations. Peer EQS variables exhibit tighter distributions due to their averaging structure. For example, peer EQS based on the SIC3 classification has a mean of -0.001 and a standard deviation of 0.018.

Finally, we look into financial constraints and distress conditions using the Whited-Wu Index (WW) and a distress dummy (DD). The WW index has a mean of -0.105 with a standard deviation of 0.567, indicating heterogeneity in firms' access to external finance. The DD measure, derived from the distance-to-default approach, has a mean of 5.616 and ranges from 0.519 at the 10th percentile to 11.213 at the 90th percentile.

We also include several standard firm-level controls commonly used in the literature. Firm size, measured as the log of total assets, has a mean of 6.110. The book-to-market ratio is highly skewed, consistent with the presence of value-oriented firms. Lastly, institutional ownership has a mean of 0.563 and a wide dispersion (standard deviation = 11.20), reflecting variation in reporting obligations and investor base across firms. Collectively, these summary statistics provide preliminary support for our hypothesized relationships. Firms with higher residual short interest tend to exhibit lower financial reporting quality, consistent with the notion that ResSI captures undisclosed negative information. Variation across peer ResSI, WW-index, and M&A-withdrawal

indicators suggests substantial heterogeneity in both information environments and sensitivity to external scrutiny, reinforcing the empirical motivation for our peer-effect tests.

[Insert Table 1]

4.2. Effect of residual short interest on firm financial reporting quality

We begin by validating our choice of residual short interest as an indicator of financial reporting quality by examining its correlation with the outcome. We also consider the cross-effects of residual short interest with M&A withdrawals and the WW-index, which will be re-evaluated using residual short interest as an instrument.

4.2.1. Validation Tests for Residual Short Interest

We regress firm future monthly abnormal returns on residual short interest (ResSI), controlling for firm and quarter fixed effects, and find a significant negative effect across all analyzed time frames. Results are outlined in Table 2.

We observe that the relationship between residual short interest and abnormal returns is negative and significant, indicating that residual short interest contains valuable information about a firm's future performance. Specifically, we find that higher residual short interest is associated with lower future abnormal returns, supporting the argument that ResSI captures managerial private negative information that is not immediately incorporated into stock prices. These findings align with Bao et al. (2019), who suggest that undisclosed negative information held by managers gradually affects stock prices. Since short interest represents market participants' expectations about a firm's future prospects, our results imply that firms with higher ResSI are more likely to experience deteriorating financial performance.

This result serves as the basis for our use of residual short interest as an instrumental variable for overall financial disclosure quality (FRQ). The strong predictive relationship between ResSI and future returns strengthens our confidence that ResSI effectively captures unobserved private information, making it a suitable proxy for evaluating strategic interactions in financial reporting quality.

[Insert Table 2]

4.2.2. Base result

Table 3 reports the effect of residual short interest (ResSI) on firm financial reporting quality (FRQ). Results show a significant positive relationship between residual short interest and FRQ, consistent across industry classifications.

From this baseline model, we observe that firm residual short interest, a measure of managerial private negative information, positively contributes to our FRQ measure. This supports our hypothesis that higher levels of undisclosed negative information are associated with lower financial reporting quality. It is important to note that our FRQ metric is measured by the absolute value of the residual, meaning that larger values indicate worse financial reporting quality. Thus, a negative relationship between ResSI and FRQ would suggest that firms with lower levels of private negative information tend to have higher reporting quality. Our results confirm this intuition, indicating that higher FRQ is associated with lower levels of managerial private bad news.

These findings are consistent with our previous validation tests and further solidify our decision to use residual short interest as an instrumental variable for FRQ. The robustness of this relationship across various industry classifications strengthens the reliability of our identification strategy, providing a strong foundation for subsequent analyses of peer effects in financial reporting quality.

[Insert Table 3]

4.2.3. Cross Effects of M&A Withdrawals and Financial Constraints on Financial Reporting Quality

Table 4 presents the results of how firm financial reporting quality (FRQ) is affected by residual short interest (ResSI) and how sensitive environments, such as mergers and acquisitions (M&A), withdrawals, and financial constraints, influence this effect. We define a sensitive environment in two ways: (1) based on whether at least one firm in the industry withdrew from an M&A event in a given quarter, and (2) based on a firm's level of financial distress, measured by the Whited and Wu (WW) index.

To examine the effects of M&A withdrawals, we analyze two scenarios: the acquirer's withdrawal and the target's withdrawal. Panels A and B of Table 4 present the results. Our results indicate that an M&A withdrawal has a negative impact on a firm's FRQ, suggesting that firms in industries experiencing withdrawn deals face heightened uncertainty and scrutiny. When examining

the interaction between the predicted peer FRQ and the withdrawn event, the cross-effect is positive and significant, which is consistent with our base result. However, this positive effect is primarily driven by cases where the withdrawn firm was the target, rather than the acquirer. Additionally, we find that the cross-effect of ResSI and an M&A withdrawal event is significantly negative across all industry classifications, including the Fama-French 12, SIC 1, SIC 2, and SIC 3. This implies that when an industry faces an M&A withdrawal, the effect of managerial private negative information on FRQ is weakened. The likely explanation for this finding is that a sensitive environment encourages managers to disclose more information, thereby mitigating investor uncertainty.

An M&A withdrawal draws attention to other firms in the industry, intensifying scrutiny from both investors and potential acquirers. When negative industry-level information emerges, investors become more cautious, prompting managers to adopt higher financial reporting transparency to maintain market confidence. This aligns with the findings of Skaife and Wangerin (2013), who show that M&A deals involving targets with low-quality financial reporting are more likely to be terminated. In such cases, the heightened attention reduces information asymmetry, weakening the influence of ResSI on FRQ.

As an alternative measure of a sensitive environment, we also examine financial distress using the WW index. By interacting the WW-index with ResSI, we assess how financial constraints impact the relationship between managerial private negative information and financial reporting quality. The WW-index is defined as in Equation 4.

The results from Panel C of Table 4 indicate that financial distress significantly influences FRQ behavior. Specifically, the cross-effect of ResSI and the WW-index is negative and statistically significant, indicating that ResSI's effect on FRQ becomes weaker as firms become more financially constrained. This result is consistent with our previous findings regarding M&A withdrawals, reinforcing the idea that firms in sensitive environments face stronger incentives to enhance financial transparency. However, in this case, it is not an external M&A event, but rather financial distress, that increases scrutiny of a firm’s financial reporting. When a firm is financially constrained, investors exercise greater caution, prompting managers to be more conservative in financial disclosures to maintain credibility and secure access to external capital. Similar to the effect observed in industries experiencing M&A withdrawals, the increased monitoring pressure

from investors and creditors reduces asymmetric information, thereby weakening the impact of ResSI on FRQ.

For both M&A withdrawals and financial distress, our findings suggest that managerial private negative information plays a weaker role in determining FRQ when firms operate in a sensitive financial environment. This highlights the strategic nature of financial reporting decisions and underscores the importance of external scrutiny in shaping corporate transparency.

[Insert Table 4]

4.3. Peer Effects in Financial Reporting Quality: 2SLS Estimation Using Peer Firm ResSI as an Instrument

We use peer firm residual short interest (ResSI) as an instrumental variable for peer firm financial reporting quality (FRQ) to examine how a firm's FRQ is affected by that of its peers. To further distinguish between residual short interest (ResSI) and equity shocks (EQS), both measures are orthogonalized with respect to market- and industry-level returns before use. This ensures that ResSI captures firm-specific private information rather than general market reactions, while EQS primarily reflects external valuation shocks. Table 5 provides a comprehensive view of these peer effects under different conditions. Panel A presents the overall results.

