Politicians' Equity Holdings and Accounting Conservatism

by

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AUTHOR'S DECLARATION

I hereby declare that I am the sole author of this thesis. This is a true copy of the thesis, including

any required final revisions, as accepted by my examiners.

I understand that my thesis may be made electronically available to the public.

ABSTRACT

In this thesis, I examine the association between politician ownership and accounting conservatism for a sample of S&P 1500 firms between 2005 and 2011. 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 conditional 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. I also examine the relationship between politician ownership and unconditional conservatism and fail to document a statistical relationship between the two constructs. Collectively, the results of my thesis provide consistent evidence of a lower contracting demand for conditional conservatism among politician owned firms.

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DEDICATION

To my family and friends, especially my mother Madhu and sister Nisha. Thank you for being great mentors and my biggest supporters, and for giving me all of the confidence, encouragement, and opportunity in the world to succeed.

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CHAPTER 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

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[1] The literature defines accounting conservatism as either taking a conditional or unconditional form. Conditional conservatism (e.g. impairment accounting) is the higher verifiability for recognizing good news as gains than for recognizing bad news as losses *after difficult-to-verify news occurs* (Basu 1997). The ultimate effect of conditional conservatism is to bias net assets and earnings downwards. Unconditional conservatism (e.g. excessive depreciation) also addresses difficult-to-verify news and biases net assets and earnings downwards, but it is applied *before difficult-to-verify news occurs* (Ball and Shivakumar 2005; Beaver and Ryan 2005). As explained more fully in Section 3.2, I primarily focus on the conditional form for the purposes of this paper.

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) 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 employments 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

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[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.

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.

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.

As a final test, I examine the association between political ownership and unconditional conservatism. The contracting explanation provides incentives for firms to provide conditional conservatism but not unconditional conservatism, because the latter does not employ new information that can generate contracting responses. The relation between the political costs explanation and conservatism is more ambiguous, as some prior research has argued that political costs provide incentives for firms to favor unconditional conservatism due to voters'

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[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.

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aversion to large negative shocks (Qiang; 2007), while other have argued that voters' primary objective is to constrain opportunistic managerial behavior, which can best be achieved through conditional conservatism (Watts; 2003). I find no association between politician ownership and unconditional conservatism, and therefore no evidence for the political costs explanation driving the demand for conservatism.

This thesis contributes to three streams of research. First, this thesis 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 thesis adds to the literature by 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 thesis 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 thesis 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 thesis is organized as follows. Section 2 discusses related literature and Section 3 develops hypotheses. Section 4 describes the sample and research design and Section 5 reports the main empirical results. Section 6 provides robustness tests and additional analyses, and Section 7 concludes.

CHAPTER 2

LITERATURE REVIEW

2.1. Introduction

In this chapter, I introduce extant research that is relevant to my dissertation. Two main themes are apparent in my work: accounting conservatism and political connections. The first part of the review (Section 2.2) describes how the literature defines conservatism, highlights the economic explanations put forth to explain the existence of conservatism, and analyzes the similarities and differences between the conditional and unconditional forms of conservatism. The second part of the review (Section 2.3) begins with a general discussion of the political connections literature in accounting, including the different measures used to capture political connections. This section concludes with a discussion of two related studies particularly germane to this thesis. The third and final part of this review (Section 2.4) introduces my empirical measure of political connections, and discusses relevant research in political science and finance using this measure. It concludes by tying this type of political connections measure to the literature on accounting conservatism.

This chapter is intended to provide a review of the main themes of this paper, and thus subsequent chapters may introduce additional research that is important to the concepts being discussed in those particular chapters. This chapter is divided into five sections, including this introduction and a conclusion.

2.2. Conservatism

2.2.1. Definition

Watts (2003, pg. 207) defines conservatism as the "differential verifiability required for recognition of profits versus losses." Application of conservative accounting policies results in a

higher degree of verification to recognize economic gains as accounting profits than to recognize economic losses as accounting losses. The greater the divergence in the verification requirement between gains and losses, the greater the level of conservatism. The most extreme form of conservatism would require that accounting reports "anticipate no profit, but anticipate all losses"

Watts (2003) explains that conservatism has persisted in accounting reports for centuries despite attempts by standard-setters and regulators to maintain accounting standards that are neutral, and not biased in any direction (i.e. as in conservatism, which imposes a downward bias on net income). Watts (2003) conjectures that accounting conservatism has persisted because it benefits financial statement users and advances four specific explanations (or sources of demand) for why conservatism exists: contracting, litigation, taxation, and political costs. Studies investigating these explanations exploit either time-series or cross-sectional variation to identify the effect of a particular explanation on accounting conservatism.

2.2.2. Explanations of Conservatism

Firms typically have contracts with various parties, including debt holders, equity investors, as well as suppliers and customers. The contracting explanation posits that because conservatism counteracts firms' incentives for aggressive accounting, it lowers potential losses for parties who use accounting numbers in contracts.

While recent research has documented some evidence consistent with equity investors (Ahmed and Duellman 2007; LaFond and Roychowdhury 2008; LaFond and Watts 2008; Ramalingegowda and Yu 2012; Kim et al. 2013) and customers and suppliers (Hui et al. 2012) valuing the contracting benefits of conservatism, the most comprehensive and convincing evidence of the contracting explanation comes from the debt markets. 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 facilities contracting on covenants. 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).

Watts (2003) argues shareholder litigation also provides another source of demand for conservatism. Shareholder class action lawsuits are extremely costly events for firms and their auditors. Firms often bear the full extent of these costs, as auditors can pass on their litigation costs by limiting the aggressiveness of accounting choices managers make, increasing auditing fees (Pratt and Stice 1994), issuing unfavorable audit opinions, or terminating relations with risky clients (Krishnan and Krishnan 1997). Firms can minimize expected litigation costs by applying conservative accounting since early recognition of economic losses reduces the probability of class action lawsuits (Kellogg 1984). Thus, the litigation explanation posits that because there is asymmetry in litigation costs (i.e. delayed recognition of economic losses is more likely to produce litigation costs than delayed recognition of economic profits), conservatism is observed in practice because it helps to reduce expected litigation costs. Consistent with this explanation, prior research finds more conservatism in institutional settings where the expected litigation costs are high (Basu 1997; Ball et al. 2000; Holthausen and Watts 2001; Lang et al. 2003; Ball and Shivakumar 2005; Bushman and Piotroski 2006; Qiang 2007; Chung and Wynn 2008).

The taxation explanation of conservatism argues that firms have incentives to report conservatively due to the links between taxation and accounting. Accelerated accounting recognition of losses and delayed accounting recognition of gains allows profitable firms to reduce the present value of taxes, and therefore increase the value of the firm (Watts 2003). While there have been limited tests of this explanation, the evidence we do have is consistent with conservatism existing, in part, because it helps firms to defer taxes (Basu 2005; Qiang 2007).

The final explanation, titled the political costs or regulatory explanation of conservatism, posits that the political process provides standard-setters, regulators, and politicians (hereafter 'politicians') with incentives to prefer conservative accounting. Watts (1977) argues that losses from overstated income are more observable and useable in the political process than foregone gains due to understated income. Watts (1977) elaborates that losses due to actions are more visible than losses due to inactions. When firms fail, it is relatively easy to argue ex post that assets were overvalued. On the other hand, it is much more difficult to observe any losses from undervaluation. To avoid blame from their constituents, politicians have an incentive to respond to constituent demand for conservatism. In turn, firms have an incentive to provide conservative accounting, to avoid negative interactions with politicians. Empirical evidence consistent with this explanation can be found in Sivakumar and Waymire (2003), Qiang (2007) and Kong et al. (2013).

2.2.3. Conditional and Unconditional Conservatism

The literature defines accounting conservatism as either taking a conditional or unconditional form. Conditional conservatism (e.g. impairment accounting) is the higher verifiability for recognizing good news as gains than for recognizing bad news as losses *after*

difficult-to-verify news occurs (Basu 1997). The ultimate effect of conditional conservatism is to bias net assets and earnings downwards. Unconditional conservatism (e.g. accelerated depreciation) also addresses difficult-to-verify news and biases net assets and earnings downwards, but it is applied *before difficult-to-verify news occurs* (Ball and Shivakumar 2005; Beaver and Ryan 2005). While the conditional form utilizes (and reveals) information when received in future periods, the unconditional form only utilizes information at the inception of an asset's life. The two forms of conservatism are also negatively related, as Beaver and Ryan (2005) demonstrate that unconditional conservatism (e.g. accelerated depreciation) lowers net assets, thereby reducing subsequent conditional conservatism (e.g. impairment accounting). In other words, if accounting depreciation on assets is accelerated relative to the true underlying economic depreciation, assets are less likely to be written down in the future under impairment accounting. Thus, application of unconditional conservatism can pre-empt the need to apply conditional conservatism.

Qiang (2007) examines the distinct, common, and interrelated roles of the two forms of conservatism as it relates to the four explanations put forth by Watts (2003). She demonstrates that taxation provides incentives for firms to record expenses and losses as early as possible, and therefore induces unconditional rather than conditional conservatism. This is also intuitively appealing as U.S. tax law allows for additional deductions relating to adoption of unconditionally conservative policies (e.g. use of LIFO) but not conditionally conservative policies (e.g. impairments). The contracting explanation provides incentives for firms to provide conditionally conservative accounting because it employs new information that can generate contracting responses, resulting in greater contracting efficiency. Ex-ante, it provides more accurate information for loan pricing and ex-post, it allows for more timely covenant violations and

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transfer of decision rights to lenders. In contrast, because unconditional conservatism does not employ any new information, it decreases (or does not impact) contracting efficiency, if the bias is unknown (known). Prior research examining the contracting explanation almost exclusively focuses on the conditional form of conservatism (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).

The form of conservatism induced by the other two explanations is more ambiguous. For the litigation explanation, Qiang (2007) argues that firms can best minimize expected litigation costs by recognizing bad news as early as possible. Thus, like the taxation explanation, it may induce unconditional conservatism, as this form recognizes economic losses earlier than conditional conservatism. However, it is possible that some plaintiffs prefer the conditional form due to its contracting benefits, suggesting that litigation may induce both forms of conservatism. The form of conservatism induced by the political costs explanation is also ambiguous. On the one hand, Qiang (2007) argues that voters (and therefore politicians) are averse to large negative shocks associated with conditional conservatism and prefer the smooth asset value decreases associated with unconditional conservatism. On the other hand, to the extent that voters are primarily motivated by a desire to constrain opportunistic managerial behavior (Watts 2003), they may favor conditional conservatism as unconditional conservatism can induce myopic managerial investment decisions (LaFond and Roychowdhury 2008). More specifically, conditional conservatism can help to discipline firms' investment decisions by giving managers less incentives to undertake ex-ante negative NPV projects and greater incentives to abandon ex-post loss projects. [5] Unconditional conservatism potentially gives managers incentives to avoid

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[5] Conditional conservatism also reduces managers' incentives and ability to overstate earnings by penalizing managers for losses immediately while deferring reward for gains until realized.

positive NPV projects by penalizing earning immediately for full costs while fully deferring any benefits, irrespective of whether the investment has positive or negative NPV.

2.3. Political Connections and Accounting

2.3.1. Survey of Literature

There is a growing literature examining the influence of political connections on accounting outcomes. Papers in this stream of research differ on a number of dimensions, most notably in measurement of political connections, the specific attribute of accounting information examined, and the theory put forth to explain the pattern of results documented.

Empirical proxies used to measure political connections in the U.S. include the past political experience of board members (Kim and Zhang 2014), campaign contributions (Correia 2014), and lobbying expenditures (Yu and Yu 2011; Kong et al. 2013). In an Indonesian setting, Leuz and Oberholzer-Gee (2006) use cumulative stock returns over six events indicating the President's health was declining to measure political connections, while in a cross-country sample, Chaney et al. (2011) employ a measure based on whether at least one of its large shareholders (anybody directly or indirectly controlling at least 10% of votes) or top directors (CEO, COB, President, Vice-President, or Secretary) is a member of parliament, a minister or a head of state, or is tightly related (e.g. family, friend) to a politician or political party.

The specific accounting attribute examined also differs across studies. Some studies focus on relatively aggressive outcomes, such as securities class action lawsuits (Yu and Yu 2011), SEC enforcement outcomes (Correia 2014), and tax aggressiveness (Kim and Zhang 2014). Other studies focus on more general measures of financial reporting quality, including the variability of discretionary accruals (Chaney et al. 2010) and accounting conservatism (Kong et al. 2013). Collectively, this literature demonstrates that political connections lead to lower reporting quality. The theories put forth to explain this general result typically focus on the costs

associated with reporting poor quality accounting information, with the papers arguing that politically connected firms face lower detection risk (Yu and Yu 2011; Correia 2014; Kim and Zhang 2014) and capital market consequences (Chaney et al. 2011) .

