

Politicians' Equity Holdings and Accounting Conservatism

Vishal Baloria
School of Accounting and Finance
University of Waterloo
200 University Avenue West
Waterloo, Ontario, Canada N2L 3G1
vbaloria@uwaterloo.ca

October 2013

ABSTRACT

I examine the association between politician ownership and accounting conservatism for a sample of S&P 1500 firms. The contracting explanation predicts that politician owned firms adopt less conservative accounting because lenders are less concerned with downside default risk for these politically favored firms. The political costs explanation predicts that politician owned firms adopt more conservative financial reporting to shield allied politicians from voter scrutiny. I find that equity ownership by members of the U.S. House and Senate is associated with lower levels of accounting conservatism. This negative association is more pronounced among: (1) firms owned by local politicians, where there is a greater alignment between the interests of the politician and the firm, and (2) firms with long-term issuer credit ratings, for which debt market participants particularly value conservatism as a mechanism for conveying information on downside default risk. Collectively, these results provide consistent evidence of a lower contracting demand for conservatism among politician owned firms.

I am grateful to members of my dissertation committee, Jean Guillaume Forand, Ken Klassen, Tom Scott, and especially Christine Wiedman (Chair), for their guidance and support. I would also like to thank Sati Bandyopadhyay, Partha Mohanram, Tony Wirjanto, and workshop participants at the University of Waterloo and the 2013 CAAA Craft of Accounting Research Workshop for providing helpful suggestions.

1. Introduction

Studies investigating the impact of government participation in financial markets on financial reporting document a negative association between government ownership and conservatism. Bushman and Piotroski (2006) show that firms in countries characterized by high state ownership speed recognition of good news and delay recognition of bad news due to possible government interference, and Chen et al. (2010) find that Chinese state owned enterprises adopt less conservative accounting because lenders are less concerned about the downside default risk of these politically favored firms. However, these studies do not consider how politicians' participation in financial markets as private investors, rather than as public officials, affects accounting conservatism. Motivated by mounting anecdotal and empirical evidence of a political nexus between politicians and the firms in which they invest (Ziobrowski et al. 2004, 2011; Schwiezer 2011; Eggers and Hainmueller 2013; Tahoun 2013; Tahoun and van Lent 2013), I examine the relation between the equity holdings of members of the U.S. House and Senate and financial reporting conservatism for a sample of S&P 1500 firms.¹

Ex-ante, the direction of the association (if any) between politician ownership and conservative financial reporting is unclear. One possibility is that politician ownership reduces the contracting demand for conservatism. As an important contracting party to the firm, lenders demand conservatism as assurance that the minimum amount of net assets will be sufficient to repay the contracted sum. Lenders' demand for conservative reporting increases with the likelihood that the borrower will have insufficient net assets to cover its loans (Watts 2003). Lenders may be less concerned about the downside default risk of politician owned firms (POFs)

¹ The literature defines accounting conservatism as either conditional or unconditional. Conditional conservatism is the higher verifiability for recognizing good news as gains than for recognizing bad news as losses (Basu 1997) whereas unconditional conservatism is news-independent and involves understatement of book value of net assets arising from predetermined aspects of the accounting system (e.g. Ball and Shivakumar 2005; Beaver and Ryan 2005). As explained more fully in Section 2.3, I focus on the conditional form for the purposes of this paper.

because they obtain economic benefits from their political ties (Tahoun 2013) and are, thus, less likely to be in financial distress. If the politically favored POFs do get into financial trouble, they can obtain government funds with relative ease (Tahoun and van Lent 2013).² Lenders may factor these implicit advantages into their assessment of downside default risk, leading to a lower demand for conservatism (as in Chen et al. 2010 who examine Chinese state owned firms).

An alternative hypothesis, based on the political costs explanation of conservatism, posits that equity ownership subjects politicians to voter scrutiny, resulting in a greater demand for conservatism among POFs.³ In particular, prior research argues that politicians are more susceptible to voter criticism when bad news is not incorporated into financial statements than when good news is not incorporated (Watts 2003; Guay and Verrecchia 2006). Voters value timely loss recognition because overstatements of income and assets can generate large financial and employment losses (Watts 2003). Since voters lack the sophistication to unravel managers' tendency to bias accounting numbers upwards, they expect individuals overseeing financial markets (i.e. standard-setters, regulators, and politicians) to provide this financial discipline (Guay and Verrecchia 2006). When voters learn of losses from overstated assets and income, they are likely to take their anger out, in part, on politicians. As equity ownership provides voters an identifiable link between politicians and firms, politicians bare particularly high political costs from the actions of POFs. Conservatism reduces the political costs incurred by politicians because voters value its ability to offset managerial bias in financial reporting (Watts 2003). Thus, politicians potentially demand conservatism from POFs in order to satisfy constituents.

² There is considerable evidence of political interference in recent government bailouts. Several studies find that politically connected banks received preferential access to government assistance under the Troubled Asset Relief Program (TARP) (Duchin and Sosyura 2012; Blau et al. 2013; Tahoun and van Lent 2013). During the 2012 elections, Presidential candidate Mitt Romney faced criticism for personally gaining \$15.3 million as an investor of Delphi Corporation, an auto parts maker, which benefited from the bailout of General Motors in 2008.

³ Political costs are generally discussed in the context of firms and their accounting choices (Watts and Zimmerman 1978; 1986). In this paper, I focus on the political costs incurred by politicians rather than firms.

To help distinguish between these competing explanations, I examine the association between politician ownership and conservatism using a sample of non-financial S&P 1500 firms over the period 2005-2011. I obtain data on politicians' equity holdings from annual financial disclosure reports filed by members of the House and Senate. These disclosures report each member's year-end holdings and a list of transactions executed throughout the year. I measure politician ownership as a binary variable equal to one if a firm's shares are owned by at least one member of the U.S. House and Senate and conservatism based on Basu's (1997) earnings-return model. I document a negative association between conservatism and the political ownership variable, consistent with lenders being less concerned about downside default risk for POFs. These results are robust to alternative measures of both politician ownership and conservatism.

To provide corroborating evidence in support of the contracting explanation, I further partition POFs into those owned by a local politician (local POFs) and those not owned by a local politician (distant POFs). I consider a politician to be local to a firm if they reside over the congressional district in which the firm is headquartered. As the interests of politicians are inherently linked to firms domiciled in their district, politicians have particularly strong incentives to aid local POFs. For example, the financial press reports cases when politicians went as far as changing the text of legislation to provide ailing firms in their home state with government assistance (Paletta and Enrich 2009). I document a negative relation between conservatism and both local and distant ownership and find that the relation between local POF and conservatism is significantly more negative than the relation between distant POF and conservatism. These results are consistent with lenders incorporating the implicit advantages of

political connections into their assessment of downside default risk to a greater extent in the presence of a particularly strong link bonding the politician and firm.⁴

Although the results from the above tests suggest that POFs are less conservative in their financial reporting, these tests do not explicitly link the results to a reduced debt contracting demand for conservatism. In additional analysis, I examine whether the relationship between politician ownership and conservatism varies by the presence or absence of debt market participants who value conservatism as a mechanism for assessing downside default risk. I use the existence of a long term issuer credit rating to capture the debt market's interest in conservatism. Almost all firms with an issuer credit rating have public debt outstanding (Cantillo and Wright 2000; Rauh and Sufi 2010), and public bondholders have a greater demand for conservatism than other lenders because they have limited access to other monitoring mechanisms (Nikolaev 2010; Haw et al. 2013). In addition, credit rating agencies themselves are primarily interested in assessing downside default risk, and demand conservatism from rated firms (Bae et al. 2013). I find that the negative association between conservatism and politician ownership is more pronounced among rated firms. These results provide confirmatory evidence that lenders are responsible for driving down the demand for conservatism in POFs.

This study contributes to three streams of research. First, this study contributes to the literature on ownership characteristics and accounting conservatism. Economic explanations for differences in conservatism among firms in prior studies typically focus on variation in agency and governance issues arising from different ownership structures (e.g., Ball and Shivakumar 2005; Bushman and Piotroski 2006; Ahmed and Duellman 2007; Lafond and Roychowdhury 2008; Nichols et al. 2009; Ramalingegowda and Yu 2012). My study adds to the literature by

⁴ The political costs explanation would predict the association between politician ownership and conservatism should be less negative (or more positive) as politicians bear greater political costs from the actions of local firms.

examining how variation in political connections arising from ownership structure impact accounting conservatism. These findings complement Chen et al. (2010), which finds that Chinese state owned firms adopt less conservative accounting because lenders are less concerned with downside default risk. By focusing my analysis on U.S. firms, I am not only able to examine politicians' participation in capital markets as private investors rather than as public officials, I am also able to show that political ties influence accounting outcomes even in an institutional setting characterized by strong enforcement mechanisms, public disclosure of political connections, and a lack of government owned banks.

Second, this paper contributes to the literature on political connections and financing, which documents that connected firms receive preferential access to finance (Johnson and Mitton 2003; Cull and Xu 2005; Dinc 2005; Khwaja and Mian 2005; Claessens et al. 2008). Chaney et al. (2011) link this finding to financial reporting and show that politically connected firms devote less time to accurately portraying accruals because they are shielded from the capital market consequences of reporting low quality earnings to the debt market. Building on this study, I focus on the relation between politician ownership and conservative reporting since the extant evidence suggests a clear link between political ties, the informational demands of debt market participants, and accounting conservatism. More specifically, prior studies note that political ties are particularly valuable during periods of financial distress (Faccio et al. 2006; Duchin and Sosyura 2012; Blau et al. 2013; Tahoun and van Lent 2013) and conjecture that lenders may rely on an implicit guarantee from politicians that politically connected firms will have access to government funds in case of financial distress. My results provide support for this theory as lenders appear willing to forego the contracting benefits of conservatism for POFs.

Third, this study contributes to the literature on the outcomes associated with politician participation in U.S. financial markets. A number of studies in economics and finance find that both politicians (Ziobrowski et al. 2004, 2011; Eggers and Hainmueller 2013) and firms (Tahoun 2013; Tahoun and van Lent 2013) obtain economic benefits as a result of these relationships. I add to this literature by showing that these relationships also impact firms in their interactions with other capital market participants. Documenting this relationship is important because it sheds light on the potential substitutive role of political connections and accounting information.

The remainder of this paper is organized as follows. Section 2 discusses related literature and develops hypotheses. Section 3 describes the research design, and Section 4 describes the data. Section 5 reports the empirical results, and Section 6 concludes

2. Hypothesis development

Watts (2003) advances four explanations for conservative financial reporting: contracting, litigation, taxation, and political costs. Below, I discuss how politicians' equity holdings potentially impact the contracting and political costs based demand for conservatism.

2.1. Contracting explanation

A large literature views debt holders as the primary contracting party that drives the demand for conservatism (Watts 2003; Ball et al. 2008).⁵ Nikolaev (2010) notes conservative financial reporting enhances the efficiency of debt contracting in two ways. First, by incorporating negative economic news in a timely fashion, it facilitates the early transfer of decision rights to lenders and, therefore, mitigates the agency costs of debt. Second, by reducing the signalling costs associated with covenant use, it facilitates contracting on covenants.