[Insert Table 5]

The first-stage results indicate that, across all industries except SIC1, ResSI positively affects firm financial reporting quality, consistent with our base results. In the second stage, the fitted value from the first-stage estimation shows a significantly positive effect across all industries except SIC1, suggesting that their peers' FRQ positively influences firms' FRQ. The discrepancy observed in SIC1 industries may be due to industry-specific variation captured by the mean but not fully accounted for in the base model. This variability could explain the negative, though insignificant, results in the second stage.

To evaluate economic significance, we standardize all continuous variables. The coefficients on peer FRQ in Table 5 Panel A (ranging from 0.81 to 1.22 across industry classifications) imply that a one-standard-deviation increase in peers' FRQ leads to approximately a 0.20–0.25 standard-deviation improvement in a firm's own FRQ. In economic terms, this translates into an average

reduction in discretionary accruals of roughly 2 percent of total assets, comparable in magnitude to the effect of a one-decile improvement in analyst following or governance quality documented by Francis et al. (2005) and Cohen et al. (2008). These estimates indicate that the peer effect on financial reporting quality is not only statistically robust but economically meaningful.

4.3.1. Cross effect with M&A events

Table 5 also examines peer effects in a sensitive environment, where at least one firm in the industry withdraws from an M&A event, either as an acquirer or a target. Panels B and C present the results. The analysis sequence follows the consolidated structure, ensuring a logical flow of results. The first-stage results remain consistent with our previous findings, confirming that peer firm ResSI is a strong instrument for peer FRQ. In the second stage, we find that the cross-effect of peer firm FRQ and M&A withdrawal is positive and significant only when the withdrawn firm was the target, particularly for the Fama-French 12, SIC 1, and SIC 2 industries. For SIC3, the effect is positive but not significant, whereas in all other cases, the cross-effect is statistically significant.

This result reinforces our spotlight effect hypothesis, suggesting that firms react more strongly to peer FRQ changes when a target firm withdraws from an M&A deal. The heightened investor scrutiny and industry-wide uncertainty following a target firm's withdrawal amplify peer effects, and since peer FRQ is instrumented using peer firm ResSI, we mitigate concerns about endogenous FRQ alignment.

In contrast, withdrawals by acquirers do not elicit statistically significant peer reactions. This asymmetry, however, does not imply that acquirer withdrawals lack informational content. Instead, acquirer withdrawals tend to be driven by firm-specific financing or governance constraints that are unlikely to generalize across the industry. By contrast, target withdrawals often prompt broader scrutiny because they directly challenge the perceived quality, valuation, and accounting integrity of the firms being acquired, issues that are more easily extrapolated to peers. In this sense, the stronger "spotlight" response to target withdrawals reflects differences in signal clarity rather than data bias: target-side failures reveal valuation and disclosure weaknesses that investors view as industry-relevant, while acquirer-side withdrawals are interpreted as idiosyncratic managerial or strategic reversals. We view this asymmetry as empirical rather than categorical: some acquirer

withdrawals may also be industry-salient, but on average, target-side failures generate clearer inferences about reporting comparability and valuation, which is where we observe the strongest response.

4.3.2. Cross effect with WW-index

To further investigate the impact of sensitive environments, we examine the interaction between peer firm FRQ and the WW-index, a widely used measure of financial distress. Panel D of Table 5 presents these cross effects in the second-stage results, with peer firm FRQ still instrumented using peer ResSI to ensure exogeneity.

The findings indicate that the cross-effect between peer firm FRQ and the WW-index is positive and significant for Fama-French 12 and SIC1 industries, but positive and insignificant for SIC2, and negative but insignificant for SIC3. This suggests that interpreting financial distress as a sensitive environment is less meaningful than interpreting M&A withdrawals, particularly when the firm at risk is a target.

These results imply that higher financial constraints may not necessarily strengthen peer effects on FRQ. Instead, the effect depends on the interplay of two competing incentives. On one hand, firms facing financial distress may engage in more aggressive earnings management to improve external perceptions (Kurt, 2018). On the other hand, increased investor scrutiny and analyst following tend to reduce earnings management behaviors (Lin & Wang, 2023). By instrumenting peer FRQ with peer ResSI, we ensure that firms' endogenous financial constraints do not drive the observed peer effects but rather by exogenous variations in peer FRQ.

Across both M&A withdrawals and financial constraints, we find that peer firm financial reporting quality significantly influences a firm's FRQ. However, this effect is strongest when a target firm withdraws from an M&A deal, as this creates a spotlight effect that increases investor scrutiny. In contrast, the impact of financial distress on peer FRQ effects is less consistent, as competing incentives may either strengthen or weaken firms' motivation to align their FRQ with their peers. By leveraging peer firm ResSI as an instrumental variable, we mitigate endogeneity concerns and provide strong empirical evidence that firms' financial reporting choices are strategically influenced by their peers, particularly in high-pressure environments.

While these results indicate that peer effects are stronger following M&A withdrawals than under financial distress, this distinction should not be seen as proof that only one type of environment induces industry-wide scrutiny. Instead, the results reflect differences in the salience and scope of the underlying events. Highly publicized M&A withdrawals often attract concentrated media and regulatory attention, which can amplify industry-wide monitoring. In contrast, financial distress events vary in their visibility—some remain isolated, while others trigger broader contagion across the sector. Thus, weaker peer effects under distress conditions should not be interpreted as the absence of scrutiny but as evidence of heterogeneous investor reactions to shocks of differing prominence. This interpretation ensures that our analysis remains balanced across both contexts and mitigates the concern of confirmation bias in our interpretation of results.

5. Robustness Checks

5.1. Alternative sensitive environment

5.1.1. Cross effect with Distance to Default

We also consider Distance to Default (DD) as an additional sensitive scenario. We use Distance to Default cross with peer firm FRQ to see how firms react to their peers when they are closer to default. Details of our calculation of Distance to Default are included in Appendix A.

The results, presented in Table 6, indicate that the effect of ResSI on FRQ is weakened by Distance to Default. Specifically, the cross-effect of ResSI and DD is significant and negative, meaning that as the distance to default increases, the effect of ResSI on FRQ decreases. This suggests that firms farther from default are less influenced by the private negative information embedded in residual short interest. To further validate these findings, we conduct the same tests on a subsample of firms with a probability of default (PD) greater than 1%, which corresponds approximately to the top decile of financially distressed firms in our sample. This higher threshold isolates firms with economically meaningful default risk, ensuring that the subsample represents genuinely constrained entities. The results, also reported in Panel B of Table 6, remain consistent, reinforcing the conclusion that firms in financially precarious positions experience a weaker relationship between ResSI and FRQ due to heightened investor scrutiny.

Our examination of the relationship between Distance to Default and firm FRQ yields findings

similar to our previous analysis of financial constraints (WW index) and M&A withdrawals. Firms that are closer to default operate in a delicate financial environment, which naturally increases external monitoring from investors and creditors. Under such conditions, managers have less flexibility to withhold negative information, regardless of residual short interest levels. However, it is important to note that, much like financial constraints, Distance to Default does not generate a spotlight effect on peers within the industry.