2.3.2. Related Studies

The two studies that are most similar to this thesis are Chaney et al. (2011) and Kong et al. (2013). Using a cross-country sample, Chaney et al. (2011) provide evidence that managers of politically connected firms devote less time to accurately portraying accruals (as measured by the standard deviation of unexplained accruals) because politicians shield these managers from the capital market consequences of reporting low quality accounting information. Given that U.S. firms make up a trivial fraction of Chaney et al. (2011)'s sample, it is unclear whether their results generalize to a setting characterized by strong enforcement mechanisms, public disclosure of political connections, and a lack of government owned banks. Chaney et al. (2011) also do not focus on a directional bias in financial reporting, as they use the variability in discretionary accruals as their measure of reporting quality. Building on this study, I focus on the relation between politician connections and accounting conservatism (which induces a negative bias) since the extant evidence suggests a clear link between political ties, the informational demands of firm stakeholders, and accounting conservatism.

Kong et al. (2013) also examine the relation between political connections (as measured by lobbying expenditures) and accounting conservatism for a sample of U.S. firms. Their most reliable result suggests that firms that are both politically connected and highly visible have higher levels of both conditional and unconditional conservatism. Their results for politically connected firms that are not highly visible vary between having a positive, no, or negative relation with conservatism, depending on how the authors measure conservatism. In contrast to this study, I examine the relation between political connections and accounting conservatism

using the complete framework articulated in Watts (2003). I also incorporate the political connections literature in finance, which argues 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. More specifically, I consider how both the contracting and political costs explanations can explain differences in conservatism among politically connected and non-politically connected firms, and provide economic rationale for why there may be observed differences in how each of these explanations influence conditional and unconditional conservatism. Finally, as I articulate in the next section, my politician ownership based measure of political connections has a number of advantages relative to the lobbying measure used in Kong et al. (2013). In sum, I view my hypotheses as being more theory-grounded and my evidence as complementing and adding to the evidence provided in Kong et al. (2013).

2.4. Political Ownership Based Measure of Political Connections

In this thesis, I use the presence of equity investment by standing members of the U.S. House and Senate to measure political connections. My use of politician ownership as a measure of political connections is motivated by research in political economics 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, lobbying expenditures, or board connections capture only a subset of factors that impact politician decision-making.

Research in political science and finance provides evidence to support the notion of a political nexus between politicians and firms in which they invest. These studies find that both politicians and firms benefit as a result of these relationships. For politicians, the benefits come in the form of abnormal returns on their equity portfolio (Ziobrowski et al. 2004, 2011; Schwiezer 2011). For firms, the benefits come in the form of preferential access to government contracts (Tahoun 2013) and bailouts (Tahoun and van Lent 2013).

Finally, there is research to support that government participation in financial markets influences financial reporting, and more specifically conditional conservatism. 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. I extend this line of research by considering how politicians' participation in financial markets as private investors, rather than as public officials, affects accounting conservatism.

2.5. Conclusions

In summary, this chapter reviews research that investigates the various explanations for the existence of accounting conservatism: contracting, litigation, taxation, and political costs. It also distinguishes between the two forms of conservatism, conditional and unconditional, and examines the interaction between these two forms and the four explanations of conservatism.

This chapter also reviews extant literature on the relation between political connections and accounting outcomes. Almost all studies in this review, irrespective of how they measure political connections or financial reporting quality, find that politically connected firms have lower financial reporting quality. However, researchers have yet to comprehensively consider whether (and in what direction) political connections induce conservatism in financial reports.

This chapter concludes with a discussion of research in political science and finance that demonstrates that U.S. politicians are politically connected to the firms in which they invest in. Given the paucity of evidence on the accounting implication of politician participation in financial markets, and the strong theoretical basis on which to make predictions on how political connections influence accounting conservatism, this appears to be a fruitful avenue for financial reporting research.

CHAPTER 3

HYPOTHESIS DEVELOPMENT

3.1. Introduction

This chapter develops testable hypotheses that build on the themes reviewed in the previous chapter. The chapter begins by describing the structure of the hypotheses, which is necessitated by the fact that politician ownership can potentially influence conservatism through two channels, and can also potentially influence both conditional and unconditional conservatism. In Section 3.2, I describe that the hypothesis primarily focus on conditional conservatism, as there is strong theoretical support to justify this choice.

Section 3.3 of this chapter relates politician ownership to conditional conservatism, utilizing both the contracting and political costs explanations. Hypothesis 1 is premised on providing evidence to bear on which of these competing explanations holds in this setting. Section 3.4 expands on this comparison and presents H2 with the objective of providing further evidence to support the evidence documented in H1. Section 3.5 develops a hypothesis to directly test the contracting explanation in this setting, using cross-sectional variation in the extent to which firms are affected by the contracting explanation of conservatism. Section 3.6 provides an indirect test of the political costs explanation in this setting by incorporating the unconditional form of conservatism. Section 3.6 concludes with a summary of the chapter.

3.2. Structure of Hypothesis Tests

In the previous chapter, I discuss four possible explanations that drive the demand for conservatism. As described more fully below, cross-sectional variation in politician ownership, and political connections more broadly, may impact the contracting and/or political costs based demand for conservatism. On the other hand, I am not aware of any evidence that suggests that

POFs have a different exposure to shareholder litigation or taxation based demands for conservatism, and therefore do not incorporate these explanations into the hypothesis development. Where appropriate, I control for these explanations as part of my research design.

The previous chapter also discussed the two forms of conservatism and the implications of each of the explanations for conditional and unconditional conservatism. The contracting explanation is expected to influence only the demand for conditional conservatism, while the political costs explanation can influence the demand for either conditional or unconditional conservatism. Since conditional conservatism has the potential to be impacted by both explanations, I primarily focus on conditional conservatism in H1-H3, and supplement these hypotheses with a hypothesis related to unconditional conservatism in H4.

3.3. Political Ownership and Conditional Conservatism

3.3.1. Contracting Demand for Conditional Conservatism

Lenders primary motivation in demanding conditional 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] 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, a 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

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[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 Depository 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).

[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

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 conditionally conservative reporting, incorporated in debt contracts, will be weaker for POFs than for non-POFs.

3.3.2. Political Costs Demand for Conditional Conservatism

In contrast to the negative association predicted by the contracting explanation, the political costs explanation predicts a positive association between politician ownership and conditional 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

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[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

[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

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]

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

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[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 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.

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).

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

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[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.

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).

3.3.3. Prediction

In summary, POFs may have less conditionally conservative financial reporting if lenders are less concerned about downside default risk, or more conditionally 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 conditional 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 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 conditional conservatism.

3.4. Strength of Politician-Firm Relationship and Conditional Conservatism

In the previous section, political ownership was discussed in general. However, perceptions by lenders and voters are likely to be shaped by the strength of the link between the investing politician and investee firm. One way of capturing the strength of the political connection is to further partition POFs into those owned by a local politician (local POFs) and those not owned by a local politician (distant POFs). This approach is particularly helpful in helping to further distinguish between the contracting and political costs explanations.

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[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.

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.[18] Capital market participants are aware of the strength of these local ties (Roberts 1990; Faccio and Parsley 2009; Acemaglou et el. 2013), suggesting lenders are likely to be less concerned with the downside default risk of local POFs, and consequently, the negative relationship between politician ownership and conservatism predicted by the contracting explanation should be stronger for local POFs than distant POFs. Under the political costs explanation, voters are more likely to view local POFs as being politically connected to the investee firm, increasing the risk to the local politician of bearing political costs. Thus, the positive relationship between politician ownership and conservatism predicted by the political costs explanation should be stronger for local POFs than distant POFs.

In sum, I expect the strength of the political connections to moderate the relationship between political ownership and conditional conservatism. Of course, the exact nature of this effect depends on the results of H1. If H1 produces a positive relation between politician ownership and conditional conservatism, I would expect the relationship to be significantly more positive for local POFs (to support the political costs explanation). If H1 produces a negative relation, I would expect the relationship to be significantly more negative for local POFs (to support the contracting explanation).

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[18] 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

H2: The association between politician ownership and conditional conservatism is more pronounced for firms where investing politicians are local to the firm.

3.5. Firm Contracting Environment and Conditional Conservatism

Another useful way to distinguish between the two competing explanations is to exploit differences across firms in the applicability of each of these explanations. Since the theory and empirical evidence relating to the contracting explanation is far more developed than that relating to the political costs explanation, I exploit cross-sectional variation in the applicability of the contracting explanation.[19] The purpose of this hypothesis is to directly test the contracting explanation of conservatism in this setting.

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 incentives to monitor managers, and exercise less control over managers' actions (Nikolaev 2010). In addition, credit rating agencies are primarily interested in assessing downside default risk, and demand conservatism from rated firms (Bae et al. 2013). If the contracting explanation holds in this setting, we should observe a negative relationship between politician ownership and conditional conservatism, and this relationship should be significantly

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[19] To my knowledge, there are only two measures used to capture cross-sectional variation in the applicability of the political costs explanation for a broad sample of firms. Qiang (2007) uses market share to capture extent of political costs faced, and finds no relation with conditional conservatism, whereas Dhaliwal et al. (2014) find a positive association, and interpret this as consistent with market share capturing strategic incentives rather than political costs. The second measure, lobbying expenditures used by Kong et al. (2013), is more traditionally viewed as a measure of political connections, thereby precluding its inclusion in any cross-sectional analysis.

more negative for firms that interact with debt market participants that value the contracting benefits of conservatism.

H3: The association between politician ownership and conditional conservatism is more pronounced for firms that interact with debt market participants that value the contracting benefits of conservatism.

3.6. Politician Ownership and Unconditional Conservatism

Thus far, I have focused on the relation between politician ownership and conditional conservatism, with the objective of distinguishing between the contracting and political costs explanations. H1 offers a direct test of which of the explanations holds in this setting, while H2 and H3 provide complimentary and confirmatory evidence. As a final test, I examine the association between politician ownership and unconditional conservatism.

As noted in the previous section, the contracting explanation provides incentives for firms to provide conditional conservatism but not unconditional conservatism, because the latter does not employ new information that can generate contracting responses. The relation between the political costs explanation and conservatism is more ambiguous, as some prior research has argued that political costs provides incentives for firms to favor unconditional conservatism due to voters aversion to large negative shocks (Qiang; 2007), while other have argued that voters primary objective is to constrain opportunistic managerial behavior, which can best be achieved through conditional conservatism (Watts; 2003). Nonetheless, documenting a positive association between politician ownership and unconditional conservatism would provide indirect evidence that would not be consistent with the contracting explanation.

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H4: Ownership by politicians is positively associated with unconditional conservatism.

3.7. Conclusions

In this chapter I posit four hypotheses to be tested in subsequent empirical analyses. I present my first hypothesis in support of a relation between politician ownership and conditional conservatism. I present the next two hypotheses in support of an interaction between politician ownership and strength of ownership and contracting environment that affect conditional conservatism. I present my final hypothesis in support of a positive relation between politician ownership and unconditional conservatism.

CHAPTER 4

SAMPLE SELECTION AND RESEARCH DESIGN

4.1. Introduction

In this chapter I describe all aspects related to the empirical design of my sample and primary analysis. The chapter begins by describing the method for selecting my sample firms (Section 4.2) and follows with separate discussions of my selection and construction of proxies for politician ownership (Section 4.3) and conditional and unconditional conservatism (Section 4.4). This chapter also presents the empirical models used to test Hypotheses 1 through 4 (Section 4.5). Overall, this chapter includes seven sections, including this introduction and a conclusion.

Section 4.2 outlines my sample selection criteria and primary sample period. Politician ownership data is hand-collected for S&P 1500 firms during the period 2005-2011. This design choice helps with comparisons to other studies in the literature, and balances the need for a reasonable sample size with the demands of hand-collection.

Section 4.3 describes the annual financial disclosure reports from which I obtain data on politician ownership. This section includes an example report, and provides descriptive statistics on the level of politician ownership in my sample firms, using multiple measures of ownership.

Section 4.4 provides rationale for my decision to use the Basu (1997) earnings-return model as a measure of conditional conservatism, and the Givoly and Hayn (2000) accruals based measure of unconditional conservatism.

Section 4.5 and 4.6 present two models, one to test Hypothesis 1 through 3, and a second model, to test Hypothesis 4. Both models are tested empirically using OLS methods. Section 4.7 concludes the chapter.

4.2. Sample

As in prior research (LaFond and Roychowdhury 2008; Ramalingegowda and Yu 2012), I focus on a sample of 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. This design choice facilitates comparisons to others studies in the literature, and also reduces the extent of hand-collection of politician ownership data. I summarize the sample selection process in Panel A of Table 1.