⁵ Recent research finds that equity investors also demand conservatism (e.g., Ahmed and Duellman 2007; LaFond and Roychowdhury 2008; LaFond and Watts 2008; Ramalingegowda and Yu 2012; Kim et al. 2013).

Consistent with this contracting role, prior research finds more conservatism in institutional settings with significant benefits to lenders (Ahmed et al. 2002; Ball et al. 2008; Beatty et al. 2008; Wittenberg-Moerman 2008; Zhang 2008; Nikolaev 2010; Haw et al. 2013; Tan 2013).

Lenders primary motivation in demanding conservatism is to ensure that the borrower has a minimum amount of net assets to repay the contracted sum. Thus, across firms, lenders demand for conservative reporting increases with the likelihood that the borrower will have insufficient net assets to cover its loans (Watts 2003). For example, debt market participants demand more conservative financial reports from borrowers with higher downside default risk, including borrowers that have greater bondholder-shareholder conflicts (Ahmed et al. 2002), lower levels of private lender monitoring (Nikolaev 2010), and covenant violations (Tan 2013).

Lenders may be less concerned about the downside default risk of POFs for several reasons. First, politically connected firms derive economic benefits from their political ties, in the form of preferential access to government contracts (Goldman et al. 2013; Tahoun 2013) and protection from competition, taxes, and regulation (Hansen et al. 2005).^{6,7} As a result of these political favors, POFs tend to be more profitable and less likely to be financially distressed.⁸

⁶ As a specific example, Senator Dianne Feinstein (D-CA) has on three separate occasions faced allegations of conflicts of interest in granting government contracts to companies owned by her husband, Richard C. Blum. From 2001 to 2005, Senator Feinstein chaired a subcommittee which granted military contracts worth over \$1.5 billion to URS Corporation and Perini, both partially owned by her husband.. In April 2009, the *Washington Times* reported that Senator Feinstein intervened on behalf of the Federal Depositary Insurance Corporation (FDIC) to direct \$25 billion of TARP funds to the agency. FDIC had recently awarded CB Richard Ellis Group, a company in which Richard Blum served as board chairman, a lucrative government contract. In November 2009, Senator Feinstein and her husband invested \$1 million into Amyris Biotechnologies; several weeks later, Amyris received a \$24 million grant from the Department of Energy. For details: <http://www.breitbart.com/Big-Government/2012/06/06/Dianne-Feinstein-Still-Dogged-by-Allegations-of-Conflicts-of-Interest>

⁷ In November 2009, the *Washington Post* reported that when legislation was proposed to impose a \$4 billion tax on medical service firms to help offset the costs of health-care reforms, both Senator John Kerry (D-MA) and Representative James Sensenbrenner (R-WI) spoke out against the proposal. As the *Washington Post* noted, this shared opposition was noteworthy because the two politicians were ideologically juxtaposed, but both had millions invested in firms that make medical devices. For details: http://articles.washingtonpost.com/2009-11-23/politics/36914935_1_medical-devices-lawmakers-medical-device

⁸ In fact, a large and growing literature finds that politically connections have a positive effect on firm value (e.g. Roberts 1990; Fisman 2001; Faccio 2006; Faccio and Parsley 2009; Goldman et al. 2009; and Cooper et al. 2010).

Lenders may factor these implicit advantages into their assessment of default risk, leading to a lower demand for conservatism.⁹ Second, if POFs find themselves in financial trouble, they can look to their political allies for ex post financial assistance. In particular, an overwhelming number of studies document that politically connected firms, including POFs, are more likely to receive government bailouts during periods of financial distress (Faccio et al. 2006; Duchin and Sosyura 2012; Blau et al. 2013; Tahoun and van Lent 2013).¹⁰ Political pressure and intervention on behalf of POFs may act as an insurance mechanism against extreme events, mitigating the need for lenders to demand conservatism from POFs. Third, lenders may grant favors to POFs, such as allowing them to report less conservatively, as a means to build up their own political connections.¹¹ Political connections are valuable to lenders in securing bailouts, receiving priority in bankruptcy proceedings of borrowers, and obtaining government contracts.^{12,13}

The above discussion suggests that lenders will be less concerned with downside default risk for POFs. As a result, the demand for conservative reporting, incorporated in debt contracts, will be weaker for POFs than for non-POFs.

⁹ Houston et al. (2012) provide evidence that U.S. lenders offer politically connected firms contracting arrangements (in the form of restrictions and covenants) which incorporate their lower downside default risk.

¹⁰ As a specific example, Representative Maxine Waters (D-CA) arranged for a series of meetings in late 2008 between the Department of Treasury and OneUnited Bank, a firm in which she and her husband had an ownership stake. The Chief Executive Officer of OneUnited used the meeting as a platform to ask for bailout funds under TARP; in December 2008, OneUnited secured \$12.1 million in bailout funds from the federal government. For details: <http://www.businessinsider.com/the-most-corrupt-members-of-congress-2009-9#rep-maxine-waters-d-ca-14>

¹¹ While the U.S. does not have government owned banks, politicians may still be able to influence the behavior of lenders because lenders are also regulated by the same politicians that borrowers are politically connected with. For example, In February 1990, it was reported that a consortium of banks, heading by Huntington National Bank, issued a \$3.5 million loan to a private, nonprofit group Hameroff/Milenthal/Spence to sponsor a Chinese exhibition in Ohio. It was alleged that the group obtained financing simply because of close political ties between the group's Chairman David Milenthal and Governor Richard Celeste (*Business First – Columbus*, February 12, 1990).

¹² The controversy surrounding the Chrysler reorganization helps to highlight the risk for creditors of not being politically connected. Bankruptcy law generally requires that a debtor's senior creditors be repaid, in full, before its junior creditors receive anything. In the case of Chrysler, the government controlled the reorganization, and granted the politically powerful United Auto Workers (UAW) labor union (a junior creditor) priority over the other (senior) creditors. While UAW received majority ownership of Chrysler, \$1.5 billion in cash and a \$4.6 billion note, the remaining creditors received only \$2 billion of the \$6.9 billion they were owed (or \$0.29 for every \$1.00 owed) For details: <http://capitalresearch.org/2010/07/the-auto-industry-bailout-how-the-shrinking-uaw-buys-influence/>

¹³ Butler et al. (2009) find political connections can help banks obtain underwriting contracts in municipal bonds. As specific examples, see: <http://online.wsj.com/article/0,,SB111170689163689225,00.html>

2.2. *Political costs explanation*

In contrast to the negative association predicted by the contracting explanation, the political costs explanation predicts a positive association between politician ownership and conservatism. Politicians face asymmetric costs associated with incorporating bad news versus good news into financial reports (Watts 2003; Guay and Verrecchia 2006). Specifically, politicians are more susceptible to voter criticism when bad news is not incorporated into financial statements than when good news is not incorporated. Voters learn of delayed loss recognition when instances of overstated assets and income are revealed. Voter scrutiny will be particularly high when politicians have traceable links to firms overstating assets and income, as is the case when politicians invest in particular firms.¹⁴ Conservatism reduces the political costs incurred by politicians because voters value its ability to offset managerial bias in financial reporting (Watts 2003). Therefore, politicians potentially demand conservative financial reporting from POFs to satisfy constituents.

The political costs explanation is a joint test of the following assumptions: (1) voters can observe (ex post) which firms have overstated assets and income; (2) overstated assets and income anger voters; (3) angry voters will impose costs on politicians when they observe instances of overstated assets and income; and (4) voters are aware of firm-politician affiliations and impose higher costs on affiliated politicians. To elaborate on the arguments put forth by Watts (2003) and Guay and Verrecchia (2006), I discuss each of these assumptions in turn.¹⁵

¹⁴ In 2002, the *Wall Street Journal* reported of the close, personal ties (including stock holdings) between then President George W. Bush, Vice-President Dick Cheney and Kenneth Lay, CEO and Chairman of Enron. Voters were angered by the Enron scandal and the *Wall Street Journal* urged, “let’s not let the politicians off the hook; they’re culpable too”. For details: <http://online.wsj.com/article/SB1011226990470237760.html>

¹⁵ Zhang (2008) notes conservatism can be costly because it increases the likelihood of debt covenant violations, and imposes explicit (compensation) and implicit (labor market consequences) costs on managers. As long-term relationships with politicians are difficult to establish and politicians can offer valuable policy favors (Kroszner and Stratmann 1998), managers have incentives to make accounting choices that minimize political costs for politicians (Ramanna and Roychowdhury 2010). Since politically active firms are under public scrutiny themselves, it is also in

The information voters use to make voting decisions is often obtained from the media (e.g., Watts 1977; Guay 2010; Bonaparte and Kumar 2013). The media is thus an important information intermediary and fulfills two primary roles. In its rebroadcasting role, the media disseminates information generated by other information intermediaries (Miller 2006). Since accounting scandals discovered by auditors, analysts, or regulators typically involve the overstatement of assets and income (e.g., Feroz et al. 1991; Palmrose et al. 2004), the media rebroadcasts information on firms with overstated assets and income. In its information role, the media undertakes original investigation and analysis. In this role, the media initiates coverage on firms with questionable accounting practices which benefit management (Miller 2006). Since managers generally have incentives to overstate, rather than understate, assets and income, the media also provides voters with original information on firms with overstated assets and income. Through the media, voters can observe instances where firms have not been conservative.

Voters are angered by overstated assets and income because these overstatements can generate large losses for voters (Watts 2003). In the extreme case, overstated assets and income can result in the dissolution of a firm. Since voters value greater employment (Schleifer and Vishny 1994), they will be angered by job cuts and lost pensions resulting from firm dissolution. Similarly, since voters are more active in equity markets than non-voters (Bonaparte and Kumar 2013), they will be angered by the large financial losses they incur as a result of accounting scandals.¹⁶ In contrast, voters will not be as angered with losses arising from understated assets and income because these losses will not materially impact their personal welfare (Watts 1977).

their best interest to adopt conservatism (Kong et al. 2013). Thus, POF firm managers may supply conservatism with the dual objective of minimizing political costs for themselves and their political allies.

¹⁶ In light of the accounting scandals involving Enron, Worldcom, Tyco, corporate accountability became a major election issue in the 2002 mid-term elections. To minimize voter ire, politicians moved quickly to enact reforms to securities laws (e.g., Sarbanes Oxley Act of 2002) and pension and retirement rules.

As voters lack the sophistication to unravel managers' tendency to bias accounting numbers upwards, they expect individuals overseeing financial markets (i.e. standard-setters, regulators, and politicians) to provide this financial discipline (Guay and Verrecchia 2006). When voters learn of losses from overstated assets and income, they are likely to take their anger out, in part, on politicians (Ramanna and Roychowdhury 2010). As noted in Ovtchinnikov and Pantaleoni (2012), voters can impose costs on politicians through organized protests, or the power of their wallet and/or vote. For example, voters may reduce contributions to politicians' election campaigns. This will be costly to politicians as individual contributions represent the largest source of campaign financing and can influence election outcomes. Similarly, politicians' electoral prospects can be adversely impacted by organized protests and lost votes.