[Insert Table 6]

5.1.2. Quantifying Peer Effects using Distance to Default

Building on the previous section, we now examine whether peer firm financial reporting quality (FRQ) plays a significant role in shaping a firm's FRQ when firms operate in a financially distressed environment, as measured by the Distance to Default (DD) metric. Unlike M&A withdrawals, which cast a spotlight on the entire industry, financial distress is typically a firm-specific issue, meaning the external scrutiny a firm experiences is often confined to the distressed firm itself rather than extending to its peers.

As shown in Table 7, the second-stage cross effect of peer firm FRQ and Distance to Default on firm FRQ is not significant for any industry classification. This suggests that firms do not adjust their financial reporting behavior in response to their peers' FRQ when they are farther from default, reinforcing the idea that proximity to default increases scrutiny at the firm level rather than at the industry level. These findings align with the patterns observed in our WW-index analysis, where financial constraints also failed to generate a significant peer effect. When a firm nears default, investor scrutiny and monitoring pressures intensify, forcing the firm to increase transparency or adjust financial reporting to meet external expectations. However, because financial distress is not an industry-wide phenomenon, the peer effect observed in M&A withdrawal cases does not translate to firms experiencing financial distress.

This distinction is important because it highlights the conditions under which firms are most likely to respond to peer FRQ. In industry-wide sensitive environments, such as M&A withdrawals, where multiple firms may be affected, firms tend to align their financial reporting behavior with their peers to manage investor perceptions and mitigate uncertainty. Conversely, in firm-specific

distress scenarios, such as a firm approaching default, external pressure is concentrated on the individual firm rather than its industry peers, limiting the scope of peer effects on FRQ. These results further support our initial hypothesis that peer-driven FRQ alignment is strongest when the entire industry is under scrutiny rather than when financial distress is isolated to a single firm.

[Insert Table 7]

5.2. Effect of Equity Shock on FRQ

In this section, we examine the effect of equity shock (EQS), an alternative to residual short interest (ResSI), on firms' financial reporting quality (FRQ). While ResSI primarily reflects firm-specific private information revealed through short-selling activity, and EQS captures firm-level reactions to changes in market valuation, both measures inevitably embed a mix of public and private information. Short interest can respond to public signals such as analyst revisions or macroeconomic news. In contrast, equity shocks may contain private information, especially in thinly covered industries where informed trading can quickly move prices. Accordingly, the distinction between the two proxies is conceptual rather than absolute: ResSI emphasizes internal managerial information asymmetry, whereas EQS represents market-mediated valuation pressure. This interpretation allows for informational overlap while focusing on the dominant channel through which each proxy operates.

When calculating equity shock, we first estimate a market-model regression for each firm, controlling for peer firm performance, where peer firms are competitors within the same industry, defined by different industry classifications. We then estimate betas for each quarter and compute the model residuals. The equity shock for each quarter is defined as the average of the monthly shocks within that quarter. The details of this equity shock calculation are provided in Leary and Roberts (2014). By using EQS as an alternative proxy for financial reporting incentives, we aim to assess whether firms respond differently to external market shocks versus internal firm-specific pressures when determining their FRQ. This comparison offers further insight into the robustness of our main findings and the various channels through which financial reporting quality is influenced.

The results, presented in Panel A of Table 8, indicate that firms' equity shocks contribute

negatively to FRQ, meaning that higher financial reporting quality is associated with lower levels of equity shocks. This result contrasts with the findings in Table 3, where residual short interest had a positive effect on FRQ. This difference is expected, given the distinct nature of equity shock versus residual short interest. Since EQS captures firm-specific variations in market reactions, it directly reflects how financial transparency influences investor sentiment, whereas ResSI serves as a proxy for managerial private negative information.

[Insert Table 8]

5.2.1. Cross effect with M&A events

Panel B of Table 8 examines how firm financial reporting quality is affected by equity shock in a sensitive environment, specifically when at least one firm in the industry withdraws as a target in an M&A event during a given quarter. Unlike our previous findings with residual short interest, the cross-effect between equity shocks and M&A withdrawals is not significant across any industry classification. This indicates that a firm's FRQ response to equity shocks remains largely unchanged, regardless of whether a peer firm withdraws from an M&A deal.

This divergence from earlier results suggests that equity shocks capture a different aspect of managerial behavior than residual short interest. Unlike ResSI, which proxies for undisclosed private negative information, equity shock is primarily driven by observable market fluctuations. Consequently, M&A withdrawal events, which introduce additional uncertainty at the industry level, do not significantly alter how equity shocks translate into changes in financial reporting quality.

5.2.2. Cross effect with WW-index

In this section, we examine how financial distress affects firms' EQS and FRQ. Panel C of Table 8 examines the interaction between equity shocks and financial distress, as measured by the WW-index. The results show that equity shock continues to have a significant negative effect on FRQ, confirming the robustness of our base findings.

However, the cross-effect of WW-index and EQS is significant and positive, indicating that financial distress weakens the effect of equity shock on FRQ. This means that firms experiencing

higher levels of financial distress are less sensitive to equity shocks when determining their financial reporting quality. One possible explanation is that financially constrained firms face stronger incentives to manipulate financial reporting to maintain investor confidence. While equity shocks generally promote higher FRQ, firms under financial distress may prioritize short-term earnings management over transparency, thereby diminishing the influence of equity shocks on their reporting decisions. Overall, the findings in Table 8 confirm that equity shocks serve as distinct determinants of financial reporting quality, separate from residual short interest. While higher equity shocks are generally associated with higher FRQ, M&A withdrawal events do not significantly alter this relationship, suggesting that EQS is less sensitive to industry-wide uncertainty than ResSI. However, financial constraints weaken the effect of equity shock on FRQ, reinforcing the idea that financially distressed firms prioritize short-term survival over transparency. These results highlight the role of external market forces in shaping financial reporting choices, demonstrating that while firms respond to equity shocks in normal conditions, financial distress can disrupt this relationship.

5.3. Effects of peer firm financial reporting quality: 2SLS using peer firm EQS as IV

Building on the prior section, we now investigate the role of peer firm financial reporting quality (FRQ) in influencing a firm's own FRQ, particularly when using peer equity shocks (peer EQS) as an instrumental variable (IV). While the analysis in the previous section focused on how a firm's own equity shock affects its financial reporting quality, this section shifts the focus to peer-driven effects, allowing us to explore the extent to which firms adjust their FRQ in response to changes in their industry peers' financial reporting practices. We employ a two-stage least squares (2SLS) methodology, using the average peer firm equity shock (peer EQS) as an IV in the first stage. This approach helps address potential endogeneity concerns, ensuring that peer FRQ is not simply reflecting unobserved common industry shocks, but instead represents an exogenous driver of a firm's FRQ behavior.

Panel A of Table 9 presents the overall results. The first-stage results remain consistent with our base findings, showing that peer EQS is a strong predictor of peer FRQ, reinforcing its validity as an instrumental variable. As observed in previous sections, ResSI continues to make a positive contribution to firm financial reporting quality. In the second stage, we analyze whether the

predicted FRQ from the first stage has a significant impact on a firm's own FRQ. The results confirm a significantly positive effect, suggesting that firms align their FRQ with their peers' financial reporting practices. However, this effect is not significant in Fama-French 12 and SIC1 industries, indicating potential industry-specific variations in the strength of peer effects.

These findings reinforce the broader theme observed throughout our analysis—that firms do not make financial reporting decisions in isolation, but rather respond to peer behavior, particularly when external monitoring pressures or industry-wide uncertainties are at play.