I begin with a sample of 10,555 firm-year observations in the S&P 1500 index during the 2005-2011 period, as per ExecuComp. I remove 763 firm-year observations with missing Compustat data to compute net income, leverage, and market-to-book. I further remove 203 firm-year observations with missing CRSP data on stock returns. Finally, I remove 1,609 firm-year observations belonging to the financial industry (SIC 6000-6999), as the reporting incentives of financial firms is quite different from non-financial firms. The sample consists of 7,980 firm-years from 1,540 firms in the S&P 1500 index covering the period 2005-2011. These are non-financial firms that have the required financial accounting data from Compustat and stock price data from CRSP.

4.3. 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 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. The Center for Responsive Politics (https://www.opensecrets.org/pfds/) maintains copies of these forms for all members of the U.S. House and Senate, and also provides its own summaries of the data.

An example of a financial disclosure report for calendar year 2009 filed by Stephen F. Lynch (D-MA), a Democrat House of Representatives member from Massachusetts is provided in Appendix A. Page 1 of the disclosure form asks for identifying data for the filer, preliminary questions that direct the filer to other schedules of the form, and declarations for whether the filer has any blind trusts or other investment vehicles that are not disclosed in the form. Note that questions relate not only to Rep. Lynch's personal wealth, but also those of any spouse or dependent child. Since no individual or organization donated to a charity in lieu of paying for a speech or appearance by Rep. Lynch (Schedule II), no transactions executed by Rep. Lynch during the year exceeded $1,000 (Schedule IV), Rep. Lynch did not receive any gift exceeding $335 (Schedule VI), Rep. Lynch did not receive any travel allowance exceeding $335 (Schedule VII), and Rep. Lynch did not have any agreement with an outside entity (Schedule IX), certain schedules are excluded from the report.

In Page 2 of the form, Rep. Lynch indicates that his wife earned income from the South Boston Community Health Center, but does not disclose the amount, presumably because it does not exceed $1,000. In Pages 3 and 4 of the form, Rep. Lynch lists all of his assets as of Dec. 31, 2009, all of which are jointly held by his spouse. For this schedule, politicians are required to disclose any asset with a value exceeding $1,000 or any asset that resulted in income in excess of $200. The form asks for the year-end value of the asset (in broad ranges), the type and amount of income the asset produces, and any transactions exceeding $1,000 that were executed during the year. In Rep. Lynch's case, he lists two residences, three publicly-traded firms, and four equity funds. Since Cisco Systems, EMC Corporation, and Intel Corporation are all S&P 1500 firms, I code each of them as being owned by Rep. Lynch. I repeat this process for all standing members of the U.S. House and Senate for each year of my sample period, to obtain the level of politician

ownership for all sample firm-year observations. As described above, the relevant schedule for this thesis is Schedule III, which lists the assets held by each member of Congress. Page 5 and 6 of the form indicate that Rep. Lynch has two mortgages with Mt. Washington Bank and is a board member for three non-profit organizations.

My main measure of politician ownership, *POLOWN*, is defined 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. 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 observations 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.

Table 2 reports the descriptive statistics for various firm-year level politician ownership variables for sample firms between 2005 and 2011. Measures included are the binary politician ownership variable described above, minimum and maximums of a range of the total dollar value of equity holdings, and a count measure based on the total number of politician equity investors. In Panel A of Table 2, I find that the mean dollar value of equity holdings by all politicians is $363,011 (the midpoint of the minimum and maximum), while the mean number of politician equity investors is 3.10. These variables exhibit considerable skewness in that the median values are only $1,000 (minimum), $4,767 (maximum), and 1 (count), respectively.[20]

Panel B of Table 2 restricts the observations to those with some level of politician ownership. The median firm-year observation for this subsample has 2 politician equity

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[20] 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.

investors, with investment values ranging from $16,000 (minimum) to 60,000 (maximum). A subset of firms have much higher equity investment by politicians, as the 90th percentile values are 13 (count), $577,741 (minimum) and $1,189,724 (maximum), respectively.

Panels C to E further break down the politician ownership data to those observations only owned by distant politicians versus those owned by both distant and local politicians. A local politician is defined as one whose congressional district coincides with the firm's headquarters (measured at the state level for members of the Senate and the district level for members of the House). As demonstrated in Panel C of Table 2, most of the 4,525 firm-year observations with some level of politician ownership do not have any local politician equity investors. For firm-year observations with only distant politician ownership, the median values of politician ownership are 2 (count), $15,000 (minimum), and $50,000 (maximum). These median values are lower than those reported in Panel D (4, $98,447, $254,097) for firm-year observations with both local and distant politician ownership, suggesting that firms with some level of local politician ownership have higher levels of total politician ownership. Finally, Panel E of Table 2 shows that ownership by local politicians makes up a non-trivial portion of the total politician ownership for firms with local ownership, as the median values of local politician ownership are 1 (count), $7,844 (minimum), and $31,801 (maximum).

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.

4.4. Measures of Conservatism

I measure conditional 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:

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

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.

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.

To measure unconditional conservatism, I use Givoly and Hayn's (2000) accrual based measure, based on the persistent use of negative accruals. I define *CONACC* as income before extraordinary items less cash flow from operations plus depreciation expense deflated by average total assets, and averaged over the previous three years, multiplied by negative one. Larger values of *CONACC* indicate greater unconditional conservatism. The basic intuition of this measure is that application of unconditional conservatism results in persistently negative accruals. The more negative the accruals over the period, the more unconditionally conservative the accounting. For example, if a firm has a policy of taking accelerated depreciation on tangible

assets it acquires, then accruals will be persistently negative, resulting in greater unconditional conservatism. This measure has both advantages and disadvantages. A key advantage is that by averaging over a number of periods, I ensure that the effects of any temporary larger accruals are mitigates, as accruals tend to reverse over a two year periods. One disadvantage is that the measure does not reflect cumulative unconditional conservatism as it ignores the effects of unconditional conservatism in prior periods (i.e. it is not a stock measure).

My use of these two measures is motivated by their frequent and persistent use by researchers over the last two decades. While measurement of conservatism is no doubt a controversial topic, these two measures are widely used and commonly accepted.

4.5. Regression Models for Hypothesis 1 to 3

To test the relation between politician ownership and conditional conservatism (H1), I follow prior research and estimate the Basu model, which specifies conservatism (the Basu coefficient) as a function of politician ownership and other determinants of conservatism:

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

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 ($POLOWN_{it\text{-}1}$) 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). *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. 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).

To test whether the relation between politician ownership and conditional conservatism varies depending on the strength of the firm-politician relationship (H2), I estimate the following regression model:

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

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 (measured at the state level for the U.S. Senate and district level for the U.S. House) 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 firm *i's* shares are owned by at least one member of the U.S. House or Senate and none of the members of Congress owning shares in firm *i* reside over the congressional district (measured at the state level for the U.S. Senate and district level for the U.S. House) in which the firm is headquartered at the end of year *t-1*, and 0 otherwise. The coefficient on $RET_{it}*NEG_{it}*LPOLOWN_{it-1}$ and $RET_{it}*NEG_{it}*LPOLOWN_{it-1}$ can either be negative or positive, depending on the outcome of H1. More importantly, if the contracting (political costs) explanation is more relevant in describing the relation between politician ownership and conditional conservatism, I should observe $\alpha_7 < \alpha_{11}$ ($\alpha_7 > \alpha_{11}$).

It is important to note that the construct of interest for H2 is the level of alignment between the interests of the politician and the firm. Given the importance of employment conditions to politicians' electoral success, an ideal measure would capture the level of employment by each of my sample firms in each politician's congressional district. However, employment data is only available on an aggregated basis, and extant research uses aggregated employment data to measure constructs such as labor intensity (Heese, 2014). Given data limitations, I use a parsimonious measure of incentive alignment based on the location of sample firms' headquarters. The maintained assumption of this measure is that there is an economic link between the district in which a firm is headquartered and the district's voters and politicians.

To test whether the relation between politician ownership and conditional conservatism varies depending on the extent to which the firm interacts with debt market participants that particularly value the contracting benefits of conservatism (H3), 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. However, it is important to

interpret the results using this measure with a caveat, as it is an indirect measure of the construct of interest. Ideally, one would like to measure the various aspects that make up sample firms debt structure, including public debt, private debt, and other forms of debt. Data at such a disaggregated level is not available for a large sample of firms. I assume that if a firm has an issuer credit rating, it is followed actively by credit rating agencies and public bondholders, two debt market participants that have been shown to value the contracting benefits of conservatism. Nonetheless, the empirical measure captures the construct of interest with noise, a point one needs to keep in mind when interpreting the results of H3.

To test H3, 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. I interact only $RATING_{it-1}$ with the main variables of interest to maintain a parsimonious model.

4.6. Regression Models for Hypothesis 4

To test the relation between politician ownership and unconditional conservatism, I follow prior research and estimate the following model:

$$CONACC_{it} = \alpha_0 + \alpha_1 POLOWN_{it-1} + \alpha_2 MV_{it-1} + + \alpha_3 MB_{it-1} + \alpha_4 LEV_{it-1}$$
$$+ \alpha_5 LIT_{it-1} + \alpha_6 CFO_{it-1} + \varepsilon_{it} \qquad (4)$$

In Equation (4), all variables are measured at the firm-year level, including the firm-specific measure of unconditional conservatism, $CONACC$. The coefficient of interest is α_1, which captures the effect of politician ownership in firm i at year $t-1$ ($POLOWN_{it-1}$) on unconditional conservatism in firm i's reporting over year t. A positive α_1 would be consistent with the political costs explanation and suggest that politician ownership induces a greater level

of unconditional conservatism. Alternatively, a negative or insignificant α_1 would provide evidence against the validity of the political costs explanation in this setting.

As for control variables, I control for firm size (*MV*), market-to-book (*MB*), leverage (*LEV*), and litigation (*LIT*). The intuition for these control variables is similar to the discussion for model (2), and these are included because Ahmed and Duellman (2013) provide evidence that these variables are consistently significant determinants of firm-specific measures of conservatism. Given that *MB* is an alternative measure of unconditional conservatism, it is unclear whether it should be included in equation (4). In untabulated tests, I find that excluding *MB* does not alter any of the inferences, and thus I retain it to maintain consistency with prior studies. I also include cash flow from operations (*CFO)* in model (4) as Ahmed and Duellman (2013) demonstrate that this measure is a strong predictor of firm-specific measures of conservatism. *CFO* is measured as cash flow from operations divided by market value.

4.7. Conclusions

This chapter reviews my sample selection and data collection methods, the construction of my politician ownership and accounting conservatism measures, and the design of my empirical models. Given that a major contribution of the thesis is the introduction of the politician ownership data to an accounting context, this section devotes considerable attention to describing the underlying data. Equations (2) to (4) in this chapter form the base of my tests for Hypothesis 1 through 4 and the results will be reported in Chapter 5.

CHAPTER 5

EMPERICAL ANALYSIS – POLITICIAN OWNERSHIP AND ACCOUNTING CONSERVATISM

5.1. Introduction

In this chapter, I test my four hypotheses and thus investigate the empirical relation between accounting conservatism and politician ownership. I empirically examine Equations (2), (3), and (4) from Sections 4.5 and 4.6 using firm-level samples of data, over the time period 2005-2011. This chapter includes six sections, including this introduction and conclusion.

Section 5.2 of this chapter examines the descriptive statistics relevant to my primary hypothesis tests. This examination also includes a review of a correlation table for my primary variables of interest and control variables. Section 5.3 of this chapter provides the main table of analysis for Hypothesis 1. Table 4 of this section reports the results of Hypothesis 1.

Section 5.4 and 5.5 reports the results of the remaining three hypotheses. Section 5.4 describes the results for the additional cross-sectional tests based on Hypothesis 2 and 3, while Section 5.5 describes the results for Hypothesis 4, where the dependent variable is a firm-year measure of unconditional conservatism. Section 5.6 concludes this chapter.

5.2. Descriptive Statistics and Correlations

Panel A of Table 3 presents the descriptive statistics of firm characteristics and control variables, separately for POFs and non-POFs. Over the sample period, POFs are profitable (median NI = 0.056), with strong stock market performance (median RET = 0.063). POFs are also relatively large firms (median MV = 4,253 million), with high growth options (median MB = 2.5), and some debt (median LEV = 0.18). 32% of POFs are in highly litigious industries. Consistent with prior studies on politically connected firms (Cooper et al. 2010), I find that POFs exhibit better operating performance but lower stock return performance, have higher growth

options, are more leveraged, and are larger than non-POFs. The most pronounced differences between POFs and non-POFs, in terms of economic magnitude, are with respect to firm size and future growth opportunities.