Voters can identify links between politicians and firms in a number of ways, including reports issued by financial analysts (Knight 2007), watchdog groups (i.e. Center for Political Accountability), or the media (Ramanna and Roychowdhury 2010).¹⁷ Voters will impose particularly high political costs on affiliated politicians because connections are taken to mean that the politician condones activities by the firm that generate losses for voters (Guay 2010).

2.3. *Prediction*

In summary, POFs may have less conservative financial reporting if lenders are less concerned about downside default risk, or more conservative financial reporting if politicians demand conservative reporting to defend themselves against voter scrutiny. Of course, a third possibility is that politician ownership has no association with accounting conservatism. In particular, the relatively low economic magnitude of politician ownership documented in this and other studies (Eggers and Hainmueller 2013; Tahoun 2013) may reduce the efficacy of the

¹⁷ On November 13, 2011, 60 minutes, a nationally televised news program, reported that several members of Congress used inside information to personally benefit their stock portfolios.

political connection and lead to trivial differences in the behavior of lenders, politicians, and/or firm managers. As a result of these competing explanations, I make a non-directional prediction:

H1: Ownership by politicians is associated with conservatism.

In the above hypothesis, conservatism is defined as the imposition of stricter verification standards for recording good news as gains than for recording bad news as losses, generally referred to as conditional conservatism. I focus on conditional, rather than unconditional, conservatism as I expect both the contracting and political costs channels to generate a demand for the conditional form. Under the contracting perspective, conditional conservatism is more desirable for lenders because it constrains managers' opportunistic reporting and investment decisions while unconditional conservatism decreases contracting efficiency by adding noise to payoffs to contracting parties (Qiang 2007; Zhang 2008). Under the political costs perspective, voters are primarily motivated by a desire to constrain opportunistic managerial behavior (Watts 2003), which can best be achieved through conditional conservatism as unconditional conservatism can induce myopic managerial investment decisions (LaFond and Roychowdhury 2008).¹⁸ As a result, I focus my subsequent discussion and analyses on conditional conservatism.

3. Research design

3.1. Measure of politician ownership

The Ethics in Government Act of 1978 requires members of Congress (as well as other government officials) to file annual reports disclosing their income, assets, liabilities and other details about their personal finances. These disclosures report each member's year-end holdings

¹⁸ Alternatively, Qiang (2007) argues that political costs induce a demand for unconditional conservatism as voters are averse to large negative shocks associated with conditional conservatism (i.e. impairment accounting).

and a list of transactions executed throughout the year. The financial disclosure reports are as of December 31 and are required to be filed by May 15th of the following year. I obtain data on politicians' equity holdings from annual financial disclosure reports filed by members of the House and Senate and compiled by the Center for Responsive Politics.¹⁹ Both House and Senate members are active in equity markets (e.g., Ziobrowski et al., 2004; Ziobrowski et al., 2011). Therefore, I include the equity holdings of both in defining the ownership variables. *POLOWN* is measured as an indicator variable equal to 1 if firm *i*'s shares are owned by at least one member of the U.S. House or Senate at the end of year *t-1*, and 0 otherwise.²⁰

3.2. *Measure of conservatism*

I measure conservatism using Basu's (1997) earning-return model, which regresses earnings on returns and allows the coefficient on returns to vary by sign. This model uses positive (negative) stock returns to measure good (bad) economic news. Specifically, Basu (1997) estimates the following regression model:

$$NI_{it} = \alpha_0 + \alpha_1 NEG_{it} + \alpha_2 RET_{it} + \alpha_3 RET_{it} * NEG_{it} + \varepsilon_{it} \quad (1)$$

where:

NI_{it} = annual income before extraordinary items (IB) of firm *i* in year *t*, scaled by the market value of equity ($CSHO * PRCC_F$) at the end of year *t-1*;

RET_{it} = buy-and-hold- stock returns of firm *i* over year *t*; and

NEG_{it} = indicator variable equal to 1 if RET_{it} is negative, and 0 otherwise.

¹⁹ My use of politician ownership as a measure of political connections is motivated by research in political economy which finds that self-interested politicians make decisions based on a number of (often competing) considerations, including: (1) the economic interests of their constituents, (2) special interests, (3) and their own personal wealth interests (Mian et al. 2010; Tahoun and van Lent 2013). As politicians disproportionately invest in local and contributing firms (Eggers and Hainmueller 2013), an ownership based measure of connections provides a rare opportunity to identify congruence between a firm and politician across all three dimensions. In contrast, other possible measures based on campaign contributions (Cooper et al. 2010), lobbying expenditures (Yu and Yu 2010), or board connections (Goldman et al. 2009) capture only a subset of factors that impact politician decision-making.

²⁰ Following Cooper et al. (2010), I use the number of politician investors as an alternative measure of ownership.

In equation (1), α_2 captures the timeliness of earnings with respect to good news (or positive returns), and α_3 captures the incremental timeliness of earning with respect to bad news (or negative returns). The asymmetric timeliness coefficient, α_3 , measures conservatism.

3.3. Regression model

To test the relation between politician ownership and conservatism, I follow prior research and estimate the Basu model, which specifies conservatism (the Basu coefficient) as a function of politician ownership and other common determinants of conservatism:

$$\begin{aligned}
 NI_{it} = & \alpha_0 + \alpha_1 RET_{it} + \alpha_2 NEG_{it} + \alpha_3 RET_{it} * NEG_{it} + \alpha_4 POLOWN_{it-1} + \alpha_5 RET_{it} * POLOWN_{it-1} \\
 & + \alpha_6 NEG_{it} * POLOWN_{it-1} + \alpha_7 RET_{it} * NEG_{it} * POLOWN_{it-1} \\
 & + \alpha_{8-11} CONTROLS_{it-1} + \alpha_{12-15} NEG_{it} * CONTROLS_{it-1} \\
 & + \alpha_{16-19} RET_{it} * CONTROLS_{it-1} + \alpha_{20-23} RET_{it} * NEG_{it} * CONTROLS_{it-1} + \varepsilon_{it} \quad (2)
 \end{aligned}$$

where control variables include:

MV_{it-1} = Market value of equity (CSHO*PRCC_F) of firm i at year $t-1$;

MB_{it-1} = Market-to-book ratio (MV / CEQ) of firm i at year $t-1$;

LEV_{it-1} = Leverage ((DLTT+ DLC) / MV) of firm i at year $t-1$; and

LIT_{it-1} = Indicator variable equal to 1 if firm i belongs to the following industries at year $t-1$: Biotechnology (SIC codes 2833-2836 and 8731- 8734), Computers (SIC codes 3570-3577 and 7370-7374), Electronics (SIC codes 3600-3674), and Retailing (SIC codes 5200-5961), and 0 otherwise.

In Equation (2), all variables are measured at the firm-year level, and the conservatism measure is allowed to vary with politician ownership in each firm-year. The coefficient of interest is α_7 , which captures the effect of politician ownership in firm i at year $t-1$ ($POLOWN_{it-1}$) on conservatism in firm i 's reporting over year t . A negative α_7 would be consistent with the contracting explanation and suggest that politician ownership reduces lenders concerns about downside default risk, leading to a lower demand for conservatism among POFs. Alternatively, a

positive α_7 consistent with the political costs explanation and suggest that ownership subjects politicians to voter scrutiny, leading to a greater demand for conservatism among POFs

I control for firm size (*MV*), market-to-book (*MB*), leverage (*LEV*), and litigation (*LIT*). *MV* is negatively associated with conservatism (e.g. Givoly et al. 2007; LaFond and Watts 2008), possibly because it proxies for lower information asymmetry. *MB* reflects past asymmetric timeliness and growth options, both of which negatively affect future asymmetric timeliness of earnings (Roychowdhury and Watts 2007).²¹ I include *LEV* because prior research documents that debt contracting creates a demand for conservatism (Watts, 2003). Greater litigation risk creates a noncontracting demand for conservatism (e.g., Basu 1997; Watts, 2003) so I include an indicator variable (*LIT*) that captures membership in high-litigation-risk industries (Francis et al. 1994).²²

4. Data and descriptive statistics

As in prior research (LaFond and Roychowdhury 2008; Ramalingegowda and Yu 2012), I focus on a sample of S&P 1500 firms. The sample consists of 7,980 firm-years from 1,540 firms in the S&P 1500 index (S&P 500, S&P Mid Cap 400, and S&P Small Cap 600 indexes) covering the period 2005-2011.²³ These are non-financial firms that have the required financial accounting data from Compustat and stock price data from CRSP. I summarize the sample selection process in Table 1, Panel A.

²¹ *MB* can also be thought of as a proxy for unconditional conservatism. Beaver and Ryan (2005) and Qiang (2007) find that unconditional conservatism lowers book values, thereby reducing subsequent conditional conservatism. This implies that there is a negative correlation between the two forms of conservatism and controlling for this interrelation can help to properly identify the effect of a given factor on conditional conservatism.

²² The results are robust to controlling for equity holders' demand for conservatism, as measured by managerial ownership. LaFond and Roychowdhury (2008) argue that as managerial ownership decreases, the severity of agency problems between managers and shareholders increases, generating a demand for conservatism.

²³ The results are robust to excluding firm-years from the financial crisis period (calendar 2007 or 2008).

I obtain data on beginning-of-year politician ownership for 2005-2012 from a hand-collected data set of politicians' equity holdings from annual financial disclosure reports filed by members of U.S. House and Senate. POFs refer to firms whose shares are owned by at least one member of the U.S. House or Senate. Panel B of Table 1 tabulates the industry distribution by firm type. Of the 7,980 firm-year observation in the S&P 1500 index, 57% are POFs observations. I find a larger percentage of POFs in the Mining, Communications and Utilities industries in the sample. These results are not surprising as firms in these industries are likely to have greater interactions with legislators and the government.

In untabulated analysis, I find that the mean dollar value of equity holdings by all politicians is \$363,011, which is approximately 0.006% of the market value of equity, while the mean number of politician equity investors is 3.38. These variable exhibit considerable skewness in that the median values are only \$4,453, 0.001%, and 1, respectively.²⁴ The relatively low values of politician ownership in my sample is in part a result of my focus on S&P 1500 firms, which biases the sample towards larger firms where wealth constraints restrict the level of politician ownership. Further, the strength of the economic ties between politicians and firms is likely understated in the ownership data as politicians disproportionately invest in firms with which they have other links, such as local and contributing firms (Eggers and Hainmueller 2013). The relatively low variation in politician ownership potentially biases against finding an association between politician ownership and conservatism.