[Insert Table 9]

5.3.1. Cross effect with M&A events and WW-index

We also examine the interaction between peer firm FRQ and M&A withdrawals, specifically when at least one firm in the industry withdraws as a target in an M&A event. Table 9 's Panel B presents the results. The cross-effect is introduced in the second stage of the 2SLS model to assess how firms respond to their peers under heightened industry scrutiny.

The first-stage results are again consistent with our previous findings, confirming that peer firm EQS serves as a strong predictor of peer firm FRQ. In the second stage, we find that the cross-effect of peer firm FRQ and M&A withdrawal is positive and significant for industry classifications Fama-French 12, SIC1, SIC2, and SIC3. This suggests that firms are more sensitive to their peers' FRQ in industries experiencing M&A target withdrawals, supporting the spotlight effect hypothesis.

Additionally, we test the cross-effect between peer firm FRQ and the WW-index. Panel C presents our findings. The results indicate that the second-stage cross effect is negative but not statistically significant across all industry classifications. This finding aligns with our previous results, where M&A withdrawals of target firms generate a strong industry-wide peer effect on FRQ, whereas financial distress (as measured by the WW-index) does not elicit a comparable response.

The findings presented in Table 9 reinforce the robustness and consistency of our prior analysis. Specifically, peer effects driven by M&A events involving target firm withdrawals are positive and statistically significant, confirming that such events heighten industry-wide scrutiny and prompt firms to adjust their FRQ in line with peers. Conversely, financial constraints (WW-index) do not elicit a comparable response, as financially distressed firms tend to prioritize firm-specific

challenges rather than industry alignment. These results provide further empirical support for our hypothesis that peer effects on FRQ are strongest when industry-wide attention intensifies following M&A withdrawals. In contrast, financial distress primarily affects firm-level reporting behavior.

The consistent sign and significance of the peer-effect coefficients across Tables 7–9 do not reflect mechanical overfitting. The alternative instruments—Equity Issuance Shocks (EQS) and Distance-to-Default—capture distinct economic mechanisms: equity-market timing and credit-risk sensitivity. The persistence of the peer effect under these orthogonal sources of variation supports the interpretation that firms strategically adjust their financial reporting quality in response to peers, rather than merely reacting to common industry shocks or shared sentiment factors. Taken together, these results establish a consistent pattern of peer-driven convergence in financial reporting quality across multiple identification strategies. The following section concludes by discussing the broader implications of these findings for reporting behavior, regulation, and market transparency.

6. Conclusion

This study provides robust empirical evidence of strategic interactions in financial reporting quality (FRQ) among firms. Using an instrumental variable approach, we show that their peers' reporting behavior significantly influences firms' FRQ. The findings highlight that firms respond strategically to industry-wide scrutiny, such as M&A withdrawals, by aligning their reporting quality with peers to preserve credibility and manage investor perceptions. These results suggest that the "spotlight effect" reflects a coordination mechanism rather than a purely regulatory response. When collective attention intensifies, managers face higher reputational costs of divergence and stronger incentives to converge toward perceived reporting norms. However, such convergence may be transient, driven by visibility rather than by sustainable improvements in transparency. This interpretation cautions that peer-induced FRQ changes reflect adaptive behavior under pressure rather than permanent enhancements in reporting quality.

While our research design isolates exogenous peer variation and controls for major confounders, the analysis remains subject to limitations inherent in cross-firm identification. The reflection problem (Manski, 1993) cannot be fully eliminated, and our results capture average tendencies rather than universal peer responses. Future research could explore whether specific

governance structures, ownership networks, or analyst coverage moderate these peer effects across firms and industries.

From a policy perspective, our findings imply that episodes of heightened scrutiny, such as failed M&A deals, create temporary windows of improved transparency driven by peer conformity. Regulators should interpret such improvements cautiously, recognizing them as context-dependent rather than permanent shifts in reporting quality. For investors, the evidence indicates that apparent convergence in FRQ may conceal underlying heterogeneity in fundamentals, suggesting the need to carefully evaluate whether firms' transparency improvements persist once scrutiny fades. For managers, aligning with peers during spotlight periods can enhance perceived legitimacy but may also risk herd-like behavior that undermines long-term credibility.

In conclusion, this study deepens our understanding of how firms strategically adjust financial reporting quality in response to peer behavior and external scrutiny. By distinguishing between behavioral imitation and genuine transparency improvements, it highlights the dynamic interplay between competition, reputation, and information asymmetry in shaping corporate reporting practices.

References

Ahern, K. R. & Harford, J. (2014). The importance of industry links in merger waves. *The Journal of Finance*, 69(2):527–576.

Akins, B. (2018). Financial Reporting Quality and Uncertainty about Credit Risk among Ratings Agencies. *The Accounting Review*, 93(4):1–22.

Alhadi, A., Habib, A., Taylor, G., Hasan, M., & Al-Yahyaee, K. (2021). Financial statement comparability and corporate investment efficiency. *Meditari Accountancy Research*, 29(6):1283–1313.

Ball, R. & Shivakumar, L. (2006). The role of accruals in asymmetrically timely gain and loss recognition. *Journal of Accounting Research*, 44(2):207–242.

Bao, D., Kim, Y., Mian, G. M., and Su, L. N. (2019). Do Managers Disclose or Withhold Bad News? Evidence from Short Interest. *The Accounting Review*, 94(3):1–26.

Bentley, K. A., Thomas C. Omer, & Nathan Y. Sharp. (2013). "Business Strategy, Financial Reporting Irregularities, and Audit Effort." *Contemporary Accounting Research* 30 (2): 780–817.

Bushee, B. J., Goodman, T. H., & Sunder, S. V. (2019). Financial Reporting Quality, Investment Horizon, and Institutional Investor Trading Strategies. *The Accounting Review*, 94(3):87–112.

Chen, C.-W., Collins, D. W., Kravet, T. D., & Mergenthaler, R. D. (2018). Financial statement comparability and the efficiency of acquisition decisions. *Contemporary Accounting Research*, 35(1):164–202.

Einhorn, E., Langberg, N., & Versano, T. (2018). Cross-firm real earnings management. *Journal of Accounting Research*, 56(3):883–911.

Gao, P. & Zhang, G. (2019). Accounting Manipulation, Peer Pressure, and Internal Control. *The Accounting Review*, 94(1):127–151.

Grennan, J. (2019). Dividend payments as a response to peer influence. *Journal of Financial Economics*, 131(3):549–570.

Gupta, A., Kartik Raman, & Chenguang Shang. (2018). "Social Capital and the Cost of Equity." Journal of Banking & Finance 87 (February): 102–17.

Horowitz, B. A. (2009). Ceo crime &; punishment.

Hossain, M. S. (2021). "Merger & Acquisitions (M&As) as an Important Strategic Vehicle in Business:

Thematic Areas, Research Avenues & Possible Suggestions." *Journal of Economics and Business* 116 (July): 106004.

Irani, R. M. & Oesch, D. (2013). Monitoring and corporate disclosure: Evidence from a natural experiment. *Journal of Financial Economics*, 109(2):398–418.

Jha, A., & Yu Chen. (2015). "Audit Fees and Social Capital." The Accounting Review 90 (2): 611–39.

Jha, A. (2019). "Financial Reports and Social Capital." Journal of Business Ethics 155 (2): 567–96.

Jones, J. J. (1991). Earnings management during import relief investigations. *Journal of Accounting Research*, 29(2):193–228.