Panel B of Table 3 presents the correlation coefficients for the complete set of variables. Typically all correlations of more than 3% in absolute value are statistically significant at a 5% level or better. Consistent with Panel A, the politician ownership indicator variable is positively correlated with *NI, MV*, and *MB*, and negatively correlated with *RET*. For the entire sample of firms, operating performance is positively correlated with stock market performance (correlation coefficient of 0.202) and size (correlation coefficient of 0.058) and negatively correlated with leverage (correlation coefficient of 0.270). In addition to having worst operating performance, more levered firms have better stock market performance (correlation coefficient of 0.164), a lower incidence of negative stock market performance (correlation coefficient of 0.038), and are smaller firms (correlation coefficient of 0.039), with lower growth options (correlation coefficient of 0.039). Most of the correlations among control variables are small, and thus, multicollinearity is not an issue.

5.3. Hypothesis Test – H1

To test Hypothesis 1, 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). To mitigate the influence of outliers, I use Cook's (1977) distance (Cook's *D)* method to remove outliers. 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). Table 4 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 finds that conditional conservatism increases with leverage and litigation risk, and decreases with size and the 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. Columns (3) and (4) employ a count measure of politician ownership, based on the number of politicians investing in a particular firm. The results based on the count measure of politician ownership yield similar inferences, although firm size is no longer significant in predicting the level of conditional conservatism among sample firms. With the exception of size, the coefficient estimates and statistical significance levels of variables are very similar across the two measures of politician ownership, providing greater confidence in the documented results.

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 conditional conservatism from POFs because they are less concerned about downside default risk, and inconsistent with the positive association predicted by the political costs explanation.

5.4. Hypotheses Tests – H2 and H3

In this subsection, I examine whether the impact of politician ownership on conditional conservatism varies with the strength of the politician-firm connection as well as the extent to which the firm interacts with debt market participants that value the contracting benefits of conservatism. As Hypothesis 1 produced a negative relation, I expect both of these factors to moderate the relationship between politician ownership, such that the relationship is significantly more negative for local POFs (H2) and firms with long-term S&P credit issuer ratings (H3). Evidence consist with these hypotheses would provide support for the contracting explanation.

Table 5 reports the results of Hypothesis 2. As in Table 4, the coefficient α_3 has a positive and statistically significant value in both columns, in line with findings in Basu (1997). In column (1), I find that both α_7 and α_{11} are significantly negative, consistent with the results in Table 4 that POFs adopt less conditionally 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*. Once again, including the control variables increases explanatory power (the adjusted R^2 increases by 8%), but do not alter the inferences from the first column. Interestingly, the coefficient on α_7 is -0.132 (or 100% of α_3), which suggests that local politician ownership completely mitigates the 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, the demand for conservatism. From this hypothesis test, I conclude that there is cross-sectional variation in the demand for conditional conservatism based on the strength of the economic connection between the politician investor and the POF, as measured by local ties. This result provides support for the contracting explanation and provides further evidence against the validity of the political costs explanation in this setting.

Table 6 presents the results of Hypothesis 3. In column (1), I find that the coefficients on $RET_{it}*NEG_{it}$ and $RET_{it}*NEG_{it}*POLOWN_{it-1}$ are significantly positive and negative (at the 1% level), consistent with expectations. 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 conditional conservatism is strengthened by the extent to which the firm interacts with debt market participants (i.e. credit rating agencies, public bondholders) that value the contracting benefits of conditional conservatism.

As in Table 5, column (2) further partitions the politician ownership variable into a local and distant component. Column (2) yields similar inferences to column (1), 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 signcificant (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. This evidence is consistent with H3 and provides support for the contracting explanation in this setting.

5.5. Hypothesis Test – H4

Table 7 presents the estimation of equation (4) using the accrual-based measures of unconditional conservatism as the dependent variable. Inconsistent with Hypothesis 4, I find an

insignificant coefficient on the binary (*p*-value = 0.13), count (*p*-value = 0.17), and distant (*p*-value = 0.16) measures of politician ownership and a significantly negative coefficient on the local ownership variable (*p*-value = 0.01). The results are inconsistent with political costs generating a demand for unconditional conservatism. The coefficients on *LIT* and *CFO* are positive and significant across all three columns (*p*-value = 0.00), indicating that firms facing greater litigation risk and more profitable firms use less unconditionally conservative accounting. As expected, I find a negative and significant coefficient on *MV* in two of the three columns (*p*-value = 0.00), suggesting that larger firms use more unconditionally conservative accounting. Unexpectedly, the coefficient on *MB* is significantly positive in all three columns, at the 10% level, while the coefficient on *LEV* is significantly negative in all three columns, at the 5% level. One possible explanation for the result on *MB* is that both *MB* and *CONACC* are capturing unconditional conservatism, and are thus positively correlated. One possible explanation for the result on *LEV* is that debtholder presence induces a demand for conditional conservatism, reducing opportunities for unconditional conservatism. Overall, the results reported in Table 7 provide further evidence against the validity of the political costs explanation in this setting.

5.6. Conclusions

In summary, evidence presented in this chapter is generally consistent with the view that politician ownership influences the level of accounting conservatism, particularly conditional conservatism. My main analysis shows a negative and statistically significant relation between measures of politician ownership and conditional conservatism. This relationship is more pronounced when the ownership includes politicians local to the firm and when the firm interacts with debt market participants (i.e. credit rating agencies, public bondholders) that particularly value the contracting benefits of conservative financial reporting. None of these results are consistent with the validity of the political costs explanation in this setting. Further analysis

suggests that politician ownership is not associated with unconditional conservatism, providing further evidence against (in support of) the political costs (contracting) explanation. The sensitivity and robustness of these conclusions will be tested in Chapter 6 of this thesis.

CHAPTER 6

SENSITIVITY ANALYSIS

6.1. Introduction

In this chapter, I conduct supplemental tests to assess the sensitivity of the preceding analyses and the robustness of the findings. The additional empirical analysis includes control variables relating to ownership structure, alternative measures of conditional conservatism, attempts to establish the direction of association between politician ownership and accounting conservatism, and alternative estimation approaches. This chapter includes six sections, including this introduction and a conclusion.

Section 6.2 of this chapter examines whether the findings of the previous chapter are robust to controlling for other attributes of the ownership structure. Section 6.3 employs alternative measures of conditional conservatism, while Section 6.4 devotes effort to assessing reverse causality and simultaneity concerns. Section 6.5 uses a number of different estimations in an effort to support and extend the results documented in the previous chapter, including clustering standard errors at the firm level and employing year and firm fixed effects. Section 6.6 concludes the chapter.

6.2. Controlling for Ownership Structure

While I motivate my analysis from the perspective of debt market participants, recent research finds that equity investors also demand conditional conservatism (e.g., Ahmed and Duellman 2007; LaFond and Roychowdhury 2008; LaFond and Watts 2008; Ramalingegowda and Yu 2012; Kim et al. 2013). These studies typically reflect themes of corporate governance, and in this section, I control for the influence on equity holders' demand for conservatism when testing H1 to H3. I do not rexamine H4, controlling for ownership structure, because LaFond and

Roychowdhury (2008) argue that the relation between managerial ownership and unconditional conservatism is ambiguous, and Ahmed and Duellman (2013) provide evidence that managerial ownership is a weak predictor of unconditional conservatism. I measure equity holders' demand for conservatism as the percentage of the firms' equity owned by the CEO (*CEOOWN)*. 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. Both LaFond and Roychowdhury (2008) and Ahmed and Duellman (2013) focus on CEO ownership, arguing that the CEO is the key agent of the shareholder in charge of the firms' operations and policies. LaFond and Roychowdhury (2008) also demonstrate a very high correlation between ownership by the CEO and ownership by the top five managers of a firm (pearson correlation coefficient of 0.87), and demonstrate that the results are insensitive to whether managerial ownership is measured for the top five managers or the CEO alone. Thus, I use the more parsimonious measure of ownership, focusing on ownership of the CEO.

Table 8 presents the results of testing Hypothesis 1 through 3, controlling for the effects of ownership structure in Equations (2) and (3). Consistent with earlier results, the coefficient on $RET_{it}*NEG_{it}*POLOWN_{it-1}$ in column 1 is significant at the 1% level, suggesting that politician ownership is negatively associated with conditional conservatism (H1), even after controlling for managerial ownership. The coefficient on $RET_{it}*NEG_{it}*CEOOWN_{it-1}$ is also significantly negative, at the 1% level, suggesting that managerial ownership is also a significant determinant of conditional conservatism. In column 2 of Table 8, the coefficients on $RET_{it}*NEG_{it}*LPOLOWN_{it-1}$ and $RET_{it}*NEG_{it}*DPOLOWN_{it-1}$ continue to be significantly negative after controlling for managerial ownership, with the coefficient on local ownership being significantly more negative than that on distant ownership (*p*-value = 0.00), consistent with

H2. Finally, in column 3 of Table 8, the coefficient on $RET_{it}*NEG_{it}*POLOWN_{it-1}*RATING_{it-1}$ remains significantly negative (p-value = 0.08) after controlling for managerial ownership, consistent with H3. As in column 1, the coefficient on $RET_{it}*NEG_{it}*CEOOWN_{it-1}$ is significantly negative, at the 1% level, in both columns 2 and 3.

In sum, managerial ownership is negatively associated with conditional conservatism in my analysis. However, the presence of managerial ownership in my empirical model does not diminish the influence of politician ownership on conditional conservatism, not does its exclusion significantly affect the estimated coefficients of the politician ownership variables. Overall, both managerial and politician ownership appear to be important factors in my model of conditional conservatism.

6.3. Alternative Measures of Conditional Conservatism

In Chapter 4, I discuss why the Basu (1997) earnings-return model is the appropriate measure of conditional conservatism for my setting. Nevertheless, there is disagreement in the literature regarding empirical measures of conditional conservatism, and so use alternative proxies for conditional conservatism. In this section, my objective is to establish that politician ownership influences conditional conservatism, and that this relationship is not an artifact of the specific measure used, and therefore focus on H1. As I have already demonstrated that politician ownership negatively influences conditional conservatism (measured using the earnings-return model) in Table 4, I make directional predictions for this analysis, and use one-tailed tests.

First, 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). Recently, the measure has been used by Ball and Shivakumar (2005) and Ramalingegowda and Yu (2012), among others, as a proxy for conditional conservatism.

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:

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

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

$\Delta NI_{t\tau}$ = 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 $\Delta NI_{t\tau}$ is negative, and 0 otherwise.

In Equation (5), α_7 captures the association between politician ownership and conservatism. If greater conditional conservatism leads to lower persistence of earnings changes, $\alpha_7 > 0$ would indicate that conditional conservatism decreases with politician ownership.

Table 9 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. The relationship approaches statistical significance for the binary variable (p-values = 0.13) and is significant for the count variable (p-values = 0.08). 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 this alternative measure of conditional conservatism.

Second, following Ball and Shivakumar (2005), I estimate conditional conservatism using the following piecewise linear relation between accruals and cash flows:

$$ACC_{it} = \alpha_0 + \alpha_1 CFO_{it} + \alpha_2 DCFO_{it} + \alpha_3 CFO_{it}*DCFO_{it} + \alpha_4 POLOWN_{it-1}$$

$$+ \alpha_5 CFO_{it}* POLOWN_{it-} + \alpha_6 DCFO_{it}*POLOWN_{it-1} + \alpha_7 CFO_{it}*DCFO_{it}*POLOWN_{it-1}$$

$$+ \alpha_{8-11} CONTROLS_{it-1} + \alpha_{12-15} CFO_{it}*CONTROLS_{it-1}$$

$$+ \alpha_{16-19} DCFO_{it}*CONTROLS_{it-1} + \alpha_{20-23} CFO_{it}*DCFO_{it}*CONTROLS_{it-1} + \varepsilon_{it} \qquad (6)$$

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

ACC_{it} = is accruals scaled by beginning total assets (AT). Accruals are defined as earnings before exceptional items and extraordinary item (IB) is minus cash flows from operations (OCANF).

CFO_{it} = is cash flows from operations (OCANF) scaled by beginning total assets (AT).

$DCFO_{it}$ = is an indicator variable equal to one if CFO is negative, and zero otherwise.

Ball and Shivakumar (2005) argue that the above piecewise linear regression captures two roles of accruals: mitigation of noise in cash flows and asymmetric recognition of unrealized gains and losses. α_1 measures the extent to which accruals mitigate noise in cash flows and is predicted to be negative. Asymmetrically timely gain and loss recognition results in asymmetry in the relation between accruals and cash flows (similar to the asymmetry between returns and net income in the Basu (1997) earnings return model). Unrealized losses, as accrual charges against earnings, are likely to be recognized more quickly than unrealized gains. This asymmetry in timeliness of recognition implies that the negative relation between cash flows and accruals is less pronounced in periods with unrealized losses than in periods with unrealized gains. Therefore, the asymmetric timeliness coefficient, α_3, captures conditional conservatism and is expected to be positive. α_7 captures the association between politician ownership and conditional conservatism. $\alpha_7 < 0$ would indicate that conservatism decreases with politician ownership.