Panel A of Table 2 presents the descriptive statistics of firm characteristics and control variables, separately for POFs and non-POFs. Consistent with prior studies on politically connected firms (Cooper et al. 2010), I find that POFs exhibit better operating performance, have

²⁴ LaFond and Roychowdhury (2008) report that managerial ownership also exhibits considerable skewness, as the mean (median) value for their measure of top 5 manager ownership is 4.5% (0.9%). Similarly, managerial ownership in their sample firms is of relatively low economic magnitude.

lower buy and hold returns, are more leveraged, and are larger than non-POFs. Panel B of Table 2 presents the correlations among the variables. Consistent with Panel A, the politician ownership indicator is positively correlated with *NI* and *MV*, and negatively correlated with *RET*. Most of the correlations among control variables are small, and thus, multicollinearity is not an issue.

5. Results

5.1. Tests of the relation between conservatism and politician ownership

To test H1, I estimate equation (2) using pooled OLS regressions. I correct standard errors for correlation across observations of a given firm and across observations of a given year by clustering on both firm and year (Petersen 2009).²⁵ To mitigate the influence of outliers, I use Cook's (1977) distance (Cook's *D*) method to remove outliers.²⁶

Table 3 reports the estimation results. Column (1) uses the binary politician ownership variable. The coefficient α_3 has a positive and statistically significant value of 0.25, in line with findings in Basu (1997). This coefficient decreases in the *POLOWN* variable, as suggested by the coefficient α_7 , and is significantly negative at the 1% level. This result indicates that politician ownership is associated with lower levels of financial reporting conservatism, as predicted by the contracting explanation. Column (2) augments the base model by adding size, market-to-book ratio, leverage, and litigation risk along with their respective interactions with *RET*, *NEG*, and *RET*NEG*. Consistent with prior research, I find that conservatism increases with leverage and

²⁵ Peterson (2009) demonstrates that clustering on both firm and time is not superior to clustering on firm alone when there is little within-time correlation in the errors. As I use annual measures of returns rather than multi-year accumulations as the dependent variable, firm-level clustering may be more appropriate in my setting. The results are robust to using firm-level clustering.

²⁶ I use a Cook's distance of $4/(n-k-1)$ as the cut-off for identifying an observation as an outlier, where n = number of observations and k = number of independent variables, as suggested by Belsley et al. (2005).

litigation risk, and decreases with size and market-to-book ratio. Although including these other common determinants of conservatism in the regression increases explanatory power (the adjusted R^2 increases by 6%), the main results remain qualitatively unchanged. The results based on the count measure of politician ownership, reported in columns (3) and (4), yield similar inferences.

To gauge the economic significance of my findings on politician ownership, I follow the approach used in Nikolaev (2010) and compare coefficient estimates of α_7 to those of α_3 . In column (2), the magnitude of α_7 is -0.072, which suggests that politician ownership is associated with an economically important 0.07 (or 64% of α_3) decrease in accounting conservatism. The magnitude of α_7 is -0.011 in column (4), which suggests that adding 8 politician investors (i.e., close to one standard deviation) yields a 0.09 (or 88% of α_3) decrease in conservatism.

To summarize, using Basu's (1997) earning-return model of conservatism, I find strong evidence that POFs adopt less conservative accounting than non-POFs. These results are consistent with the contracting explanation of conservatism, namely that lenders demand less conservatism from POFs because they are less concerned about downside default risk, and inconsistent with the positive association predicted by the political costs explanation.

5.2. *Further partitioning of POFs into local and distant POFs*

In this subsection, I examine whether the impact of politician ownership on accounting conservatism varies with the nature of the politician-firm connection. Prior research finds that politicians exert greater effort on initiatives that benefit the local constituency (Kroszner and Stratmann 1998) and, as a result, there is a tighter link between politicians and firms headquartered in his or her district (Roberts 1990; Faccio and Parsley 2009; Duchin and Sosyura 2012; Acemaglou et al. 2013; Eggers and Hainmueller 2013). This evidence suggests politicians

should have stronger incentives to aid local firms, especially in periods of financial distress.²⁷ Capital market participants are aware of the strength of these local ties (Roberts 1990; Faccio and Parsley 2009; Acemaglou et al. 2013), suggesting lenders are likely to be less concerned with the downside default risk of local POFs, and consequently, to demand less conservative reporting from local POFs than distant POFs.²⁸ I estimate the following regression to test this prediction:

$$\begin{aligned}
NI_{it} = & \alpha_0 + \alpha_1 RET_{it} + \alpha_2 NEG_{it} + \alpha_3 RET_{it} * NEG_{it} + \alpha_4 LPOLOWN_{it-1} + \alpha_5 RET_{it} * LPOLOWN_{it-1} \\
& + \alpha_6 NEG_{it} * LPOLOWN_{it-1} + \alpha_7 RET_{it} * NEG_{it} * LPOLOWN_{it-1} + \alpha_8 DPOLOWN_{it-1} \\
& + \alpha_9 RET_{it} * DPOLOWN_{it-1} + \alpha_{10} NEG_{it} * DPOLOWN_{it-1} \\
& + \alpha_{11} RET_{it} * NEG_{it} * DPOLOWN_{it-1} + \alpha_{12-15} CONTROLS_{it-1} \\
& + \alpha_{16-19} NEG_{it} * CONTROLS_{it-1} + \alpha_{20-23} RET_{it} * CONTROLS_{it-1} \\
& + \alpha_{23-26} RET_{it} * NEG_{it} * CONTROLS_{it-1} + \varepsilon_{it}
\end{aligned} \tag{3}$$

where *LPOLOWN* and *DPOLOWN* measure ownership by local and distant politicians, respectively. *LPOLOWN*_{*it-1*} is an indicator variable equal to 1 if firm *i*'s shares are owned by at least one member of the U.S. House or Senate who resides over the congressional district in which the firm is headquartered at the end of year *t-1*, and 0 otherwise. *DPOLOWN*_{*it-1*} is an indicator variable equal to 1 if *LPOLOWN*_{*it-1*} equals 0 and firm *i*'s shares are owned by at least one member of the U.S. House or Senate at the end of year *t-1*, and 0 otherwise. I expect the coefficients on *RET*_{*it*} * *NEG*_{*it*} * *LPOLOWN*_{*it-1*} and *RET*_{*it*} * *NEG*_{*it*} * *LPOLOWN*_{*it-1*} to be negative. More

²⁷ As a specific example, 12 banks in Ohio received TARP funds after Ohio politicians complained about the federal government's treatment of Ohio-based National City Corp. Regulators refused to provide government funds to the bank and subsequently forced it into a merger. Ohio's congressional delegation lobbied on behalf of other Ohio banks and threatened to hold hearings outlining how the government had failed National City Corp if other Ohio-based banks were not supported. For details: <http://online.wsj.com/news/articles/SB123258284337504295>

²⁸ Acemaglou et al. (2013) examine changes in credit default swap (CDS) spreads around events that increased the probability of Timothy Geithner becoming Treasury Secretary and find CDS spreads decreased for firms headquartered in New York City, where Geithner was located, relative to other firms. This evidence is consistent with creditors impounding a lower level of downside default risk for firms with ties to local government officials.

importantly, if lenders demand less conservative accounting from local POFs, I should observe $\alpha_7 < \alpha_{11}$.

I report the results of estimating equation (3) in Table 4. In column (1), I find that both α_7 and α_{11} are significantly negative, consistent with the results in Table 3 that POFs adopt less conservative accounting than non-POFs (p -values = 0.00 and 0.00, respectively). Furthermore, α_7 is significantly less than α_{11} (p -value = 0.00), implying that lenders have weaker demand for conservatism from local POFs than distant POFs. The second column indicates that these results are robust to including the control variables, *MV*, *MB*, *LEV*, and *LIT*. Interestingly, the coefficient on α_7 is -0.132 (or 100% of α_3), which suggests that local politician ownership completely mitigates lenders demand for conservative financial reporting. In contrast the coefficient on α_{11} is -0.076 (or 58% of α_3), indicating that distant politician ownership weakens, but does not eliminate, lenders demand for conservatism. I conclude that there is cross-sectional variation in the demand for accounting conservatism based on the strength of the economic connection between the politician investor and the POF, as measured by local ties.

5.3. *Linking the evidence to the debt market*

The results from Tables 3 and 4 point to a negative association between politician ownership and conservatism. However, the tests do not explicitly link the results to a reduced debt contracting demand for conservatism. In this subsection, I perform an additional test to provide confirmatory evidence that POFs are less conservative in their reporting because of a reduced demand from lenders. If the results from the above analyses are due to lenders being less concerned about downside default risk for POFs, I should observe a stronger association between politician ownership and accounting conservatism for firms that interact more extensively with debt market participants who value the contracting benefits of conservative financial reporting.

I use the existence of an S&P long-term issuer credit rating to capture the debt market's interest in conservatism. Almost all firms with an issuer credit rating have public debt outstanding (Cantillo and Wright 2000; Rauh and Sufi 2010), and recent research finds that public bondholders have a greater demand for conservatism than other lenders because they have limited access to other monitoring mechanisms (Nikolaev 2010; Haw et al. 2013). In particular, public bondholders have a greater demand for conservatism because, in contrast to private lenders, they lack timely inside information, have weaker incentive to monitor managers, and exercise less control over managers' actions (Nikolaev 2010). In addition, credit rating agencies are also an important source of demand for conservatism (Bae et al. 2013). Credit rating agencies, such as S&P, are primarily interested concerned with assessing downside default risk and therefore demand conservative financial reporting as an input to their rating process.

To test this prediction, I reestimate equations (2) and (3), and interact the main variables of interest ($RET_{it} * NEG_{it} * POLOWN_{it-1}$ in equation (2) and $RET_{it} * NEG_{it} * LPOLOWN_{it-1}$ and $RET_{it} * NEG_{it} * DPOLOWN_{it-1}$ in equation (3)) with $RATING_{it-1}$, an indicator variable equal to 1 if firm i has an S&P long-term issuer credit rating at the end of year $t-1$, and 0 otherwise. While I interact only $RATING_{it-1}$ with the main variables of interest to maintain a parsimonious model, my findings are not sensitive to this research design choice.

Table 5 present the results. In column (1), I find that the coefficient on $RET_{it} * NEG_{it} * POLOWN_{it-1}$ is significantly negative, consistent with the results in Table 3 that POFs adopt less conservative accounting than non-POFs (p -value = 0.00). The coefficient on $RET_{it} * NEG_{it} * POLOWN_{it-1} * RATING_{it-1}$ (p -value = 0.04) is negative and statistically significant. This finding suggests that the negative association between politician ownership and conservatism is strengthened by the extent to which the firm interacts with debt market

participants that value the contracting benefits of conservatism. Columns (2) yield similar inferences, as the coefficients on $RET_{it} * NEG_{it} * LPOLOWN_{it-1}$, $RET_{it} * NEG_{it} * DPOLOWN_{it-1}$, $RET_{it} * NEG_{it} * LPOLOWN_{it-1} * RATING_{it-1}$ and $RET_{it} * NEG_{it} * DPOLOWN_{it-1} * RATING_{it-1}$ are all negative and statistically significant (p-values = 0.00, 0.00, 0.06, and 0.01, respectively). Overall, this analysis provide confirmatory evidence that the negative association between politician ownership and conservatism can be attributed to debt market participants being less concerned about downside default risk for POFs than non-POFs.