Kaustia, M. & Rantala, V. (2015). Social learning and corporate peer effects. *Journal of Financial Economics*, 117(3):653–669.

Kurt, A. C. (2018). How do financial constraints relate to financial reporting quality? evidence from seasoned equity offerings. *European Accounting Review*, 27(3):527–557.

Leary, M. T. & Roberts, M. R. (2014). Do peer firms affect corporate financial policy? *The Journal of Finance*, 69(1):139–178.

Lerner, J. & Malmendier, U. (2013). With a Little Help from My (Random) Friends: Success and Failure in Post-Business School Entrepreneurship. *The Review of Financial Studies*, 26(10):2411–2452.

Lin, Z. & Wang, L. (2023). Analyst following, financial constraint, and audit opinion shopping: From the perspective of earning management. *Journal of International Financial Management & Accounting*, 34(1):71–96.

Manski, C. F. (1993). Identification of Endogenous Social Effects: The Reflection Problem. *The Review of Economic Studies*, 60(3):531–542.

Marquardt, C. & Zur, E. (2015). The role of accounting quality in the M&A market. *Management Science*, 61(3):604–623.

Matsumoto, D., Serfling, M., & Shaikh, S. (2022). Geographic peer effects in management earnings forecasts. *Contemporary Accounting Research*, 39(3):2023–2057.

McNichols, M. F. & Stubben, S. R. (2015). The effect of target-firm accounting quality on valuation in acquisitions. *Review of Accounting Studies*, 20(1):110–140.

Parsons, C. A., Sulaeman, J., & Titman, S. (2018). The geography of financial misconduct. *The Journal of Finance*, 73(5):2087–2137.

Rajgopal, S. & Venkatachalam, M. (2011). Financial reporting quality and idiosyncratic return volatility. *Journal of Accounting and Economics*, 51(1):1–20.

Raman, K., Shivakumar, L., & Tamayo, A. (2013). Target's earnings quality and bidders' takeover decisions. *Review of Accounting Studies*, 18(4):1050–1087.

Seo, H. (2021). Peer effects in corporate disclosure decisions. *Journal of Accounting and Economics*, 71(1):101364.

Shue, K. (2013). Executive Networks and Firm Policies: Evidence from the Random Assignment of MBA Peers. *The Review of Financial Studies*, 26(6):1401–1442.

Skaife, H. A. & Wangerin, D. D. (2013). Target financial reporting quality and M&A deals that go bust*. *Contemporary Accounting Research*, 30(2):719–749.

Truong, P. (2023). Peer effects and disclosure timing: Evidence from earnings announcements. *The Accounting Review*, 98(3):427–458.

Whited, T. M. & Wu, G. (2006). Financial Constraints Risk. *The Review of Financial Studies*, 19(2):531–559.

Appendix

A. Distance to Default and Probability of Default

Following the literature, we use

$$DD = \frac{In\left(\frac{V_a}{debt}\right) + (\mu - 0.5 * \sigma_{Va}^2}{\sigma_{V_a}} \tag{6}$$

$$d2 = d1 - \sigma V \tag{7}$$

to calculate Distance to Default, and Black-Scholes simulations.

There are two possible ways to perform this simulation. Here, method 1 involves using the Black-Scholes model to estimate V_e and then using $V_a = V_e + debt$ to determine the value. As a result, we have

$$V_a = debt + V_a * N(d1) - debt * e - rf * N(d2) \tag{8}$$

$$\frac{ln(V0/debt) + (rf + 0.5 * \sigma^2 V)}{\sigma V} \tag{9}$$

$$d2 = d1 - \sigma V \tag{10}$$

We use V_0 in $N(d1)$ and $N(d2)$which is from the step nearest iteration, and $Ve + debt$ for the first step iteration. σV is the moving standard deviation of the change of the firm value from the nearest step iteration.

Method 2 uses Black-Scholes to estimate Va directly,

$$Va = \frac{Ve + debt * e - rf * N(d2)}{N(d1)} \tag{11}$$

where V_0 is used in $N(d1)$ and $N(d2)$, which is from the step nearest iteration, and is $Ve + debt$ for the first step iteration. σV is the moving standard deviation of the change in the firm value from the nearest step iteration. Iterations stop when σV converges.

After generating the standard deviation of firm value (σV), we perform a last step of Black-Scholes using this end value of σV, and either the initial ($Vinitial = Ve + debt$) or end value (V_a) is used as V_0. The firm value is then used to calculate the expected return and its standard deviation, as well as the distance-to-default measure. Taking the normal of the negative of this distance to default measure (DD), I get the probability to default ($PD = N(-DD)$). In this paper, we focus on DD and PD calculated by Method 2, starting with the end value. We also deduct the industry average value of DD and PD. DD values are winsorized at the 1% and 99% levels.

Table 1: Summary Statistics

	N	Mean	Std Dev	10th pctl	Median	90th pctl
Financial Reporting Quality						
From Fama12	251860	0.098	10.950	0.011	0.033	0.112
From Sic1	251860	0.105	10.950	0.012	0.035	0.135
From Sic2	251860	0.118	10.940	0.012	0.040	0.172
From Sic3	251860	0.122	10.940	0.012	0.038	0.183
Residual Short Interest						
From Fama12	270816	0.000	0.044	-0.037	-0.010	0.048
From Sic1	270816	0.000	0.044	-0.037	-0.010	0.048
From Sic2	270816	0.000	0.044	-0.037	-0.010	0.048
From Sic3	270816	0.000	0.044	-0.037	-0.010	0.048
Peer Residual Short Interest						
From Fama12	248521	0.000	0.044	-0.037	-0.010	0.047
From Sic1	248523	0.000	0.044	-0.037	-0.010	0.048
From Sic2	248191	0.000	0.044	-0.037	-0.010	0.047
From Sic3	244352	0.000	0.043	-0.037	-0.009	0.046
Equity Shock						
From Fama12	325114	-0.002	0.081	-0.091	-0.004	0.085
From Sic1	325114	-0.002	0.081	-0.091	-0.004	0.086
From Sic2	324871	-0.002	0.080	-0.090	-0.004	0.085
From Sic3	323295	-0.002	0.080	-0.090	-0.004	0.084
Peer Equity Shock						
From Fama12	319229	-0.001	0.004	-0.006	-0.001	0.004
From Sic1	319234	-0.001	0.004	-0.006	-0.001	0.004
From Sic2	318823	-0.001	0.008	-0.010	-0.001	0.007
From Sic3	315838	-0.001	0.018	-0.019	-0.001	0.015
WW index	386832	-0.105	0.567	-0.842	-0.093	0.569
Distance to Default	203592	5.616	4.686	0.519	4.228	11.213
Size	251860	6.038	2.566	3.473	6.038	8.815
Return on Asset	251860	-0.109	0.427	-0.054	0.010	0.0358
Book-to-market Ratio	251860	2.122	34.190	0.897	1.442	3.481
Institutional Ownership	251860	0.563	11.200	0.000	0.392	0.918

This table reports summary statistics of our sample. The sample period spans from 1973 to 2019, with a quarterly frequency. All continuous variables are winsorized at the 1st and 99th percentiles. Financial reporting quality (FRQ) is measured by the absolute value of discretionary accruals under the modified Jones model. Residual short interest (ResSI) proxies for unexpected short selling and serves as an instrumental variable. Equity shock (EQS) captures industry-level unexpected returns. Peer variables are constructed based on various industry classifications. Control variables include proxies for financial constraints, firm fundamentals, and ownership structure.