Table 10 reports the results for estimating Equation (6). Column 1 reports the results for the binary ownership variable, while Column 2 reports the results for the count ownership variable. As expected, the coefficient on α_1 is significantly negative in both columns. However, the asymmetric timeliness coefficient, α_3, is not significantly positive in either column. The coefficient of interest, α_7 is also not significantly different from zero, suggesting that politician ownership is not associated with conditional conservatism. In untabulated results, I find that *MB* and *LEV* are also not significant determinants of conditional conservatism in this model.

These results are inconsistent with those using the earning-return and earnings-change models. It is particularly troubling that the coefficient on α_3 and the control variables are not significant in the direct predicted. I investigate the percentage of firm-year observations with negative cashflows ($DCFO = 1$) during the sample period, and find that the percentage is very low (5%) relative to the percentage of firm-year observations with negative returns (41%) in the earning-return model and negative changes in earnings (35%) in the earnings-change model. Given the distribution of cash flows for my sample, it is possible that the Ball and Shivakumar (2005) piecewise linear regression model lacks adequate power to identify significant determinants of conditional conservatism. Thus, I am unable to conclude whether my results are robust to using the Ball and Shivakumar (2005) measure of conditional conservatism.

6.4. Establishing the Direction of Association

A negative relation between politician ownership and conditional 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, conditional conservatism and ownership by politicians could arise simultaneously, driven by some unknown underlying factor (the "simultaneity" explanation). In this subsection, I perform two tests to provide evidence on the direction of association between politicians' equity holdings and conditionally conservative reporting. In this section, my objective is to establish the direction of association, and therefore focus on H1. As I have not previously demonstrated this relationship, I make non-directional predictions, and therefore use two-tailed tests.

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 conditional conservatism is related to lagged, current, and lead ownership by politicians:

$$NI_{it} = \alpha_0 + \alpha_1 RET_{it} + \alpha_2 NEG_{it} + \alpha_3 RET_{it}*NEG_{it} + \alpha_4 POLOWN_{it-1} + \alpha_5 RET_{it}* POLOWN_{it-1}$$

$$+ \alpha_6 NEG_{it}*POLOWN_{it-1} + \alpha_7 RET_{it}*NEG_{it}*POLOWN_{it-1} + \alpha_8 POLOWN_{it}$$

$$+ \alpha_9 RET_{it}* POLOWN_{it} + \alpha_{10} NEG_{it}*POLOWN_{it}$$

$$+\alpha_{11} RET_{it}*NEG_{it}*POLOWN_{it} + \alpha_{12} POLOWN_{it+1} + \alpha_{13} RET_{it}* POLOWN_{it+1}$$

$$+ \alpha_{14} NEG_{it}*POLOWN_{it+1} + \alpha_{15} RET_{it}*NEG_{it}*POLOWN_{it+1}$$

$$+\alpha_{16-19} CONTROLS_{it-1} + \alpha_{20-23} NEG_{it}*CONTROLS_{it-1}$$

$$+\alpha_{24-27} RET_{it}*CONTROLS_{it-1} +\alpha_{28-31} RET_{it}*NEG_{it}*CONTROLS_{it-1} + \varepsilon_{it} \qquad (7)$$

In Equation (7), α_7, $\alpha_{11,}$ 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 11 reports the results from estimating equation (7). Consistent with lenders demanding less conservative reporting from POFs, I find a significant negative relation between conditional conservatism and *lagged* politician ownership *(p*-values = 0.01 and 0.00 in columns (1) and (2), respectively). In contrast, the relation between conditional 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.

In the second test, I follow LaFond and Watts (2008) and Ramalingegowda and Yu (2012) and examine the relation between changes in politician ownership and lagged, concurrent, and lead changes in conditional conservatism. I sort each firm-year observations into one of three groups based on the change in politician ownership from *t-1* to *t* (i.e., *POLOWNit - POLOWNit-1*). The first group includes firm-years with a decrease in the number of politician investors (n = 1,152 observations) relative to the prior year, the second group includes firm-years with no change in the number of politician investors relative to the prior year (n = 2,169), and the third group includes firm-years with an increase in the number of politician investors relative to the prior year (n=969). Then, for each group, I estimate the level of conditional conservatism (i.e., $\alpha3$ in Equation (1)) for each of the years *t-2* to *t+1*. This approach allows me to estimate the year-to-year change in conditional conservatism prior to the ownership change ($\alpha3t-1$ - $\alpha3t-2$), concurrent with the ownership change ($\alpha3t$ - $\alpha3t-1$), and after the ownership change ($\alpha3t+1$ - $\alpha3t$). Since I require two years of lagged data and one year of lead data, I restrict this analysis to sample years 2007 to 2010. If politician ownership impacts the demand for conditional conservatism, I would expect a positive (negative) association between decreases (increases) in politician ownership and *lead* changes in conditional conservatism. In contrast, the reverse

causality (simultaneity) explanation would make similar directional predictions between changes in politician ownership and *lagged* (*concurrent*) changes in conditional conservatism. The Basu coefficients are estimated based on separate regressions, for each group (3 in total) and time period (4 in total), and differences in means are compared using t-tests.

Panel A of Table 12 presents the average change in politician ownership for each of the groups as well as the Basu coefficients (the coefficient from Equation (1)) for each of the groups and reporting periods. For the firms in the ownership decrease (increase) group, the average change in politician ownership is 2.05 (1.78) politician investors. In general, conservatism is increasing over time as indicated by the general increase in the Basu coefficient from *t-2* to *t+1*.

Panel B reports the change in the conditional conservatism measure (i.e., the Basu coefficient) *prior to* the ownership change ($\alpha3,t\text{-}1$ - $\alpha3,t\text{-}2$), *concurrent* with the ownership change ($\alpha3,t$ - $\alpha3,t\text{-}1$), and *after* the ownership change ($\alpha3,t\text{+}1$ - $\alpha3,t$), respectively. For the ownership decrease group, there is no statistically significant change in conservatism prior to or concurrent with the period of change of politician ownership, but an increase in the level of conservatism after the change in ownership. This evidence is consistent with politician ownership influencing the level of conditional conservatism and inconsistent with the reverse causality or simultaneity explanations. For the ownership increase group, there is no significant increase in any of the three periods. These results provide no definitive evidence consistent with any of three explanations. Finally, in Panel C, I compare across group differences between the ownership increase and decrease groups in the three periods. There is no statistically significant difference in the change in conservatism across the groups in any of three periods.

Overall, this test provides limited evidence consistent with politician ownership influencing the level of conditional conservatism in future years. Importantly, this test provides

no evidence consistent with either the simultaneity or reverse causality explanations. A possible explanation for the lack of consistent results, particularly for the ownership increase group, includes a lack of power stemming from a reduced sample period which is concentrated heavily in financial crisis years (relative to the main sample). Of course, another interpretation of the results is that it casts doubt on my main results, and the direction of association predicted. While I cannot definitively rule out alternative explanations, I interpret the collective evidence from Table 11 and Table 12 as suggesting that the direction of the relation goes from politician ownership to conservatism, rather than the reverse or arising simultaneously.

6.5. Alternative Estimations

In this subsection, I report the results of several different estimations to provide evidence on the sensitivity of the hypothesis tests.

First, I assess the sensitivity of clustering standard errors on firm alone rather than on both firm and time. Petersen (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 the underlying concern relates to estimation and is not specific to a particular for of conservatism or hypothesis, I retest all four hypotheses here. Table 13 provides the results, with Panel A reporting the results for conditional conservatism (H1 to H3) and Panel B reporting the results for unconditional conservatism (H4). As I use annual measures of returns rather than multi-year accumulations as the dependent variable for H1 to H3, firm-level clustering may be more appropriate in my setting. The results in Panel A are quite consistent with those reported earlier in that all three hypothesis are supported, at similar level of statistical significance. In contrast to the results reported in Table 7, results in Panel B of Table 13 demonstrate that politician ownership is negatively associated with unconditional conservatism, at the 10% level of significance or better, in all three specifications. Given that the dependent variable, *CONACC*, is

measured based on firm's accrual averaged over the previous three years, clustering on both firm and time for the analysis on unconditional conservatism is arguably superior to clustering on firm alone. Furthermore, the test reveals a negative relationship between politician ownership and unconditional conservatism, and thus earlier inferences regarding the lack of support for H4 continue to hold.

Second, I assess the robustness of the results to inclusion of firm and year fixed effects. Several researchers discuss and provide empirical evidence of bias in Basu (1997) based estimates of conditional conservatism (e.g., Dietrich et al., 2007; Givoly et al., 2007; Patatoukas and Thomas, 2011). However, Ball et al., (2012) show that inclusion of firm and year fixed effects eliminates the bias as it helps to control for information that is incorporated in lagged earnings. Given the relatively low variation in politician ownership over time, inclusion of firm fixed effects may not be the most appropriate estimation for my setting. Thus, my approach is to estimate my models with and without fixed effects, triangulating evidence from both estimations. As the underlying concern relates to estimation and is specific to the conditional form of conservatism, I retest H1-H3. Table 14 reports the results of H1-H3, with the firm and year fixed effects included in Equations (2) and (3). As expected, the r-squared values increase considerably with the inclusion of firm and year fixed effects, ranging between 64% and 68% in Table 14. In the first two columns of Table 14, I continue to find support for H1 and H2, as politician ownership is negatively associated with conditional conservatism (p-value = 0.04), and this relationship is more pronounced when the ownership is local (p-value = 0.00). While I continue to find directional support consistent with H3, the coefficient on $RET_{it}*NEG_{it}*POLOWN_{it-1}*RATING_{it-1}$ is not significant at conventional levels (p-value = 0.19).

Overall, including firm and year fixed effect in my models of conditional conservatism does not appear to drastically alter inferences.

Finally, I examine the level of collinearity among the many interaction variables in Tables 4-6 to assess whether estimation techniques (such a centering approach) are needed to reduce the extent of collinearity in the interaction terms. I compute condition indexes to formally assess collinearity. Weak dependencies are associated with condition indexes of 5–10; moderate to strong dependencies have condition indexes of 30–100 (Belsey et al. 1980). The highest condition number for the models reported in Table 4-6 is 24, suggesting that collinearity is not a significant problem in reported results and that a centering approach is not needed.

6.6. Conclusions

In summary, evidence presented in this chapter helps to demonstrate that the inferences from Chapter 5 are robust to controlling for equity ownership, using an alternative measure of conditional conservatism, and different estimation techniques. The evidence from this chapter that aims to establish the direction of association is mixed, with one test providing strong support for politician ownership influencing the level of conservatism, while another test provides little support for this particular direction of association. Thus, the evidence from this chapter provides only partial evidence to rule out reverse causality and simultaneity based explanations. Final remarks on the implications of these findings follow in Chapter 7.

Of course, as in any study, a number of lingering questions remain. First, this thesis argues that lenders assess a lower downside default risk for politician owned firms, and therefore demand less conditional conservatism from these firms. In future research, it would be useful to establish an explicit link between politician ownership and lenders' assessment of default risk. It would also be useful to more carefully establish the chain of events, by identifying when politician investment is made in a particular firm, how this influences contracting terms once a

debt agreement is initiated, and how this subsequently alters the conservatism of the firm's reporting. Furthermore, the construct of interest in this study is political connections, and it would therefore be fruitful to examine whether the documented results are consistent for different measures of politician connections. At this stage, I leave these, and other important research questions, for future research.

CHAPTER 7

CONCLUSION

This thesis 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 predict 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 conditionally 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 conditional 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. In tests relating politician ownership to unconditional conservatism, I do not find evidence that POFs adopt more unconditionally conservative accounting practices. This provides further evidence against the validity of the political costs hypothesis in this setting. Taken together, the collective evidence is consistent with lender incorporating the implicit advantages of political connections into their assessment of downside default risk.

This thesis 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. Furthermore, for my sample firms and over my sample period, there is variation in important institutional features such as the proximity to the election cycle, term limits, and the ability of the politician to influence firms' reporting choices, which may add noise to the analysis. Therefore, the extent to which politician ownership correlates with conditional and unconditional conservatism may not represent the most powerful test 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.