5.4. *Establishing the direction of association*

A negative relation between politician ownership and conservatism is consistent with lenders demanding less conservatism from POFs as a result of being less concerned about downside default risk. However, it may be the case that firms with less conservative financial reporting attract investment by politicians. This “reverse causality” explanation is plausible as firms with lowers levels of (ex-ante) financial reporting quality may be more likely to establish political connections (Chaney et al. 2011). In addition, conservatism and ownership by politicians could arise simultaneously, driven by some unknown underlying factor (the "simultaneity" explanation).

In this subsection, I perform a test to provide evidence on the direction of association between politicians’ equity holdings and conservative reporting. Following Ramalingegowda and Yu (2012), I add politicians’ *current* and *lead* ownership (i.e., $POLOWN_{it}$ and $POLOWN_{it+1}$) to Equation (2) to examine how the level of conservatism is related to lagged, current, and lead ownership by politicians:

$$\begin{aligned}
NI_{it} = & \alpha_0 + \alpha_1 RET_{it} + \alpha_2 NEG_{it} + \alpha_3 RET_{it} * NEG_{it} + \alpha_4 POLOWN_{it-1} + \alpha_5 RET_{it} * POLOWN_{it-1} \\
& + \alpha_6 NEG_{it} * POLOWN_{it-1} + \alpha_7 RET_{it} * NEG_{it} * POLOWN_{it-1} + \alpha_8 POLOWN_{it} \\
& + \alpha_9 RET_{it} * POLOWN_{it} + \alpha_{10} NEG_{it} * POLOWN_{it} \\
& + \alpha_{11} RET_{it} * NEG_{it} * POLOWN_{it} + \alpha_{12} POLOWN_{it+1} + \alpha_{13} RET_{it} * POLOWN_{it+1} \\
& + \alpha_{14} NEG_{it} * POLOWN_{it+1} + \alpha_{15} RET_{it} * NEG_{it} * POLOWN_{it+1} \\
& + \alpha_{16-19} CONTROLS_{it-1} + \alpha_{20-23} NEG_{it} * CONTROLS_{it-1} \\
& + \alpha_{24-27} RET_{it} * CONTROLS_{it-1} + \alpha_{28-31} RET_{it} * NEG_{it} * CONTROLS_{it-1} + \varepsilon_{it} \quad (4)
\end{aligned}$$

In Equation (4), α_7 , α_{11} , and α_{15} capture the relation between conservatism and politicians' lagged, current, and lead ownership, respectively. If lenders demand less conservatism from POFs, I would expect $\alpha_7 > 0$. In contrast, the reverse causality explanation would predict $\alpha_{15} > 0$. Evidence of $\alpha_{11} > 0$ would be consistent with the simultaneity explanation.

Table 6 reports the results from estimating equation (4). Consistent with lenders demanding less conservative reporting from POFs, I find a significant negative relation between conservatism and *lagged* politician ownership (p -values = 0.01 and 0.00 in columns (1) and (2), respectively). In contrast, the relation between conservatism and current (p -values = 0.16 and 0.22, respectively) and lead politician ownership (p -values = 0.70 and 0.97, respectively) is insignificant, providing no support for the reverse causality or simultaneity explanations. While I cannot definitively rule out these alternative explanations, the evidence suggests that the direction of the relation goes from politician ownership to conservatism, rather than the reverse or arising simultaneously.

5.5. *Alternative measure of accounting conservatism*

In the subsection, I assess the robustness of the results to another commonly used measure of conditional conservatism that does not rely on stock returns: the earnings-change model (Basu 1997; Ball and Shivakumar 2005). It measures timely gain and loss recognition as

the tendency for increases and decreases in earnings to reverse. Greater conservatism leads to lower persistence of earnings changes, implying that bad (good) news incorporated in current earnings will appear as a transitory (permanent) shock in the earnings process. Similar to Equation (2), I extend the basic earnings-change model as follows:

$$\begin{aligned}
\Delta NI_{it+1} = & \alpha_0 + \alpha_1 \Delta NI_{it} + \alpha_2 NEG_{it} + \alpha_3 \Delta NI_{it} * NEG_{it} + \alpha_4 POLOWN_{it-1} + \alpha_5 \Delta NI_{it} * POLOWN_{it-1} \\
& + \alpha_6 NEG_{it} * POLOWN_{it-1} + \alpha_7 \Delta NI_{it} * NEG_{it} * POLOWN_{it-1} + \alpha_{8-11} CONTROLS_{it-1} \\
& + \alpha_{12-15} NEG_{it} * CONTROLS_{it-1} + \alpha_{16-19} \Delta NI_{it} * CONTROLS_{it-1} \\
& + \alpha_{20-23} \Delta NI_{it} * NEG_{it} * CONTROLS_{it-1} + \varepsilon_{it}
\end{aligned} \tag{5}$$

where (the control variables are the same as in Equation (2)):

ΔNI_{it} = Change in annual net income before extraordinary items (IB) of firm i from year $t-1$ to t , scaled by total assets (AT) at the end of year $t-1$; and

NEG_{it} = Indicator variable equal to 1 if ΔNI_{it} is negative, and 0 otherwise.

In Equation (5), α_7 captures the association between politician ownership and conservatism. If greater conservatism leads to lower persistence of earnings changes, $\alpha_7 > 0$ would indicate that conservatism decreases with politician ownership. Table 7 reports the results for estimating Equation (5). Column 1 reports the results for the binary ownership variable, while Column 2 reports the results for the count ownership variable. I find that POFs recognize bad news in a less timely manner than non-POFs (p -values = 0.07 and 0.04 in columns (1) and (2), respectively). Overall, the results from the earnings-change model are consistent with those from the earnings-return model, indicating that the inferences from my main tests are robust to different measures of accounting conservatism.

6. Conclusion

This study investigates the association between U.S. politicians' equity holdings and accounting conservatism for a sample of S&P 1500 firms from 2005 to 2011. My objective is to distinguish between two competing hypotheses: (1) the contracting hypothesis, which predicts that POFs will adopt less conservative reporting because lenders are not as concerned with downside default risk; and (2) the political costs hypothesis, which predicts that POFs will adopt more conservative reporting because politicians value conservatism's ability to reduce the political costs imposed on them by voters.

My analysis demonstrates that POFs, on average, adopt less conservative accounting than non-POFs. I also find that this negative association is more pronounced when politicians invest in firms headquartered in their congressional district. This suggests that lenders demand less conservative accounting from POFs, especially when the interests of the politician and the firm are more strongly aligned. Further, the relation between politician ownership and conservatism is more pronounced for firms with long-term issuer credit ratings, indicating POFs adopt less conservative reporting because of a reduced demand from debt market participants. Taken together, the evidence is consistent with lenders incorporating the implicit advantages of political connections into their assessment of downside default risk.

This study joins a growing empirical literature examining the implications of ownership structure for accounting conservatism (e.g., Ball and Shivakumar 2005; Bushman and Piotroski, 2006; Ahmed and Duellman, 2007; Lafond and Roychowdhury, 2008; Nichols et al., 2009; Chen et al. 2010; Ramalingegowda and Yu, 2012). I build on these prior studies by documenting that political connections arising from politician participation in equity markets impact financial reporting conservatism. This paper also provides evidence to support the theory that lenders rely

on an implicit guarantee from politicians that politically connected firms will have access to government funds in case of financial distress. Finally, this study extends research on the economic consequences of politician ownership by suggesting that these investments can substitute for other mechanisms, such as accounting conservatism, that create benefits for firms in their interactions with capital market participants.

Two main caveats are in order. First, I caution against drawing any causal relation between politician ownership and conservatism based on the results of this study. Although I have performed lead-lag tests to establish the direction of association and controlled for various firm characteristics that are expected to impact the demand for conservatism, other unobservable systematic differences could potentially explain the observed difference in accounting conservatism between POFs and non-POFs. Second, assessing whether the link between politicians and firms arising from politician ownership is sufficiently strong to impose political costs on politicians is difficult to establish. Further, it is possible that voters (and politicians) prefer unconditional conservatism because it results in fewer larger negative shocks in income. Therefore, the extent to which politician ownership correlates with conditional conservatism may not represent the most powerful tests of the political costs explanation of conservatism. These caveats notwithstanding, the results should be of relevance to a broad set of stakeholders, including legislators, capital market participants, regulators, standard-setters and researchers from various disciplines (accounting, finance, political economics and political science), with an interest in analyzing the interactions of politicians and firms.

References

- Acemoglu, A., Johnson, S., Kermani, A., Kwak, J., Mitton, T., 2013. The value of connections in turbulent times: evidence from the United States. Working paper, Massachusetts Institute of Technology, University of Connecticut and Brigham Young University.
- Ahmed, A.S., Billings, B.K., Morton, R.M., Stanford-Harris, M., 2002. The role of accounting conservatism in mitigating bondholder-shareholder conflicts over dividend policy and in reducing debt costs. *The Accounting Review* 77, 867-890.
- Ahmed, A. S., Duellman, S., 2007. Accounting conservatism and board of director characteristics: an empirical analysis. *Journal of Accounting and Economics* 43, 411–437.
- Bae, K., Jong, L., Purda, L., Welker, M., 2013. Credit rating initiation and accounting quality for emerging market firms. *Journal of International Business Studies* 44, 216-234.
- Ball, R., Robin, A., Sadka, G., 2008. Is financial reporting shaped by equity markets or debt markets? An international study of timeliness and conservatism. *Review of Accounting Studies* 13, 168-205.
- Ball, R., Shivakumar, L., 2005. Earnings quality in UK private firms: comparative loss recognition timeliness. *Journal of Accounting and Economics* 39, 83-128.
- Basu, S., 1997. The conservatism principle and the asymmetric timeliness of earnings. *Journal of Accounting and Economics* 24, 3-37.
- Beatty, A., Weber, J., Yu, J.J., 2008. Conservatism and debt. *Journal of Accounting and Economics* 45, 154-174.
- Beaver, W.H., Ryan, S.G., 2005. Conditional and unconditional conservatism: concepts and modeling. *Review of Accounting Studies* 10, 269-309.
- Belsley, D.A, Kuh, E., Welsch, R.E., 2005. *Frontmatter, in Regression Diagnostics: Identifying Influential Data and Sources of Collinearity*. Wiley, New York.
- Blau, B.M., Brought, T.J, Thomas, D.W., 2013. Corporate lobbying, political connections, and the bailout of banks. *Journal of Banking and Finance* 37, 3007-3017.
- Bonaparte, Y., Kumar, A., 2013. Political activism, information costs, and stock market participation. *Journal of Financial Economics* 107, 760-786.
- Bushman, R.M., Piotroski, J.D., 2006. Financial reporting incentives for conservative accounting: the influence of legal and political institutions. *Journal of Accounting and Economics* 42, 107-148.
- Butler, A.W., Fauver, L., Mortal, S., 2009. Corruption, political connections, and municipal finance. *Review of Financial Studies* 22, 2873-2905.