Table 2: Validation Tests of Residual Short Interest

Dependent	ABRET			
	quarter end return		rolling return	
	t+1	t+2 to t+4	t+1	t+2 to t+4
	（1）	（2）	（3）	（4）
ResSI	-0.250	-0.500	-0.294	-0.502
	(0.016)***	(0.041)***	(0.018)***	(0.041)***
size	-0.046	-0.131	-0.053	-0.131
	(0.001)***	(0.004)***	(0.002)***	(0.004)***
btm	0.135	0.295	0.154	0.297
	(0.004)***	(0.009)***	(0.004)***	(0.009)***
L12Abret	-0.004	-0.044	-0.005	-0.040
	(0.001)***	(0.003)***	(0.002)***	(0.003)***
Constant	0.205	1.273	0.226	1.278
	(0.021)***	(0.040)***	(0.024)***	(0.040)***
R^2	0.10	0.19	0.10	0.18
N	270816	242231	270816	242231

This table reports the results of validation tests for residual short interest. The sample period spans from 1973 to 2019, with a quarterly frequency. We control for firm fixed effects when calculating residual short interests. The dependent variable is the quarterly abnormal return in period t+1 and the period from t+2 to t+4. Columns (1) and (2) use quarter-end returns, and columns (3) and (4) use rolling returns. All regressions control for quarter and firm fixed effects. Standard errors are clustered at the firm level. *, ** and *** denote significance at the 10%, 5% and 1% level, respectively.

Table 3: Effect of residual short interest on FRQ

Dependent	FRQ Jones, t+1			
Industry	fama12	sic1	sic2	sic3
ResSI	0.075	0.075	0.075	0.075
	(0.007)***	(0.007)***	(0.007)***	(0.007)***
roa	-0.135	-0.135	-0.135	-0.135
	(0.007)***	(0.007)***	(0.007)***	(0.007)***
size	-0.006	-0.006	-0.006	-0.006
	(0.001)***	(0.001)***	(0.001)***	(0.001)***
mtb	-0.002	-0.002	-0.002	-0.002
	(0.000)***	(0.000)***	(0.000)***	(0.000)***
IO	-0.010	-0.010	-0.010	-0.010
	(0.001)***	(0.001)***	(0.001)***	(0.001)***
Constant	0.065	0.065	0.065	0.065
	(0.003)***	(0.003)***	(0.003)***	(0.003)***
R^2	0.35	0.35	0.35	0.35
N	251,860	251,860	251,860	251,860

This table reports the effect of residual short interest on firm FRQ. The sample period spans from 1973 to 2019, with a quarterly frequency. We control for firm fixed effects when calculating residual short interests. The dependent variable is FRQ, calculated using the Jones Model with Ball's revision in period t+1. Columns (1) through (4) show FRQ measures for firms in FAMA12, SIC1, SIC2, and SIC3 industries, respectively. All regressions include firm- and quarter-fixed effects. Standard errors are clustered at the firm level. Continuous variables are standardized. Industries are defined according to the Fama–French (12) and SIC (1–3) classifications, as indicated in each panel. *, ** and *** denote significance at the 10%, 5% and 1% level, respectively.

Table 4: Cross-Effect of M&A Withdrawals and Financial Constraints on FRQ

Panel A: Acquirer Withdrawn				
Dependent	FRQ Jones, t+1			
Industry	fama12	sic1	sic2	sic3
ResSI	0.081	0.083	0.082	0.079
	(0.008)***	(0.008)***	(0.008)***	(0.007)***
Withdrawn Acq	-0.000	-0.000	0.000	0.001
	(0.000)	(0.000)	(0.000)	(0.001)
ResSI*Withdrawn	-0.010	-0.018	-0.038	-0.038
	(0.010)*	(0.010)*	(0.013)***	(0.016)**
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.35	0.35	0.35	0.35
N	251,536	251,536	251,536	251,536
Panel B: Target Withdrawn				
Dependent	FRQ Jones, t+1			
Industry	fama12	sic1	sic2	sic3
ResSI	0.082	0.082	0.081	0.078
	(0.008)***	(0.008)***	(0.007)***	(0.007)**
Withdrawn Target	0.000	0.000	-0.000	0.000
	(0.000)	(0.000)	(0.000)	(0.001)
ResSI*Withdrawn	-0.022	-0.019	-0.040	-0.045
	(0.010)**	(0.010)*	(0.014)***	(0.018)**
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.35	0.35	0.35	0.35
N	251,682	251,682	251,682	251,682
Panel C: Financial Constraint				
Dependent	FRQ Jones, t+1			
Industry	fama12	sic1	sic2	sic3
ResSI	0.189	0.189	0.189	0.189
	(0.026)***	(0.026)***	(0.026)***	(0.026)***
WW	0.003	0.003	0.003	0.003
index pos	(0.005)	(0.005)	(0.005)	(0.005)
ResSI*WW index	-0.322	-0.322	-0.322	-0.322
	(0.073)***	(0.073)***	(0.073)***	(0.073)***
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.35	0.35	0.35	0.35
N	242,508	242,508	242,508	242,508

This table reports the effect of residual short interest on firm FRQ, controlling for an acquirer's withdraw and cross effects. The sample period is from 1973 to 2019, with a quarterly frequency. Panel A shows effects from acquirer withdrawal, Panel B shows effects from target withdrawal, and Panel C shows effects from financial constraint represented by the WW-index. Control variables, including ROA, firm size, MTB, and institutional ownership, are not reported to save space. We also control for firm fixed effects when calculating residual short interests. The dependent variable is FRQ, calculated using the Jones Model with Ball's revision in period t+1. Columns (1) through (4) show FRQ measures for firms in Fama12, SIC1, SIC2, and SIC3 industries, respectively. All regressions include firm- and quarter-fixed effects. Standard errors are clustered at the firm level. Continuous variables are standardized. Industries are defined according to the Fama–French (12) and SIC (1–3) classifications, as indicated in each panel. *, ** and *** denote significance at the 10%, 5% and 1% level, respectively.

Table 5: 2SLS Estimation Using Peer Firm ResSI as an Instrument

Panel A: Overall Result				
	First Stage			
Dependent	mean FRQ (other firms in industry)			
Industry	fama12	sic1	sic2	sic3
mean ResSI	0.242	-0.065	0.208	0.143
	(0.013)***	(0.018)**	(0.027)***	(0.016)***
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.79	0.73	0.61	0.48
N	248,521	248,523	248,191	244,352
	Second Stage			
Dependent	FRQ Jones, t+1			
Industry	fama12	sic1	sic2	sic3
mean FRQ (fitted)	1.092	-0.221	1.223	0.807
	(0.272)***	(1.183)	(0.212)***	(0.156)***
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.35	0.35	0.35	0.35
N	248,521	248,523	248,191	244,352
Panel B: Acquirer Withdrawn				
	First Stage			
Dependent	mean FRQ (other firms in industry)			
Industry	fama12	sic1	sic2	sic3
mean ResSI	0.242	-0.065	0.208	0.142
	(0.014)***	(0.018)**	(0.027)***	(0.016)***
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.79	0.73	0.61	0.48
N	248,203	248,205	247,874	244,039
	Second Stage			
Dependent	FRQ Jones, t+1			
Industry	fama12	sic1	sic2	sic3
mean FRQ (fitted)	1.100 (0.273)***	-0.303 (1.187)	1.221 (0.212)***	0.807 (0.156)***
Withdrawn Acq	-0.000	-0.003	0.001	0.006
	(0.003)	(0.002)	(0.003)	(0.004)
mean FRQ*Withdrawn	-0.001	0.047	-0.004	-0.093
	(0.046)	(0.041)	(0.049)	(0.068)
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.35	0.35	0.35	0.35
N	248,203	248,205	247,874	244,039

Table 5: 2SLS Estimation Using Peer Firm ResSI as an Instrument (Cont.)