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APPENDIX A

EXAMPLE OF FINANCIAL DISCLOSURE REPORT

UNITED STATES HOUSE OF REPRESENTATIVES	FORM A	Page 1 of 6	HAND DELIVERED

CALENDAR YEAR 2009 FINANCIAL DISCLOSURE STATEMENT — For use by Members, officers, and employees

LEGISLATIVE RESOURCE CENTER

Stephen F. Lynch (Full Name)

202-225-8273 (Daytime Telephone)

20 0 MAY 14 PM 4:41 MC

(Office Use Only)

Filer Status
☑ Member of the U.S. House of Representatives   State: MA   District: 09
☐ Officer Or Employee   Employing Office:

A $200 penalty shall be assessed against anyone who files more than 30 days late.

Report Type
☑ Annual (May 15)   ☐ Amendment   ☐ Termination   Termination Date:

PRELIMINARY INFORMATION -- ANSWER EACH OF THESE QUESTIONS

I. Did you or your spouse have "earned" income (e.g., salaries or fees) of $200 or more from any source in the reporting period?
If yes, complete and attach Schedule I.
Yes ☑ No ☐

II. Did any individual or organization make a donation to charity in lieu of paying you for a speech, appearance, or article in the reporting period?
If yes, complete and attach Schedule II.
Yes ☐ No ☑

III. Did you, your spouse, or a dependent child receive "unearned" income of more than $200 in the reporting period or hold any reportable asset worth more than $1,000 at the end of the period?
If yes, complete and attach Schedule III.
Yes ☑ No ☐

IV. Did you, your spouse, or dependent child purchase, sell, or exchange any reportable asset in a transaction exceeding $1,000 during the reporting period?
If yes, complete and attach Schedule IV.
Yes ☐ No ☑

V. Did you, your spouse, or a dependent child have any reportable liability (more than $10,000) during the reporting period?
If yes, complete and attach Schedule V.
Yes ☑ No ☐

VI. Did you, your spouse, or a dependent child receive any reportable gift in the reporting period (i.e., aggregating more than $335 and not otherwise exempt)?
If yes, complete and attach Schedule VI.
Yes ☐ No ☑

VII. Did you, your spouse, or a dependent child receive any reportable travel or reimbursements for travel in the reporting period (worth more than $335 from one source)?
If yes, complete and attach Schedule VII.
Yes ☐ No ☑

VIII. Did you hold any reportable positions on or before the date of filing in the current calendar year?
If yes, complete and attach Schedule VIII.
Yes ☑ No ☐

IX. Did you have any reportable agreement or arrangement with an outside entity?
If yes, complete and attach Schedule IX.
Yes ☐ No ☑

Each question in this part must be answered and the appropriate schedule attached for each "Yes" response.

EXCLUSION OF SPOUSE, DEPENDENT, OR TRUST INFORMATION -- ANSWER EACH OF THESE QUESTIONS

Trusts-- Details regarding "Qualified Blind Trusts" approved by the Committee on Standards of Official Conduct and certain other "excepted trusts" need not be disclosed. Have you excluded from this report details of such a trust benefiting you, your spouse, or dependent child?
Yes ☐ No ☑

Exemptions-- Have you excluded from this report any other assets, "unearned" income, transactions, or liabilities of a spouse or dependent child because they meet all three tests for exemption? Do not answer "yes" unless you have first consulted with the Committee on Standards of Official Conduct.
Yes ☐ No ☑

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SCHEDULE I - EARNED INCOME

List the source, type, and amount of earned income from any source (other than the filer's current employment by the U.S. Government) totaling $200 or more during the preceding calendar year. For a spouse, list the source and amount of any honoraria; list only the source for other spouse earned income exceeding $1,000.

Source	Type	Amount
South Boston Community Health Center	Spouse Salary	N/A

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BLOCK A	BLOCK B	BLOCK C	BLOCK D	BLOCK E
Asset and/or Income Source Identify (a) each asset held for investment or production of income with a fair market value exceeding $1,000 at the end of the reporting period, and (b) any other assets or sources of income which generated more than $200 in "unearned" income during the year. For rental property or land, provide a complete address. Provide full names of stocks and mutual funds (do not use ticker symbols). For all IRAs and other retirement plans (such as 401(k) plans) that are self directed (i.e., plans in which you have the power, even if not exercised, to select the specific investments), provide the value and income information on each asset in the account that exceeds the reporting threshold. For retirement plans that are not self-directed, name the institution holding the account and its value at the end of the reporting period. For an active business that is not publicly traded, state the name of the business, the nature of its activities, and its geographic location in Block A. For additional information, see the instruction booklet. Exclude: Your personal residence(s) (unless there is rental income); any debt owed to you by your spouse, or by your or your spouse's child, parent or sibling; any deposits totaling $5,000 or less in personal savings accounts; any financial interest in or income derived from U.S. Government retirement programs. If you so choose, you may indicate that an asset or income source is that of your spouse (SP) or dependent child (DC) or is jointly held (JT), in the optional column on the far left.	**Year-End Value of Asset** at close of reporting year. If you use a valuation method other than fair market value, please specify the method used. If an asset was sold and is included only because it is generated income, the value should be "None."	**Type of Income** Check all columns that apply. For retirement plans or accounts that do not allow you to choose specific investments, you may write "NA". For all other assets including all IRAs, indicate the type of income by checking the appropriate box below. Dividends and Interest, even if reinvested, should be listed as income. Check "None" if asset did not generate any income during the calendar year.	**Amount of Income** For retirement plans or accounts that do not allow you to choose specific investments, you may write "NA" for income. For all other assets, including all IRAs, indicate the category of income by checking the appropriate box below. Dividends and interest, even if reinvested, should be listed as income. Check "None" if no income was earned or generated.	**Transaction** Indicate if asset had purchases (P), sales (S), or exchanges (E) exceeding $1,000 in reporting year.
JT 3 Jason Terrace, South Boston, MA 02127	$250,001 - $500,000	RENT	$5,001 - $15,000	
JT 55 G Street, South Boston, MA 02127	$500,001 - $1,000,000	RENT	$5,001 - $15,000	
JT Cisco Systems	$1 - $1,000	None	NONE	
JT EMC Corporation	$1,001 - $15,000	None	NONE	
JT Intel Corporation	$1 - $1,000	DIVIDENDS	$1 - $200	
JT Morgan Stanley Growth Fund	$1 - $1,000	None	NONE	

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JT	Morgan Stanley Money Market-Liquid Asset Fund	$1 - $1,000	INTEREST	$1 - $200	
JT	Pioneer Equity Income Fund	$1,001 - $15,000	DIVIDENDS	$1 - $200	
JT	Pioneer Mid Cap Growth Fund	$1 - $1,000	None	NONE	

SCHEDULE V - LIABILITIES

Report liabilities of over $10,000 owed to any one creditor at any time during the reporting period by you, your spouse, or dependent child. Mark the highest amount owed during the year. Exclude: Any mortgage on your personal residence (unless all or part of it is rented out); loans secured by automobiles, household furniture, or appliances; and liabilities owed to a spouse, or the child, parent, or sibling of you or your spouse. Report "revolving charge accounts" (i.e., credit cards) only if the balance at the close of the preceding calendar year exceeded $10,000.

SP, DC, JT	Creditor	Type of Liability	Amount of Liability
JT	Mt. Washington Bank	Mortgage on 55 G Street, South Boston, MA 02127	$250,001 - $500,000
JT	Mt. Washington Bank	Mortgage on 3 Jason Terrcae, South Boston, MA 02127	$50,001 - $100,000

Report all positions, compensated or uncompensated, held during the current calendar year as an officer, director, trustee of an organization, partner, proprietor, representative, employee, or consultant of any corporation, firm, partnership, or any business enterprise, any nonprofit organization, any labor organization, or any educational or other institution other than the United States. Exclude: Positions held in any religious, social, fraternal, or political entities; positions solely of an honorary nature; and positions listed on Schedule I.

Position	Name of Organization
Board Member	Colonel Daniel Marr Boys Club
Board Member	Friends for Children
Board Member	South Boston Boys & Girls Club

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
Less:	
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
COMMON STOCK HOLDINGS OF MEMBERS OF CONGRESS: 2005-2011

Panel A: Firm-year measures of politician ownership (n=7,980)

	POLOWN	POLOWN$MIN	POLOWN$MAX	POLOWN#
Mean	0.567	234,386	491,636	3.101
Median	1.000	1,000	4,767	1.000
Standard Deviation	0.495	3,208,806	4,714,502	7.741
10th Percentile	0.000	0	0	0.000
25th Percentile	0.000	0	0	0.000
75th Percentile	1.000	21,000	83,125	3.000
90th Percentile	1.000	251,000	600,000	8.000

Panel B: Firm-year measures of politician ownership when POLOWN = 1 (n=4,525)

	POLOWN$MIN	POLOWN$MAX	POLOWN#
Mean	413,350	867,018	5.470
Median	16,000	60,000	2.000
Standard Deviation	4,252,750	6,235,022	9.630
10th Percentile	1,000	3,000	1.000
25th Percentile	2,000	15,000	1.000
75th Percentile	116,000	302,780	5.000
90th Percentile	577,741	1,189,724	13.000

Panel C: Firm-year measures of politician ownership when POLOWN = 1 and ownership is distant (n=3,943)

	POLOWN$MIN	POLOWN$MAX	POLOWN#
Mean	388,582	761,886	4.795
Median	15,000	50,000	2.000
Standard Deviation	4,520,125	6,422,916	8.818
10th Percentile	1,000	2,630	1.000
25th Percentile	1,805	15,000	1.000
75th Percentile	91,742	237,047	4.000
90th Percentile	503,451	1,043,811	10.000

Panel D: Firm-year measures of politician ownership when *POLOWN* = 1 and ownership is local (n= 582)

	POLOWN$MIN	POLOWN$MAX	POLOWN#
Mean	581,145	1,579,279	10.043
Median	98,447	254,097	4.000
Standard Deviation	1,473,023	4,714,062	13.054
10th Percentile	1,258	15,000	1.000
25th Percentile	15,000	50,000	2.000
75th Percentile	375,018	963,673	14.000
90th Percentile	1,491,568	3,757,657	27.000

Panel E: Firm-year measures of local politician ownership when *POLOWN* = 1 and ownership is local (n= 582)

	POLOWN$MIN	POLOWN$MAX	POLOWN#
Mean	127,418	382,260	1.069
Median	7,844	31,801	1.000
Standard Deviation	533,270	2,048,241	0.273
10th Percentile	609	2,000	1.000
25th Percentile	1,000	15,000	1.000
75th Percentile	50,000	100,000	1.000
90th Percentile	250,000	500,000	1.000

This table presents summary statistics across the 2005-2011 period based on end of year financial disclosure reports of members of Congress. Panel A reports summary statistics at the firm-year level, based on the full sample of S&P 1500 firms. Panel B reports summary statistics only for firm-years with some level of politician ownership, and Panels C-E impose additional constraints. Panel C reports summary statistics only for firm-years with distant politician ownership, Panel D reports summary statistics only for firm-years with local politician ownership, and Panel E reports summary statistics only for the portion of the ownership that relates to a local politician. *POLOWN*, is defined 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. *POLOWN$MIN* is measured as the minimum dollar value of equity holdings of the range provided in the financial disclosure reports in firm *i* at year *t-1* by all current members of Congress. *POLOWN$MAX* is measured as the maximum dollar value of equity holdings of the range provided in the financial disclosure reports in firm *i* at year *t-1* by all current members of Congress. *POLOWN#* is measured as the number of distinct current members of Congress with equity investments in firm *i* at year *t-1*. All variables are measured at the beginning of the calendar year.