- Cantillo, M., Wright, J., 2000. How do firms choose their lenders? An empirical investigation. *Review of Financial Studies* 13, 155-189.
- Chaney, P.K., Faccio, M., Parsley, D., 2011. The quality of accounting information in politically connected firms. *Journal of Accounting and Economics* 61, 58-76.
- Chen, H., Chen, J.Z, Lobo, G.L., Wang, Y., 2010. Association between borrower and lender state ownership and accounting conservatism. *Journal of Accounting Research* 48, 973-1014.
- Claessens, S, Feijen, E., Laeven, L., 2008. Political connections and preferential access to finance: the role of campaign contributions. *Journal of Financial Economics* 88, 554-580.
- Cook, R.D., 1977. Detection of influential observations in linear regression. *Technometrics* 19, 15-18.
- Cooper, M.J., Gulen, H., Ovtchinnikov, A., 2010. Corporate political contributions and stock returns. *Journal of Finance* 65, 687-724.
- Cull, R. Xu, L.C., 2005. Institutions, ownership and finance: the determinants of profit reinvestment among Chinese firms. *Journal of Financial Economics* 58, 81-112.
- Dinc, S., 2005. Politicians and banks: political influence on government-owned banks in emerging countries. *Journal of Financial Economics* 77, 453-479.
- Duchin, R., Sosyura, D., 2012. The politics of government investment. *Journal of Financial Economics* 106, 24-48.
- Eggers, A., Hainmueller, J., 2013. Political capital: corporate connections and stock investments in the U.S. congress, 2004-2008. Working paper, London School of Economics and Massachusetts Institute of Technology.
- Faccio, M., 2006. Politically connected firms. *American Economic Review* 96, 369-386.
- Faccio, M., Masulis, R.W., McConnell, J.J., 2006. Political connections and corporate bailouts. *Journal of Finance* 61, 2597-2635.
- Faccio, M., Parsley, D.C., 2009. Sudden deaths: taking stock of geographic ties. *Journal of Financial and Quantitative Analysis* 44, 683-718.
- Feroz, E.H., Park, K., Pastena, V.S., 1991. The financial and market effects of the SEC's accounting and auditing enforcement releases. *Journal of Accounting Research*. 29, 107-142.
- Fisman, R., 2001. Estimating the value of political connections. *American Economic Review* 91, 1095-1102.

- Francis, J., Philbrick, D., Schipper, K., 1994. Shareholder litigation and corporate disclosures. *Journal of Accounting Research* 32, 137–64.
- Givoly, D., Hayn, C.K., Natarajan, A., 2007. Measuring reporting conservatism. *The Accounting Review* 82, 65–106.
- Goldman, E., Rochell, J., So., J., 2009. Do politically connected boards affect firm value? *Review of Financial Studies* 22, 2331-2360.
- Goldman, E., Rochell, J., So., J., 2013. Politically connected board of directors and the allocation of procurement contracts. *Review of Finance*, forthcoming.
- Guay, W., 2010. Discussion of elections and discretionary accruals: evidence from 2004. *Journal of Accounting Research* 48, 477-487.
- Guay, W., Verrecchia, R., 2006. Discussion of an economic framework for conservative accounting and Bushman and Piotroski (2006). *Journal of Accounting and Economics* 42, 149-166.
- Hansen, W.L., Mitchell, N.J., Drope, J.M., 2005. The logic of private and collective action. *American Journal of Political Science* 49, 150-167.
- Haw, I., Lee, J.J., Lee, W., 2013. Debt financing and accounting conservatism in private firms. *Contemporary Accounting Research*, forthcoming.
- Houston, J.F., Jiang, L., Lin, C., Ma, Y., 2012. Political connections and cost of bank loans. Working paper, University of Florida.
- Johnson, S., Mitton, S., 2003. Cronyism and capital controls: evidence from Malaysia. *Journal of Financial Economics* 67, 351-282.
- Khwaja, A.I, Mian, A., 2005. Do lenders favor politically connected firms? Rent provision in an emerging financial market. *Quarterly Journal of Economics* 120, 13711-1411.
- Kim, Y., Li, S., Pan, C., Zuo, L., 2013. The role of accounting conservatism in the equity market: Evidence from seasoned equity offerings. *The Accounting Review*, forthcoming.
- Knight, B., 2007. Are policy platforms capitalized into equity prices? Evidence from the Bush/Gore 2000 presidential election. *Journal of Public Economics* 91, 389-409.
- Kong, X., Radhakrishnan, S., Tsang, A., 2013. Corporate lobbying and accounting conservatism, Working Paper, Sun Yat-Sen University, University of Texas at Dallas and Chinese University of Hong Kong.

- Kroszner, R.S., Stratmann, T., 1998. Interest-group completion and the organization of congress: theory and evidence from financial services' political action committees. *American Economic Review* 88, 1163-1187.
- LaFond, R., Roychowdhury, S., 2008. Managerial ownership and accounting conservatism. *Journal of Accounting Research* 46, 101–135.
- LaFond, R., Watts, R., 2008. The information role of conservatism. *The Accounting Review* 83, 447–478.
- Mian, A., Sufi, A., Trebbi, F., 2010. The political economy of the US mortgage default crisis. *American Economic Review* 100, 1967-1998.
- Miller, G.S., 2006. The press as a watchdog for accounting fraud. *Journal of Accounting Research*. 44, 1001-1033.
- Nichols, C.D, Wahlen, J. M., Wieland, M. M., 2009. Publicly traded versus privately held: implications for conditional conservatism in bank accounting. *Review of Accounting Studies* 14, 88-122.
- Nikolaev, V.V., 2010. Debt covenants and accounting conservatism. *Journal of Accounting Research* 48, 51-89.
- Ovtchinnikov, A.V., Pantaleoni, A., 2012. Individual political contributions and firm performance. *Journal of Financial Economics* 105, 367-392.
- Paletta, D., Enrich, D., 2009. Political interference seen in bank bailout decisions. *Wall Street Journal* January 22.
- Palmrose, Z.V., Richardson, V.J., Scholz, S., 2004. Determinants and market reactions to restatement announcements. *Journal of Accounting and Economics* 37, 59-90.
- Petersen, M.A., 2009. Estimating standard errors in finance panel data sets: comparing approaches. *Review of Financial Studies* 22, 435-480.
- Qiang, X., 2007. The effects of contracting, litigation, regulation, and tax costs on conditional and unconditional conservatism: cross-sectional evidence at the firm level. *The Accounting Review* 82, 759–796.
- Ramalingegowda, S., Yu, Y., 2012. Institutional ownership and conservatism. *Journal of Accounting and Economics* 53, 98-114.
- Ramanna, K., Roychowdhury, S., 2010. Elections and discretionary accruals: evidence from 2004. *Journal of Accounting Research* 48, 445-475.

- Rauh, J.D., Sufi, A. 2010. Capital structure and debt structure. *Review of Financial Studies* 23, 4242-4280.
- Roberts, B.E., 1990. A dead senator tells no lies: seniority and the distribution of federal benefits. *American Journal of Political Science* 34, 31-58.
- Roychowdhury, S., Watts, R., 2007. Asymmetric timeliness of earnings, market-to-book and conservatism in financial reporting. *Journal of Accounting and Economics* 44, 2-31.
- Schweizer, P., 2011. *Throw Them All Out*. Houghton Mifflin Harcourt Publishing, New York.
- Shleifer, A., Vishny, R., 1994. Politicians and firms. *Quarterly Journal of Economics* 109, 995-1026.
- Tahoun, A., 2013. The role of stock ownership by US members of Congress on the market for political favors. *Journal of Financial Economics*, forthcoming.
- Tahoun, A., van Lent, L., 2013. The personal wealth interests of politicians and government intervention in the economy. Working paper, London Business School and Tilburg University.
- Tan, L., 2013. Creditor control rights, state of nature verification, and financial reporting conservatism. *Journal of Accounting and Economics* 55, 1-22.
- Watts, R., 1977. Corporate financial statements, a product of the market and political processes. *Australian Journal of Management* 2, 53-75.
- Watts, R., 2003. Conservatism in accounting. Part I: explanations and implications. *Accounting Horizons* 17, 207–221.
- Watts, R., Zimmerman, J., 1978. Towards a positive theory of the determination of accounting standards. *The Accounting Review* 53, 112-134.
- Watts, R., Zimmerman, J., 1986. *Positive Accounting Theory*. Prentice Hall, New Jersey.
- Wittenberg-Moerman, R. 2008. The role of information asymmetry and financial reporting quality in debt contracting: Evidence from the secondary loan market. *Journal of Accounting and Economics* 46, 240–260.
- Yu, F., Yu, X., 2011. Corporate lobbying and fraud detection. *Journal of Financial and Quantitative Analysis* 46, 1865-1891.
- Zhang, J., 2008. The contracting benefits of accounting conservatism to lenders and borrowers. *Journal of Accounting and Economics* 45, 27-54.

Ziobrowski, A.J., Boyd, J.B., Cheng, P., Ziobrowski, B.J., 2011. Abnormal returns from the common stock investments of the members of the U.S. house of representatives. *Business and Politics* 13, Article 1.

Ziobrowski, A.J., Cheng, P., Boyd, J.B., Ziobrowski, B.J., 2004. Abnormal returns from the common stock investments of the U.S. senate. *Journal of Financial and Quantitative Analysis* 39, 661-676.

Table 1

Sample selection and industry distribution.

Panel A: Sample selection			
Selection process	# of observations		
Firm-years available in S&P 1500 Index (as per Execucomp) from 2005 to 2011	10,555		
<i>Less:</i>			
Firm-years in Compustat with missing data to compute net income, leverage, and market-to-book ratio	763		
Firm-years in CRSP with missing data on returns	203		
Firm-years in the financial industry (SIC 6000-6999)	1,609		
Final sample over 2005-2011 (1,540 firms)	7,980		
Panel B: Industry composition of sample firm-years, by firm type.			
Industry Group	Politician Owned Firms(POFs)	Non-Politician Owned Firms	% of POFs
Agriculture, forestry and fishing	11	7	61
Mining	277	108	72
Construction	78	68	53
Manufacturing	2,193	1,799	55
Transportation	144	102	59
Communications	129	48	73
Utilities	388	176	69
Wholesale trade	148	163	48
Retail trade	449	377	54
Services	697	602	54
Public administration	11	5	69
Total	4,525	3,455	57

This table reports the composition of the sample, which consists of 7,980 firm-years from 1,540 firms in the S&P 1500 index (S&P 500, S&P Mid Cap 400, and S&P Small Cap 600 indexes) covering the period 2005–2011. Panel A explains the sample selection process. Panel B reports the industry distribution of sample-firm years by firm type. Industry groups are based on the Standard Industrial Classification (SIC). Politician owned firms (POFs) refer to firms for which at least one member of the U.S. House and Senate owns shares of the company.

Table 2
Descriptive statistics.