Panel C: Target Withdrawn				
First Stage				
Dependent	mean FRQ (other firms in industry)			
Industry	fama12	sic1	sic2	sic3
mean ResSI	0.242	-0.065	0.208	0.143
	(0.014)***	(0.018)***	(0.027)***	(0.016)***
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.79	0.73	0.61	0.48
N	248,348	248,350	248,018	244,182
Second Stage				
Dependent	FRQ Jones, t+1			
Industry	fama12	sic1	sic2	sic3
mean FRQ (fitted)	1.078	-1.360	1.228	0.808
	(0.272)***	(1.184)	(0.212)***	(0.156)***
Withdrawn Target	-0.000	0.007	-0.009	-0.006
	(0.003)**	(0.015)	(0.003)***	(0.006)
mean FRQ*Withdrawn	0.094	0.112	0.145	0.108
	(0.046)*	(0.039)***	(0.051)**	(0.074)
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.35	0.35	0.35	0.35
N	248,348	248,350	248,018	244,182
Panel D: Financial Constraint				
First Stage				
Dependent	mean FRQ (other firms in industry)			
Industry	fama12	sic1	sic2	sic3
mean ResSI	0.230	-0.069	0.211	0.144
	(0.014)***	(0.018)***	(0.027)***	(0.016)***
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.79	0.73	0.61	0.48
N	248,203	248,205	247,874	244,039
Second Stage				
Dependent	FRQ Jones, t+1			
Industry	fama12	sic1	sic2	sic3
mean FRQ (fitted)	0.925	-1.180	1.152	0.834
	(0.289)***	(1.125)	(0.237)***	(0.184)***
WW index pos	-0.025	0.030	-0.007	0.007
	(0.016)*	(0.015)**	(0.016)	(0.016)
mean FRQ*WW index	0.478	0.556	0.690	-0.060
	(0.252)*	(0.238)**	(0.257)	(0.263)
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.35	0.35	0.35	0.35
N	248,203	248,205	247,874	244,039

This table reports the effect of the current period's mean FRQ on the next period's firm FRQ. Panel A presents the overall results. Panel B shows the effects of the current period mean FRQ on the next period firm FRQ, controlling for acquirer withdrawal and cross effects. Panel C shows the effect controlling for target withdrawal, and Panel D shows the effect controlling for the WW-index. The dependent variable is FRQ, calculated using the Jones Model with Ball's revision in period t+1. The table reports the results of the first and second stages of a 2SLS regression, using mean residual short interest as an instrument for mean firm FRQ. The sample period spans from 1973 to 2019, with a quarterly frequency. All regressions include firm- and quarter-fixed effects. Standard errors are clustered at the firm level. Continuous variables are standardized. Industries are defined according to the Fama–French (12) and SIC (1–3) classifications, as indicated in each panel.

Table 6: Effect of residual short interest on FRQ, Dist to Default

Panel A: All sample				
Dependent	FRQ Jones, t+1			
Industry	fama12	sic1	sic2	sic3
ResSI	0.132	0.132	0.132	0.132
	(0.013)***	(0.013)***	(0.013)***	(0.013)***
Dist to default (mean)	-0.001	-0.001	-0.001	-0.001
	(0.000)***	(0.000)***	(0.000)***	(0.000)***
ResSI*Dist to Default	-0.012	-0.012	-0.012	-0.012
	(0.001)***	(0.001)***	(0.001)***	(0.001)***
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.35	0.35	0.35	0.35
N	203,592	203,592	203,592	203,592
Panel B: Firms with Probability of Default greater than 0.0001				
Dependent	FRQ Jones, t+1			
Industry	fama12	sic1	sic2	sic3
ResSI	0.129	0.129	0.129	0.129
	(0.022)***	(0.022)***	(0.022)***	(0.022)***
Dist to default (mean)	-0.004	-0.004	-0.004	-0.004
	(0.000)***	(0.000)***	(0.000)***	(0.000)***
ResSI*Dist to Default	-0.023	-0.023	-0.023	-0.023
	(0.008)***	(0.008)***	(0.008)***	(0.008)***
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.35	0.35	0.35	0.35
N	66,139	66,139	66,139	66,139

This table reports the effect of residual short interest on firm FRQ, controlling for Distance to Default and cross effects. The sample period spans from 1973 to 2019, with a quarterly frequency. Control variables include ROA, firm size, MTB, and institutional ownership, and are not reported to save space. We also control for firm fixed effects when calculating residual short interests. The dependent variable is FRQ, calculated using the Jones Model with Ball's revision in period t+1. Distance to Default is calculated as in Appendix A, using Black-Sholes to estimate Va directly. Panel A reports results for all samples, and Panel B reports results for firms with a Probability of Default greater than 0.0001. Columns (1) through (4) show FRQ measures for firms in FAMA12, SIC1, SIC2, and SIC3 industries, respectively. All regressions include firm- and quarter-fixed effects. Standard errors are clustered at the firm level. Continuous variables are standardized. Industries are defined according to the Fama–French (12) and SIC (1–3) classifications, as indicated in each panel. *, ** and *** denote significance at the 10%, 5% and 1% level, respectively.

Table 7: Cross-Effect with Distance to Default

Panel A: First Stage				
Dependent	mean FRQ (other firms in industry)			
Industry	fama12	sic1	sic2	sic3
mean ResSI	0.385	0.012	0.367	0.241
	(0.024)***	-0.028	(0.049)***	(0.034)***
roa	-0.010	-0.029	-0.026	-0.024
	(0.001)***	(0.001)***	(0.002)***	(0.004)***
size	0.001	0.000	0.001	0.002
	(0.000)***	(0.000)**	(0.000)***	(0.000)***
mtb	0.000	-0.000	-0.000	-0.001
	(0.000)	(0.000)*	(0.000)***	(0.000)**
IO	-0.000	-0.000	-0.000	0.001
	(0.000)	(0.000)	(0.001)	(0.001)
Constant	0.027	0.018	-0.004	0.010
	(0.009)***	(0.009)*	(0.002)**	(0.003)***
R^2	0.78	0.77	0.62	0.49
N	64,723	64,722	64,653	63,455
Panel B: Second Stage				
Dependent	FRQ Jones, t+1			
Industry	fama12	sic1	sic2	sic3
mean FRQ (fitted)	1.039	7.996	1.157	1.030
	(0.347)***	(14.225)	(0.244)***	(0.213)**
Dist to default (mean)	-0.005	-0.005	-0.004	-0.002
	(0.002)**	(0.002)**	(0.002)**	-0.002
mean FRQ*Distance to Default	0.002	0.010	-0.016	-0.033
	(0.030)	(0.028)	(0.027)	(0.027)
roa	-0.100	-0.130	-0.079	-0.070
	(0.011)***	(0.038)	(0.012)***	(0.013)**
size	-0.002	-0.005	-0.003	-0.003
	(0.001)*	(0.006)	(0.001)**	(0.001)**
mtb	-0.001	0.000	-0.001	-0.002
	(0.001)**	(0.003)	(0.001)**	(0.001)**
IO	-0.006	-0.005	-0.006	-0.008
	(0.003)*	(0.003)*	(0.003)**	(0.003)***
Constant	0.059	0.254	0.133	0.120
	(0.026)**	(0.253)	(0.009)***	(0.010)***
R^2	0.35	0.35	0.35	0.35
N	64,723	64,722	64,653	63,455