TABLE 3
SUMMARY STATISTICS AND CORRELATIONS

Panel A: Descriptive statistics

Variable	Politician Owned Firms (POFs)			Non-Politician Owned Firms			*p-values* 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. ***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. ***NIit*** =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*. ***RETit*** =Buy-and-hold stock returns of firm *i* in year *t*. ***NEGit*** =Indicator variable equal to 1 if ***RETit*** is negative, and 0 otherwise. ***MVit-1*** =Market value of equity (CSHO*PRCC_F) of firm *i* at the end of year *t-1*. ***MBit-1*** =Market to book ratio (MV/CEQ) of firm *i* at the end of year *t-1*. ***LEVit-1*** = Leverage ((DLTT+ DLC) / MV) of firm *i* at the end of year *t-1*. ***LITit-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 4
THE RELATION BETWEEN CONDITIONAL CONSERVATISM AND POLITICIAN OWNERSHIP

$NI_{it} = \alpha_0 + \alpha_1 RET_{it} + \alpha_2 NEG_{it} + \alpha_3 RET_{it}*NEG_{it} + \alpha_4 POLOWN_{it-1} + \alpha_5 RET_{it}*POLOWN_{it-1} + \alpha_6 NEG_{it}*POLOWN_{it-1} + \alpha_7 RET_{it}*NEG_{it}*POLOWN_{it-1}$

$+ \alpha_{8-11} CONTROLS_{it-1} + \alpha_{12-15} NEG_{it}*CONTROLS_{it-1} + \alpha_{16-19} RET_{it}*CONTROLS_{it-1} + \alpha_{20-23} RET_{it}*NEG_{it}*CONTROLS_{it-1} + \varepsilon_{it}$ (2)

	Predicted Sign	(1) Coeff.	(1) p-value	(2) Coeff.	(2) p-value	(3) Coeff.	(3) p-value	(4) Coeff.	(4) p-value
					Dependent Variable = NI_{it}				
INTERCEPT		0.047199	0.00	0.050393	0.00	0.047528	0.00	0.051273	0.00
RET_{it}		0.025255	0.00	0.031964	0.00	0.021841	0.00	0.035697	0.00
NEG_{it}		0.022018	0.00	0.010845	0.16	0.017618	0.00	0.014420	0.01
$RET_{it}*NEG_{it}$	+	0.247706	0.00	0.111507	0.00	0.200416	0.00	0.099545	0.00
$POLOWN_{it-1}$		0.006537	0.19	0.002899	0.56	0.000221	0.07	-0.000665	0.04
$RET_{it}*POLOWN_{it-1}$		-0.003678	0.39	0.007669	0.24	0.001579	0.00	0.002311	0.07
$NEG_{it}*POLOWN_{it-1}$		-0.013278	0.01	0.001490	0.77	-0.000885	0.02	-0.000240	0.58
$RET_{it}*NEG_{it}*POLOWN_{it-1}$	?	**-0.130707**	**0.00**	**-0.071551**	**0.00**	**-0.011916**	**0.00**	**-0.010932**	**0.01**
MV_{it-1}				0.000000	0.02			0.000000	0.00
$RET_{it}*MV_{it-1}$				0.000001	0.00			-0.000000	0.68
$NEG_{it}*MV_{it-1}$				-0.000000	0.00			-0.000000	0.13
$RET_{it}*NEG_{it}*MV_{it-1}$	-			-0.000002	0.00			-0.000000	0.39
MB_{it-1}				0.000056	0.60			0.000044	0.71
$RET_{it}*MB_{it-1}$				-0.000388	0.46			-0.000149	0.81
$NEG_{it}*MB_{it-1}$				-0.001249	0.00			-0.001347	0.00
$RET_{it}*NEG_{it}*MB_{it-1}$	-			-0.008157	0.00			-0.009728	0.00
LEV_{it-1}				-0.008611	0.03			-0.006300	0.05
$RET_{it}*LEV_{it-1}$				-0.006207	0.29			-0.011064	0.00
$NEG_{it}*LEV_{it-1}$				0.010768	0.10			0.007832	0.11
$RET_{it}*NEG_{it}*LEV_{it-1}$	+			0.313810	0.00			0.306607	0.00
LIT_{it-1}				-0.004598	0.42			-0.003134	0.60

$RET_{it}*LIT_{it-1}$			-0.027725	0.00			-0.029412	0.00
$NEG_{it}*LIT_{it-1}$			0.000906	0.81			-0.002100	0.62
$RET_{it}*NEG_{it}*LIT_{it-1}$	+		0.091501	0.00			0.082705	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. *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 as previously defined.

TABLE 5
THE RELATION BETWEEN CONDITIONAL CONSERVATISM AND LOCAL AND DISTANT POLITICIAN OWNERSHIP

$NI_{it} = \alpha_0 + \alpha_1 RET_{it} + \alpha_2 NEG_{it} + \alpha_3 RET_{it}*NEG_{it} + \alpha_4 LPOLOWN_{it-1} + \alpha_5 RET_{it}* LPOLOWN_{it-1}$

$+ \alpha_6 NEG_{it}*LPOLOWN_{it-1} + \alpha_7 RET_{it}*NEG_{it}*LPOLOWN_{it-1} + \alpha_8 DPOLOWN_{it-1} + \alpha_9 RET_{it}* DPOLOWN_{it-1}$

$+ \alpha_{10} NEG_{it}*DPOLOWN_{it-1} + \alpha_{11} RET_{it}*NEG_{it}*DPOLOWN_{it-1} + \alpha_{12-15} CONTROLS_{it-1}$

$+ \alpha_{16-19} NEG_{it}*CONTROLS_{it-1} + \alpha_{20-23} RET_{it}*CONTROLS_{it-1} + \alpha_{23-26} RET_{it}*NEG_{it}*CONTROLS_{it-1} + \varepsilon_{it}$ (3)

		Dependent Variable $= NI_{it}$			
		(1)		(2)	
	Predicted Sign	Coeff.	p-value	Coeff.	p-value
INTERCEPT		0.047099	0.00	0.049677	0.00
RET_{it}		0.021839	0.00	0.033094	0.00
NEG_{it}		0.019157	0.03	0.015058	0.07
$RET_{it}*NEG_{it}$	+	0.240681	0.00	0.132449	0.00
$LPOLOWN_{it-1}$		0.010661	0.09	0.004764	0.36
$RET_{it}*LPOLOWN_{it-1}$		-0.001296	0.91	0.005381	0.61
$NEG_{it}*LPOLOWN_{it-1}$		-0.019919	0.00	-0.008370	0.02
$RET_{it}*NEG_{it}*LPOLOWN_{it-1}$	?	**-0.177614**	**0.00**	**-0.132130**	**0.00**
$DPOLOWN_{it-1}$		0.005421	0.32	0.003864	0.43
$RET_{it}*DPOLOWN_{it-1}$		0.001301	0.79	0.003601	0.53
$NEG_{it}*DPOLOWN_{it-1}$		-0.007737	0.31	-0.000762	0.88
$RET_{it}*NEG_{it}*DPOLOWN_{it-1}$	?	**-0.109335**	**0.00**	**-0.076403**	**0.00**
$CONTROLS_{it-1}$				Included	
$NEG_{it}*CONTROLS_{it-1}$				Included	
$RET_{it}*CONTROLS_{it-1}$				Included	
$RET_{it}*NEG_{it}*MV_{it-1}$	-			-0.000002	0.00
$RET_{it}*NEG_{it}*MB_{it-1}$	-			-0.008112	0.00
$RET_{it}*NEG_{it}*LEV_{it-1}$	+			0.310677	0.00
$RET_{it}*NEG_{it}*LIT_{it-1}$	+			0.087395	0.00
N		7,728		7,710	
Adjusted R^2		0.20		0.28	
Test of differences between local and distant owners					
$RET_{it}*NEG_{it}*LPOLOWN_{it-1} < RET_{it}*NEG_{it}*DPOLOWN_{it-1}$		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.
LPOLOWNit-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. **DPOLOWNit-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 and none of the members of Congress owning shares in firm *i* reside over the congressional district (measured at the state level for the U.S. Senate and district level for the U.S. House) in which the firm is headquartered at the end of year *t-1,* and 0 otherwise. All other variables are as previously defined.

TABLE 6
THE RELATION BETWEEN CONDITIONAL CONSERVATISM, POLITICIAN OWNERSHIP, AND ISSUER CREDIT RATINGS

| | | Dependent Variable = NI_{it} | | | |
| | | (1) | | (2) | |
		Coeff.	p-value	Coeff.	p-value
INTERCEPT		0.045195	0.00	0.043720	0.00
RET_{it}		0.033987	0.00	0.034721	0.00
NEG_{it}		0.013127	0.02	0.015088	0.01
$RET_{it}*NEG_{it}$	+	0.136076	0.00	0.136476	0.00
$POLOWN_{it-1}$		0.000139	0.98		
$RET_{it}*POLOWN_{it-1}$		0.003783	0.55		
$NEG_{it}*POLOWN_{it-1}$		-0.003414	0.53		
$RET_{it}*NEG_{it}*POLOWN_{it-}$	?	-0.078547	0.00		
$LPOLOWN_{it-1}$				0.000184	0.97
$RET_{it}*LPOLOWN_{it-1}$				0.001070	0.92
$NEG_{it}*LPOLOWN_{it-1}$				-0.008488	0.03
$RET_{it}*NEG_{it}*LPOLOWN_{it-1}$	?			-0.091293	0.00
$DPOLOWN_{it-1}$				-0.000332	0.95
$RET_{it}*DPOLOWN_{it-1}$				0.003531	0.60
$NEG_{it}*DPOLOWN_{it-1}$				-0.001099	0.84
$RET_{it}*NEG_{it}*DPOLOWN_{it-1}$	?			-0.068909	0.00
$RATING_{it-1}$		0.015948	0.00	0.017753	0.00
$RET_{it}*NEG_{it}*POLOWN_{it-1}*RATING_{it-1}$	-	**-0.021881**	**0.04**		
$RET_{it}*NEG_{it}*LPOLOWN_{it-1}*RATING_{it-1}$	-			**-0.044007**	**0.06**
$RET_{it}*NEG_{it}*DPOLOWN_{it-1}*RATING_{it-1}$	-			**-0.022900**	**0.01**
$CONTROLS_{it-1}$		Included		Included	
$NEG_{it}*CONTROLS_{it-1}$		Included		Included	
$RET_{it}*CONTROLS_{it-1}$		Included		Included	
$RET*NEG_{it}*CONTROLS_{it-1}$		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.
RATINGit-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 as previously defined.

TABLE 7
THE RELATION BETWEEN UNCONDITIONAL CONSERVATISM
AND POLITICIAN OWNERSHIP

$CONACC_{it} = \alpha_0 + \alpha_1 POLOWN_{it-1} + \alpha_2 MV_{it-1} + \alpha_3 MB_{it-1} + \alpha_4 LEV_{it-1} + \alpha_5 LIT_{it-1} + \alpha_6 CFO_{it-1} + \varepsilon_{it}$ (4)

	Predicted Sign	(1)		(2)		(3)	
		Coeff.	*p-value*	*Coeff.*	*p-value*	*Coeff.*	*p-value*
INTERCEPT	?	0.001155	0.73	0.000523	0.86	0.001377	0.68
$POLOWN_{it-1}$	?	**-0.002326**	**0.13**	**-0.000171**	**0.17**		
$LPOLOWN_{it-1}$	?					**-0.005808**	**0.01**
$DPOLOWN_{it-1}$	?					**-0.002437**	**0.16**
MV_{it-1}	-	-0.000000	0.00	-0.000000	0.17	-0.000000	0.01
MB_{it-1}	-	0.000134	0.06	0.000139	0.05	0.000135	0.07
LEV_{it-1}	+	-0.002459	0.02	-0.002459	0.03	-0.002478	0.02
LIT_{it-1}	+	0.014111	0.00	0.013966	0.00	0.014212	0.00
CFO_{it-1}	+	0.114704	0.00	0.116105	0.00	0.113790	0.00

Test of differences between local and distant owners

$RET_{it}*NEG_{it}*LPOLOWN_{it-1} < RET_{it}*NEG_{it}*DPOLOWN_{it-1}$ 0.00

N	7,546	7,570	7,541
Adjusted R^2	0.12	0.12	0.12

The table reports the results of estimating Equations (4) using pooled OLS regressions over 2005-2011. The dependent variable in all three columns is **CONACCit**, defined as income before extraordinary items less cash flow from operations plus depreciation expense deflated by average total assets, and averaged over the previous three years, multiplied by negative one. **CFOit-1** is equal to cash flow from operations deflated by market value. In columns 1, **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 2, **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 3. In columns 3, **LPOLOWNit-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. **DPOLOWNit-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 and none of the members of Congress owning shares in firm *i* reside over the congressional district (measured at the state level for the U.S. Senate and district level for the U.S. House) in which the firm is headquartered at the end of year *t-1,* and 0 otherwise. All other variables are as previously defined.

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.