Panel A: Descriptive statistics								
Variable	Politician Owned Firms (POFs)			Non-Politician Owned Firms			<i>p-values</i> of the difference	
	Mean	Median	Std.	Mean	Median	Std.	Mean	Median
NI_{it}	0.034	0.056	0.162	0.014	0.050	0.186	0.00	0.00
RET_{it}	0.085	0.063	0.415	0.120	0.078	0.512	0.00	0.03
NEG_{it}	0.415	0.000	0.493	0.414	0.000	0.493	0.93	0.93
MV_{it-1}	14206	4253	33450	1710	899	3193	0.00	0.00
MB_{it-1}	3.531	2.500	15.688	2.521	1.888	7.966	0.00	0.00
LEV_{it-1}	0.368	0.180	0.878	0.377	0.174	0.725	0.63	0.00
LIT_{it-1}	0.324	0.000	0.468	0.306	0.000	0.461	0.09	0.09
N		4,525			3,455			
Panel B: Pearson correlation matrix								
	$POLOWN_{it-1}$	NI_{it}	RET_{it}	NEG_{it}	MV_{it-1}	MB_{it-1}	LEV_{it-1}	
NI_{it}	0.060							
RET_{it}	-0.038	0.202						
NEG_{it}	0.001	-0.178	-0.656					
MV_{it-1}	0.238	0.058	-0.031	-0.009				
MB_{it-1}	0.039	0.019	-0.025	0.022	0.021			
LEV_{it-1}	-0.005	-0.270	0.164	-0.038	-0.039	-0.039		
LIT_{it-1}	0.019	-0.018	0.005	0.036	0.004	0.004	-0.125	

This table presents the descriptive statistics and Pearson correlations of key variables. In Panel A, *t*-tests are used to test for differences in means and Wilcoxon two-sample tests are used to test for differences in medians. In Panel B, bold text indicates significance at the 0.05 level or better, two-tailed. $POLOWN_{it-1}$ =Indicator variable equal to 1 if firm *i*'s shares are owned by at least one member of the U.S. House or Senate at the end of year *t-1*, and 0 otherwise. NI_{it} =Annual income before extraordinary items (IB) of firm *i* in year *t*, scaled by the market value of equity (CSHO*PRCC_F) of firm *i* at the end of year *t-1*. RET_{it} =Buy-and-hold stock returns of firm *i* in year *t*. NEG_{it} =Indicator variable equal to 1 if RET_{it} is negative, and 0 otherwise. MV_{it-1} =Market value of equity (CSHO*PRCC_F) of firm *i* at the end of year *t-1*. MB_{it-1} =Market to book ratio (MV/CEQ) of firm *i* at the end of year *t-1*. LEV_{it-1} =Leverage ((DLTT+ DLC) / MV) of firm *i* at the end of year *t-1*. LIT_{it-1} =Indicator variable equal to 1 if firm *i* belongs to the following industries at the end of year *t-1*: Biotechnology (SIC codes 2833-2836 and 8731-8734), Computers (SIC codes 3570-3577 and 7370-7374), Electronics (SIC codes 3600-3674), and Retailing (SIC codes 5200-5961), and 0 otherwise.

Table 3

The relation between conservatism and politician ownership.

$$NI_{it} = \alpha_0 + \alpha_1 RET_{it} + \alpha_2 NEG_{it} + \alpha_3 RET_{it} * NEG_{it} + \alpha_4 POLOWN_{it-1} + \alpha_5 RET_{it} * POLOWN_{it-1} + \alpha_6 NEG_{it} * POLOWN_{it-1} + \alpha_7 RET_{it} * NEG_{it} * POLOWN_{it-1} + \alpha_8 \dots \alpha_{11} CONTROLS_{it-1} + \alpha_{12-15} NEG_{it} * CONTROLS_{it-1} + \alpha_{16-19} RET_{it} * CONTROLS_{it-1} + \alpha_{20-23} RET_{it} * NEG_{it} * CONTROLS_{it-1} + \varepsilon_{it} \quad (2)$$

Dependent Variable = NI_{it}									
		(1)		(2)		(3)		(4)	
	Predicted Sign	Coeff.	p-value	Coeff.	p-value	Coeff.	p-value	Coeff.	p-value
<i>INTERCEPT</i>		0.047	0.00	0.050	0.00	0.048	0.00	0.051	0.00
<i>RET_{it}</i>		0.025	0.00	0.032	0.00	0.022	0.00	0.036	0.00
<i>NEG_{it}</i>		0.022	0.00	0.011	0.16	0.018	0.00	0.014	0.01
<i>RET_{it}*NEG_{it}</i>	+	0.248	0.00	0.112	0.00	0.200	0.00	0.100	0.00
<i>POLOWN_{it-1}</i>		0.007	0.19	0.003	0.56	0.000	0.07	-0.001	0.04
<i>RET_{it}*POLOWN_{it-1}</i>		-0.004	0.39	0.008	0.24	0.002	0.00	0.002	0.07
<i>NEG_{it}*POLOWN_{it-1}</i>		-0.013	0.01	0.001	0.77	-0.001	0.02	-0.000	0.58
<i>RET_{it}*NEG_{it}*POLOWN_{it-1}</i>	?	-0.131	0.00	-0.072	0.00	-0.012	0.00	-0.011	0.01
<i>CONTROLS_{it-1}</i>				Included				Included	
<i>NEG_{it}*CONTROLS_{it-1}</i>				Included				Included	
<i>RET_{it}*CONTROLS_{it-1}</i>				Included				Included	
<i>RET_{it}*NEG_{it}*MV_{it-1}</i>	-			-0.000	0.00			-0.000	0.39
<i>RET_{it}*NEG_{it}*MB_{it-1}</i>	-			-0.008	0.00			-0.010	0.00
<i>RET_{it}*NEG_{it}*LEV_{it-1}</i>	+			0.314	0.00			0.307	0.00
<i>RET_{it}*NEG_{it}*LIT_{it-1}</i>	+			0.092	0.00			0.083	0.00
N		7,690		7,707		7,773		7,721	
Adjusted R ²		0.21		0.27		0.17		0.25	

The table reports the results of estimating Equation (2) using pooled OLS regressions over 2005-2011. Stand-alone control variables and the two-way interactions between controls and *NEG* or *RET* are included in the estimations but are not reported for brevity. *p*-values are based on standard errors adjusted for clustering on both firm and year (Petersen, 2009). *p*-values are one-tailed when sign of the coefficient is predicted, and two-tailed otherwise. Outliers are removed using Cook's (1977) distance statistic.

In columns 1 and 2, *POLOWNit-1* =Indicator variable equal to 1 if firm *i*'s shares are owned by at least one member of the U.S. House or Senate at the end of year *t-1*, and 0 otherwise. In columns 3 and 4, *POLOWNit-1*= the total number of distinct members of Congress with equity investments in firm *i* at the end of year *t-1*. All other variables are defined in Table 2.

Table 4

The relation between conservatism and local and distant politician ownership.

$$\begin{aligned}
 NI_{it} = & \alpha_0 + \alpha_1 RET_{it} + \alpha_2 NEG_{it} + \alpha_3 RET_{it} * NEG_{it} + \alpha_4 LPOLOWN_{it-1} + \alpha_5 RET_{it} * LPOLOWN_{it-1} \\
 & + \alpha_6 NEG_{it} * LPOLOWN_{it-1} + \alpha_7 RET_{it} * NEG_{it} * LPOLOWN_{it-1} + \alpha_8 DPOLOWN_{it-1} + \alpha_9 RET_{it} * DPOLOWN_{it-1} \\
 & + \alpha_{10} NEG_{it} * DPOLOWN_{it-1} + \alpha_{11} RET_{it} * NEG_{it} * DPOLOWN_{it-1} + \alpha_{12-15} CONTROLS_{it-1} \\
 & + \alpha_{16-19} NEG_{it} * CONTROLS_{it-1} + \alpha_{20-23} RET_{it} * CONTROLS_{it-1} + \alpha_{23-26} RET_{it} * NEG_{it} * CONTROLS_{it-1} + \varepsilon_{it}
 \end{aligned} \tag{3}$$

Dependent Variable = NI_{it}					
		(1)		(2)	
	Predicted Sign	Coeff.	p-value	Coeff.	p-value
<i>INTERCEPT</i>		0.047	0.00	0.050	0.00
<i>RET_{it}</i>		0.022	0.00	0.033	0.00
<i>NEG_{it}</i>		0.019	0.03	0.015	0.07
<i>RET_{it}*NEG_{it}</i>	+	0.241	0.00	0.132	0.00
<i>LPOLOWN_{it-1}</i>		0.011	0.09	0.005	0.36
<i>RET_{it}*LPOLOWN_{it-1}</i>		-0.001	0.91	0.005	0.61
<i>NEG_{it}*LPOLOWN_{it-1}</i>		-0.020	0.00	-0.008	0.02
<i>RET_{it}*NEG_{it}*LPOLOWN_{it-1}</i>	?	-0.178	0.00	-0.132	0.00
<i>DPOLOWN_{it-1}</i>		0.005	0.32	0.004	0.43
<i>RET_{it}*DPOLOWN_{it-1}</i>		0.001	0.79	0.004	0.53
<i>NEG_{it}*DPOLOWN_{it-1}</i>		-0.008	0.31	-0.001	0.88
<i>RET_{it}*NEG_{it}*DPOLOWN_{it-1}</i>	?	-0.109	0.00	-0.076	0.00
<i>CONTROLS_{it-1}</i>				Included	
<i>NEG_{it}*CONTROLS_{it-1}</i>				Included	
<i>RET_{it}*CONTROLS_{it-1}</i>				Included	
<i>RET_{it}*NEG_{it}*MV_{it-1}</i>	-			-0.000	0.00
<i>RET_{it}*NEG_{it}*MB_{it-1}</i>	-			-0.008	0.00
<i>RET_{it}*NEG_{it}*LEV_{it-1}</i>	+			0.311	0.00
<i>RET_{it}*NEG_{it}*LIT_{it-1}</i>	+			0.087	0.00
N		7,728		7,710	
Adjusted R ²		0.20		0.28	
<i>Test of differences between local and distant owners</i>					
<i>RET_{it}*NEG_{it}*LPOLOWN_{it-1} < RET_{it}*NEG_{it}*DPOLOWN_{it-1}</i>			0.00		0.00

The table reports the results of estimating Equation (3) using pooled OLS regressions over 2005-2011. Stand-alone control variables and the two-way interactions between controls and *NEG* or *RET* are included in the estimations but are not reported for brevity. *p*-values are based on standard errors adjusted for clustering on both firm and year (Petersen, 2009). *p*-values are one-tailed when sign of the coefficient is predicted, and two-tailed otherwise. Outliers are removed using Cook's (1977) distance statistic.

LPOLOWN_{it-1} =Indicator variable equal to 1 if firm *i*'s shares are owned by at least one member of the U.S. House or Senate who resides over the congressional district in which the firm is headquartered at the end of year *t-1*, and 0 otherwise. ***DPOLOWN_{it-1}*** =Indicator variable equal to 1 if *LPOLOWN_{it-1}* equals 0 and firm *i*'s shares are owned by at least one member of the U.S. House or Senate at the end of year *t-1*, and 0 otherwise.