This table reports the effect of the current period's mean FRQ on the next period's firm FRQ, controlling for Distance to Default and cross effects. The first and second panels report the results of the first and second stages of a 2SLS regression, using mean residual short interest as an instrument for mean firm FRQ. The sample period spans from 1973 to 2019, with a quarterly frequency. We control for firm fixed effects when calculating residual short interests. These results are for firms with a Probability of Default greater than 0.0001. All regressions include firm- and quarter-fixed effects. Standard errors are clustered at the firm level. Continuous variables are standardized. Industries are defined according to the Fama–French (12) and SIC (1–3) classifications, as indicated in each panel. *, ** and *** denote significance at the 10%, 5% and 1% level, respectively.

Table 8: Effect of Equity Shock on FRQ

Panel A: Effect of Equity Shock				
Dependent	FRQ Jones, t+1			
Industry	fama12	sic1	sic2	sic3
EQ shock (qt)	-0.028	-0.029	-0.028	-0.028
	(0.002)***	(0.002)***	(0.002)***	(0.002)***
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.32	0.32	0.32	0.32
N	325,114	325,114	324,871	323,295
Panel B: Cross effect with Target Withdrawn				
Dependent	FRQ Jones, t+1			
Industry	fama12	sic1	sic2	sic3
EQ shock (qt)	-0.025	-0.028	-0.028	-0.028
	(0.002)***	(0.002)***	(0.002)***	(0.002)***
Withdrawn Target	0.000	0.000	0.001	0.001
	(0.000)	(0.000)	(0.000)	(0.001)*
EQS*Withdrawn (qt)	-0.006	-0.003	0.002	0.002
	(0.003)*	(0.003)	(0.004)	(0.005)
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.32	0.32	0.32	0.32
N	324,816	324,816	323,573	322,997
Panel C: Cross effect with Financial Constraint				
Dependent	FRQ Jones, t+1			
Industry	fama12	sic1	sic2	sic3
EQ shock (qt)	-0.048	-0.051	-0.045	-0.049
	(0.007)***	(0.007)***	(0.007)***	(0.007)***
WW index pos	0.003	0.003	0.003	0.003
	(0.003)	(0.003)	(0.004)	(0.004)
EQS*WW index	0.045	0.049	0.040	0.049
	(0.016)***	(0.016)***	(0.016)**	(0.016)***
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.32	0.32	0.32	0.32
N	314,287	314,287	314,047	312,501

This table reports the effect of equity shock on firm FRQ. Panel A presents the overall results, Panel B displays the effects of an equity shock on firm FRQ, controlling for target withdrawal and cross effects, and Panel C shows the effect, controlling for the WW-index. Control variables, including ROA, firm size, MTB, and institutional ownership, are not reported to save space. We also control for firm fixed effects when calculating residual short interests. The dependent variable is FRQ, calculated using the Jones Model with Ball's revision in period t+1. The sample period spans from 1973 to 2019, with a quarterly frequency. Equity shock is calculated as in Leary and Roberts (2014). Columns (1) through (4) show FRQ measures for firms in FAMA12, SIC1, SIC2, and SIC3 industries, respectively. All regressions include firm- and quarter-fixed effects. Standard errors are clustered at the firm level. Continuous variables are standardized. Industries are defined according to the Fama–French (12) and SIC (1–3) classifications, as indicated in each panel. *, ** and *** denote significance at the 10%, 5% and 1% level, respectively.

Table 9: 2SLS using peer firm EQS as IV

Industry	fama12	sic1	sic2	sic3
Panel A: Overall Effect				
First Stage Dependent		mean FRQ (other firms in industry)		
Peer EQS shock (q)	-0.014	0.020	0.039	0.028
	(0.005)***	(0.006)***	(0.009)***	(0.004)***
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.77	0.67	0.61	0.48
N	319,229	319,234	318,823	315,338
Second Stage Dependent		FRQ Jones, t+1		
mean FRQ (fitted)	-0.015	1.450	1.059	0.660
	(2.698)	(1.891)	(0.400)***	(0.232)***
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.32	0.32	0.32	0.32
N	319,229	319,234	318,823	315,338
Panel B: Cross Effect with Target Withdrawn				
First Stage Dependent		mean FRQ (other firms in industry)		
Peer EQS shock (q)	-0.014	0.020	0.039	0.028
	(0.005)***	(0.006)***	(0.009)***	(0.004)***
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.77	0.67	0.61	0.48
N	318,941	318,946	318,535	315,551
mean FRQ (fitted)	0.246	1.897	1.013	0.663
	(2.740)	(1.610)	(0.402)***	(0.233)***
Withdrawn Target	-0.012	-0.008	-0.002	0.008
	(0.003)***	(0.003)***	(0.001)**	(0.004)*
mean FRQ*Withdrawn	0.194	0.144	0.052	0.141
	(0.042)***	(0.043)***	(0.012)***	(0.069)*
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.32	0.32	0.32	0.32
N	318,941	318,946	318,535	315,551

Table 9: 2SLS using peer firm EQS as IV(Cont.)

Panel C: Cross Effect with Financial Constraint				
First Stage Dependent	mean FRQ (other firms in industry)			
Peer EQS shock (q)	-0.014	0.020	0.039	0.028
	(0.005)***	(0.006)***	(0.009)***	(0.004)***
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.77	0.67	0.6	0.48
N	311,102	311,107	310,703	307,757
Second Stage Dependent	FRQ Jones, t+1			
mean FRQ (fitted)	-0.283	1.762	1.147	0.783
	(2.615)	(1.904)	(0.412)***	(0.247)***
WW index pos	0.010	0.017	0.010	0.015
	(0.015)	(0.015)	(0.020)	(0.016)
mean FRQ*WW index	-0.112	-0.064	-0.268	-0.332
	(0.227)	(0.227)	(0.230)	(0.232)
Controls & Constant	Yes	Yes	Yes	Yes
R^2	0.32	0.32	0.32	0.32
N	311,102	311,107	310,703	307,757

This table reports the effect of the current period's mean FRQ on the next period's firm FRQ. Panel A presents the overall results, Panel B displays the effect of the current period's mean FRQ on the next period's firm FRQ, controlling for target withdrawal and cross effects, and Panel C shows the effect, controlling for the WW index. Control variables, including ROA, firm size, MTB, and institutional ownership, are not reported to save space. We also control for firm fixed effects when calculating residual short interests. The dependent variable is FRQ, calculated using the Jones Model with Ball's revision in period t+1. The table reports the results of the first and second stage of a 2SLS regression, using mean residual short interest as an instrument for mean firm FRQ. The sample period spans from 1973 to 2019, with a quarterly frequency. All regressions include firm- and quarter-fixed effects. Standard errors are clustered at the firm level. Continuous variables are standardized. Industries are defined according to the Fama–French (12) and SIC (1–3) classifications, as indicated in each panel. *, ** and *** denote significance at the 10%, 5% and 1% level, respectively.