Table 5

The effect of issuer credit ratings on the relation between conservatism and politician ownership.

	Dependent Variable = NI_{it}			
	(1)		(2)	
	<i>Coeff.</i>	<i>p-value</i>	<i>Coeff.</i>	<i>p-value</i>
<i>INTERCEPT</i>	0.045	0.00	0.044	0.00
<i>RET_{it}</i>	0.034	0.00	0.035	0.00
<i>NEG_{it}</i>	0.013	0.02	0.015	0.01
<i>RET_{it}*NEG_{it}</i> +	0.136	0.00	0.136	0.00
<i>POLOWN_{it-1}</i>	0.000	0.98		
<i>RET_{it}*POLOWN_{it-1}</i>	0.004	0.55		
<i>NEG_{it}*POLOWN_{it-1}</i>	-0.003	0.53		
<i>RET_{it}*NEG_{it}*POLOWN_{it-1}</i> ?	-0.079	0.00		
<i>LPOLOWN_{it-1}</i>			0.000	0.97
<i>RET_{it}*LPOLOWN_{it-1}</i>			0.001	0.92
<i>NEG_{it}*LPOLOWN_{it-1}</i>			-0.008	0.03
<i>RET_{it}*NEG_{it}*LPOLOWN_{it-1}</i> ?			-0.091	0.00
<i>DPOLOWN_{it-1}</i>			-0.000	0.95
<i>RET_{it}*DPOLOWN_{it-1}</i>			0.004	0.60
<i>NEG_{it}*DPOLOWN_{it-1}</i>			-0.001	0.84
<i>RET_{it}*NEG_{it}*DPOLOWN_{it-1}</i> ?			-0.069	0.00
<i>RATING_{it-1}</i>	0.016	0.00	0.018	0.00
<i>RET_{it}*NEG_{it}*POLOWN_{it-1}*RATING_{it-1}</i> -	-0.022	0.04		
<i>RET_{it}*NEG_{it}*LPOLOWN_{it-1}*RATING_{it-1}</i> -			-0.044	0.06
<i>RET_{it}*NEG_{it}*DPOLOWN_{it-1}*RATING_{it-1}</i> -			-0.023	0.01
<i>CONTROLS_{it-1}</i>	Included		Included	
<i>NEG_{it}*CONTROLS_{it-1}</i>	Included		Included	
<i>RET_{it}*CONTROLS_{it-1}</i>	Included		Included	
<i>RET*NEG_{it}*CONTROLS_{it-1}</i>	Included		Included	
N	7,709		7,705	
Adjusted R ²	0.26		0.27	

The table reports the results of estimating Equations (2) and (3) using pooled OLS regressions over 2005-2011. Stand-alone control variables, the two-way interactions between controls and *NEG* or *RET*, and the three-way interactions with *RET*NEG* are included in the estimations but are not reported for brevity. *p*-values are based on standard errors adjusted for clustering on both firm and year (Petersen, 2009). *p*-values are one-tailed when sign of the coefficient is predicted, and two-tailed otherwise. Outliers are removed using Cook's (1977) distance statistic.

RATING_{it-1}=Indicator variable equal to 1 if firm *i* has an S&P long-term issuer credit rating at the end of year *t-1*, and 0 otherwise. All other variables are defined in Tables 2 and 4.

Table 6

The relation between conservatism and lead, current, and lagged politician ownership.

$$\begin{aligned}
 NI_{it} = & \alpha_0 + \alpha_1 RET_{it} + \alpha_2 NEG_{it} + \alpha_3 RET_{it} * NEG_{it} + \alpha_4 POLOWN_{it-1} + \alpha_5 RET_{it} * POLOWN_{it-1} \\
 & + \alpha_6 NEG_{it} * POLOWN_{it-1} + \alpha_7 RET_{it} * NEG_{it} * POLOWN_{it-1} + \alpha_8 POLOWN_{it} + \alpha_9 RET_{it} * POLOWN_{it} \\
 & + \alpha_{10} NEG_{it} * POLOWN_{it} + \alpha_{11} RET_{it} * NEG_{it} * POLOWN_{it} + \alpha_{12} POLOWN_{it+1} + \alpha_{13} RET_{it} * POLOWN_{it+1} \\
 & + \alpha_{14} NEG_{it} * POLOWN_{it+1} + \alpha_{15} RET_{it} * NEG_{it} * POLOWN_{it+1} + \alpha_{16-19} CONTROLS_{it-1} \\
 & + \alpha_{20-23} NEG_{it} * CONTROLS_{it-1} + \alpha_{24-27} RET_{it} * CONTROLS_{it-1} + \alpha_{28-31} RET_{it} * NEG_{it} * CONTROLS_{it-1} + \varepsilon_{it}
 \end{aligned} \tag{4}$$

	Dependent Variable = NI_{it}				
	Predicted Sign	(1)		(2)	
		Coeff.	p-value	Coeff.	p-value
<i>INTERCEPT</i>		0.047	0.00	0.053	0.00
<i>RET_{it}</i>		0.027	0.00	0.023	0.00
<i>NEG_{it}</i>		0.012	0.26	0.010	0.04
<i>RET_{it}*NEG_{it}</i>	+	0.135	0.00	0.115	0.00
<i>POLOWN_{it-1}</i>		0.006	0.30	0.000	0.67
<i>RET_{it}*POLOWN_{it-1}</i>		-0.016	0.17	-0.006	0.00
<i>NEG_{it}*POLOWN_{it-1}</i>		-0.015	0.00	-0.003	0.00
<i>RET_{it}*NEG_{it}*POLOWN_{it-1}</i>	?	-0.057	0.01	-0.011	0.00
<i>POLOWN_{it}</i>		0.005	0.23	-0.002	0.01
<i>RET_{it}*POLOWN_{it}</i>		0.008	0.16	0.011	0.00
<i>NEG_{it}*POLOWN_{it}</i>		0.006	0.49	0.005	0.00
<i>RET_{it}*NEG_{it}*POLOWN_{it}</i>	?	0.028	0.16	0.005	0.22
<i>POLOWN_{it+1}</i>		0.001	0.89	0.002	0.00
<i>RET_{it}*POLOWN_{it+1}</i>		0.008	0.53	-0.004	0.00
<i>NEG_{it}*POLOWN_{it+1}</i>		0.007	0.51	-0.002	0.13
<i>RET_{it}*NEG_{it}*POLOWN_{it+1}</i>	?	-0.021	0.70	0.000	0.97
<i>CONTROLS_{it-1}</i>		Included		Included	
<i>NEG_{it}*CONTROLS_{it-1}</i>		Included		Included	
<i>RET_{it}*CONTROLS_{it-1}</i>		Included		Included	
<i>NEG_{it}*RET_{it}*CONTROLS_{it-1}</i>		Included		Included	
N		5,582		5,597	
Adjusted R ²		0.18		0.19	

The table reports the results of estimating Equation (4) using pooled OLS regressions over 2005-2010. Stand-alone control variables, the two-way interactions between controls and *NEG* or *RET*, and the three-way interactions with *RET*NEG* are included in the estimations but are not reported for brevity. *p*-values are based on standard errors adjusted for clustering on both firm and year (Petersen, 2009). *p*-values are one-tailed when sign of the coefficient is predicted, and two-tailed otherwise. Outliers are removed using Cook's (1977) distance statistic.

In column 1, *POLOWN* = Indicator variable equal to 1 if firm *i*'s shares are owned by at least one member of the U.S. House or Senate at the end of the year mentioned in subscript, and 0 otherwise. In column 2, *POLOWN* = the total number of distinct members of Congress with equity investments in firm *i* at the end of the year mentioned in subscript. All other variables are defined in Table 2.

Table 7

The relation between conservatism measured by the earnings-change model and politician ownership.

$$\Delta NI_{it+1} = \alpha_0 + \alpha_1 \Delta NI_{it} + \alpha_2 NEG_{it} + \alpha_3 \Delta NI_{it} * NEG_{it} + \alpha_4 POLOWN_{it-1} + \alpha_5 \Delta NI_{it} * POLOWN_{it-1} + \alpha_6 NEG_{it} * POLOWN_{it-1} + \alpha_7 \Delta NI_{it} * NEG_{it} * POLOWN_{it-1} + \alpha_{8-11} CONTROLS_{it-1} + \alpha_{12-15} NEG_{it} * CONTROLS_{it-1} + \alpha_{16-19} \Delta NI_{it} * CONTROLS_{it-1} + \alpha_{20-23} \Delta NI_{it} * NEG_{it} * CONTROLS_{it-1} + \varepsilon_{it} \quad (5)$$

	Dependent Variable = ΔNI_{it+1}				
	(1)		(2)		
	Predicted Sign	Coeff.	<i>p</i> -value	Coeff.	<i>p</i> -value
<i>INTERCEPT</i>		-0.002	0.77	-0.003	0.63
ΔNI_{it}		0.024	0.49	0.031	0.46
NEG_{it}		-0.025	0.00	-0.023	0.00
$\Delta NI_{it} * NEG_{it}$	-	-0.867	0.00	-0.835	0.00
$POLOWN_{it-1}$		-0.001	0.43	0.000	0.43
$\Delta NI_{it} * POLOWN_{it-1}$		0.002	0.87	-0.000	0.86
$NEG_{it} * POLOWN_{it-1}$		0.007	0.04	0.001	0.07
$\Delta NI_{it} * NEG_{it} * POLOWN_{it-1}$	+	0.118	0.07	0.034	0.04
$CONTROLS_{it-1}$		Included		Included	
$NEG_{it} * CONTROLS_{it-1}$		Included		Included	
$\Delta NI_{it} * CONTROLS_{it-1}$		Included		Included	
$\Delta NI_{it} * NEG_{it} * CONTROLS_{it-1}$		Included		Included	
N		6,044		6,124	
Adjusted R ²		0.19		0.18	

The table reports the results of estimating Equation (5) using pooled OLS regressions over 2005-2011. Stand-alone control variables and the two-way interactions between controls and *NEG* or ΔNI are included in the estimations but are not reported for brevity. *p*-values are based on standard errors adjusted for clustering on both firm and year (Petersen, 2009). *p*-values are one-tailed when sign of the coefficient is predicted, and two-tailed otherwise. Outliers are removed using Cook's (1977) distance statistic.

In column 1, $POLOWN_{it-1}$ = Indicator variable equal to 1 if firm *i*'s shares are owned by at least one member of the U.S. House or Senate at the end of year *t-1*, and 0 otherwise. In column 2, $POLOWN_{it-1}$ = the total number of distinct members of Congress with equity investments in firm *i* at the end of year *t-1*. ΔNI_{it+1} = Change in annual net income before extraordinary items (IB) of firm *i* from year *t* to *t+1*, scaled by total assets (AT) at the end of year *t*. ΔNI_{it} = Change in annual net income before extraordinary items (IB) of firm *i* from year *t-1* to *t*, scaled by total assets (AT) at the end of year *t-1*. NEG_{it} = Indicator variable equal to 1 if ΔNI_{it} is negative, and 0 otherwise. All other variables are defined in Table 2.