TABLE 8

THE RELATION BETWEEN CONDITIONAL CONSERVATISM AND POLITICIAN OWNERSHIP AFTER CONROLLING FOR MANAGERIAL OWNERSHIP

	Predicted Sign	(1) Coeff.	(1) p-value	(2) Coeff.	(2) p-value	(3) Coeff.	(3) p-value
$INTERCEPT$		0.050888	0.00	0.049785	0.00	0.046164	0.00
RET_{it}		0.032007	0.00	0.034219	0.00	0.032114	0.00
NEG_{it}		0.017498	0.02	0.020883	0.00	0.016592	0.00
$RET_{it}*NEG_{it}$	+	0.141579	0.00	0.155325	0.00	0.156259	0.00
$POLOWN_{it-1}$		0.001272	0.79			-0.002012	0.66
$LPOLOWN_{it-1}$				0.003861	0.47		
$DPOLOWN_{it-1}$				0.001917	0.71		
$RET_{it}* POLOWN_{it-1}$		0.011429	0.09			0.008994	0.16
$RET_{it}* LPOLOWN_{it-1}$				0.005897	0.61		
$RET_{it}* DPOLOWN_{it-1}$				0.007370	0.29		
$NEG_{it}*POLOWN_{it-1}$		-0.002149	0.68			-0.004429	0.44
$NEG_{it}*LPOLOWN_{it-1}$				-0.012357	0.00		
$NEG_{it}*DPOLOWN_{it-1}$				-0.002826	0.63		
$RET_{it}*NEG_{it}*POLOWN_{it-1}$	?	**-0.101178**	**0.00**			-0.098675	0.00
$RET_{it}*NEG_{it}*LPOLOWN_{it-1}$	?			**-0.154359**	**0.00**		
$RET_{it}*NEG_{it}*DPOLOWN_{it-1}$	?			**-0.098477**	**0.00**		
$CEOOWN_{it-1}$		-0.000144	0.19	-0.000068	0.58	0.000004	0.97
$CONTROLS_{it-1}$		Included		Included		Included	
$NEG_{it}*CONTROLS_{it-1}$		Included		Included		Included	
$RET_{it}*CONTROLS_{it-1}$		Included		Included		Included	

$RET_{it}*NEG_{it}*MV_{it-1}$	-	-0.000002	0.00	-0.000002	0.00	-0.000002	0.00
$RET_{it}*NEG_{it}*MB_{it-1}$	-	-0.007916	0.00	-0.008677	0.00	-0.007848	0.00
$RET_{it}*NEG_{it}*LEV_{it-1}$	+	0.311347	0.00	0.296967	0.00	0.283816	0.00
$RET_{it}*NEG_{it}*LIT_{it-1}$	+	0.087281	0.00	0.091602	0.00	0.061906	0.00
$RET_{it}*NEG_{it}*CEOWN_{it-1}$	-	-0.002995	0.00	-0.003150	0.00	-0.002752	0.00
$RATING_{it-1}$	?					0.016348	0.00
$RET_{it}*NEG_{it}*POLOWN_{it-1*}$ $RATING_{it-1}$	**-**					**-0.016822**	**0.08**
$RET_{it}*NEG_{it}*LPOLOWN_{it-1} < RET_{it}*NEG_{it}*DPOLOWN_{it-1}$				**0.00**			
N		7,583		7,588		7,577	
Adjusted R^2		0.28		0.29		0.27	

The table reports the results of estimating Equations (2) and (3) using pooled OLS regressions over 2005-2011. **$CEOWN_{it-1}$** is equal to the percentage of the firm's equity owned by its CEO. All other variables are as previous defined. *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.

TABLE 9
THE RELATION BETWEEN CONDITIONAL CONSERVATISM MEASURED USING THE EARNINGS-CHANGE MODEL AND POLITICIAN OWNERSHIP

$\Delta NI_{it+1} = \alpha_0 + \alpha_1 \Delta NI_{t\tau} + \alpha_2 NEG_{it} + \alpha_3 \Delta NI_{it}*NEG_{it} + \alpha_4 POLOWN_{it-1} + \alpha_5 \Delta NI_{it}*POLOWN_{it-1} + \alpha_6 NEG_{it}*POLOWN_{it-1}$

$+ \alpha_7 \Delta NI_{it}*NEG_{it}*POLOWN_{it-1} + \alpha_{8-11} CONTROLS_{it-1} + \alpha_{12-15} NEG_{it}*CONTROLS_{it-1} + \alpha_{16-19} \Delta NI_{it}*CONTROLS_{it-1}$

$+ \alpha_{20-23} \Delta NI_{it}*NEG_{it}*CONTROLS_{it-1} + \varepsilon_{it}$

(5)

		Dependent Variable = ΔNI_{it+1}			
		(1)		(2)	
	Predicted Sign	*Coeff.*	*p-value*	*Coeff.*	*p-value*
INTERCEPT		-0.002385	0.77	-0.003956	0.63
ΔNI_{it}		0.023614	0.49	0.030648	0.46
NEG_{it}		-0.025010	0.00	-0.022991	0.00
$\Delta NI_{it}*NEG_{it}$	-	-0.867116	0.00	-0.835107	0.00
$POLOWN_{it-1}$		-0.001399	0.43	0.000085	0.43
$\Delta NI_{it}* POLOWN_{it-1}$		0.002178	0.87	-0.000312	0.86
$NEG_{it}*POLOWN_{it-1}$		0.007334	0.04	0.000968	0.07
$\Delta NI_{it}*NEG_{it}*POLOWN_{it-1}$	?	**0.117944**	**0.15**	**0.033540**	**0.08**
$CONTROLS_{it-1}$		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		6,108		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 as well as the three way interactions between control variables and *NEG* and 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 columns 1, **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 column 2, **POLOWNit-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*. $\Delta NI_{t\tau}$ = 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 $\Delta NI_{t\tau}$ is negative, and 0 otherwise. All other variables are as previously defined.

TABLE 10

THE RELATION BETWEEN CONDITIONAL CONSERVATISM, MEASURED USING THE PIECEWISE LINEAR RELATION BETWEEN ACCRUALS AND CASH FLOWS, AND POLITICIAN OWNERSHIP

$ACC_{it} = \alpha_0 + \alpha_1 CFO_{it} + \alpha_2 DCFO_{it} + \alpha_3 CFO_{it}*DCFO_{it} + \alpha_4 POLOWN_{it-1} + \alpha_5 CFO_{it}* POLOWN_{it-1}$

$+ \alpha_6 DCFO_{it}*POLOWN_{it-1} + \alpha_7 CFO_{it}*DCFO_{it}*POLOWN_{it-1} + \alpha_{8-11} CONTROLS_{it-1} + \alpha_{12-15} CFO_{it}*CONTROLS_{it-1}$

$+ \alpha_{16-19} DCFO_{it}*CONTROLS_{it-1} + \alpha_{20-23} CFO_{it}*DCFO_{it}*CONTROLS_{it-1} + \varepsilon_{it}$ (6)

		Dependent Variable = ACC_{it}			
		(1)		(2)	
	Predicted Sign	Coeff.	p-value	Coeff.	p-value
INTERCEPT		-0.011060	0.21	-0.011492	0.19
CFO_{it}	-	-0.353958	0.00	-0.328409	0.00
$DCFO_{it}$		0.002948	0.72	0.013268	0.21
$CFO_{it}*DCFO_{it}$	+	0.027960	0.37	-0.005362	0.95
$POLOWN_{it-1}$		0.003508	0.36	-0.000333	0.39
$CFO_{it}*POLOWN_{it-1}$		0.030224	0.17	0.004265	0.04
$DCFO_{it}*POLOWN_{it-1}$		0.013108	0.26	-0.002169	0.75
$CFO_{it}*DCFO_{it}*POLOWN_{it-1}$	**+**	**0.215105**	**0.14**	**-0.014335**	**0.94**
$CONTROLS_{it-1}$		Included		Included	
$CFO_{it}*CONTROLS_{it-1}$		Included		Included	
$DCFO_{it}*CONTROLS_{it-1}$		Included		Included	
$CFO_{it}*DCFO_{it}*CONTROLS_{it-1}$		Included		Included	
N		6,967		7,004	
Adjusted R^2		0.27		0.25	

The table reports the results of estimating Equation (6) using pooled OLS regressions over 2005-2011. Stand-alone control variables and the two-way interactions between controls and *CFO* or *DCFO,* as well as the three way interactions between control variables and *CFO* and *DCFO* 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, **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 column 2, **POLOWNit-1=** the total number of distinct members of Congress with equity investments in firm *i* at the end of year *t-1*. **ACC_{it}** = is accruals scaled by beginning total assets (AT). Accruals are defined as earnings before exceptional items and extraordinary item (IB) is minus cash flows from operations (OCANF). **CFO_{it}** = is cash flows from operations (OCANF) scaled by beginning total assets (AT). **$DCFO_{it}$** = is an indicator variable equal to one if *CFO* is negative, and zero otherwise. All other variables are as previously defined.

TABLE 11
THE RELATION BETWEEN CONDITIONAL CONSERVATISM AND LEAD, CONCURRENT, AND LAGGED POLITICIAN OWNERSHIP

$NI_{it} = \alpha_0 + \alpha_1 RET_{it} + \alpha_2 NEG_{it} + \alpha_3 RET_{it}*NEG_{it} + \alpha_4 POLOWN_{it-1} + \alpha_5 RET_{it}* POLOWN_{it-1}$

$+ \alpha_6 NEG_{it}*POLOWN_{it-1} + \alpha_7 RET_{it}*NEG_{it}*POLOWN_{it-1} + \alpha_8 POLOWN_{it} + \alpha_9 RET_{it}* POLOWN_{it}$

$+ \alpha_{10} NEG_{it}*POLOWN_{it} + \alpha_{11} RET_{it}*NEG_{it}*POLOWN_{it} + \alpha_{12} POLOWN_{it+1} + \alpha_{13} RET_{it}* POLOWN_{it+1}$

$+ \alpha_{14} NEG_{it}*POLOWN_{it+1} + \alpha_{15} RET_{it}*NEG_{it}*POLOWN_{it+1} + \alpha_{16-19} CONTROLS_{it-1}$

$+ \alpha_{20-23} NEG_{it}*CONTROLS_{it-1} + \alpha_{24-27} RET_{it}*CONTROLS_{it-1} + \alpha_{28-31} RET_{it}*NEG_{it}*CONTROLS_{it-1} + \varepsilon_{it}$ (7)

		Dependent Variable = NI_{it}			
		(1)		(2)	
	Predicted Sign	*Coeff.*	*p-value*	*Coeff.*	*p-value*
INTERCEPT		0.046522	0.00	0.053191	0.00
RET_{it}		0.027462	0.00	0.022731	0.00
NEG_{it}		0.011713	0.26	0.009989	0.04
$RET_{it}*NEG_{it}$	+	0.134655	0.00	0.115067	0.00
$POLOWN_{it-1}$		0.005751	0.30	0.000245	0.67
$RET_{it}*POLOWN_{it-1}$		-0.016182	0.17	-0.006396	0.00
$NEG_{it}*POLOWN_{it-1}$		-0.015287	0.00	-0.003448	0.00
$RET_{it}*NEG_{it}*POLOWN_{it-1}$	?	**-0.057410**	**0.01**	**-0.010590**	**0.00**
$POLOWN_{it}$		0.004926	0.23	-0.001544	0.01
$RET_{it}*POLOWN_{it}$		0.007812	0.16	0.010598	0.00
$NEG_{it}*POLOWN_{it}$		0.006118	0.49	0.004482	0.00
$RET_{it}*NEG_{it}*POLOWN_{it}$	?	**0.027727**	**0.16**	**0.005020**	**0.22**
$POLOWN_{it+1}$		0.000877	0.89	0.001718	0.00
$RET_{it}*POLOWN_{it+1}$		0.008286	0.53	-0.004357	0.00
$NEG_{it}*POLOWN_{it+1}$		0.007017	0.51	-0.001607	0.13
$RET_{it}*NEG_{it}*POLOWN_{it+1}$	?	**-0.021124**	**0.70**	**0.000274**	**0.97**
$CONTROLS_{it-1}$		Included		Included	
$NEG_{it}*CONTROLS_{it-1}$		Included		Included	
$RET_{it}*CONTROLS_{it-1}$		Included		Included	
$NEG_{it}*RET_{i}*CONTROLS_{it-1}$		Included		Included	
N		5,582		5,597	
Adjusted R^2		0.18		0.19	

The table reports the results of estimating Equation (6) 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 as previously defined

TABLE 12
CHANGE IN CONDITIONAL CONSERVATISM PRIOR TO, CONCURRENT WITH, AND AFTER THE CHANGE IN POLITICIAN OWNERSHIP

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

Panel A: Basu Coefficient Estimates

	Mean Change in POLOWN	Year t-2	Year t-1	Year t	Year t+1
Ownership Decrease (n = 1,152)	-2.05	0.055330	0.059073	0.074159	0.146110
No Change (n =2,169)	0	0.114064	0.143085	0.177144	0.257117
Ownership Increase (n = 969)	1.78	0.086342	0.067450	0.093864	0.128462

Panel B: Within Group Test of Differences

	Pre-Change Period Difference (Year t-2, Year t-1)	Concurrent Change Period Difference (Year t-1, Year t)	Post Change Period Difference (Year t, Year t+1)
Ownership Decrease	0.003743	0.015086	0.071951
p-value	0.87	0.50	0.01
No Change	0.029021	0.034059	0.079973
p-value	0.07	0.04	0.00
Ownership Increase	-0.018892	0.026414	0.034598
p-value	0.48	0.35	0.28

Panel C: Across Group Tests of Differences

	Pre-Change Period Difference (Year t-2, Year t-1)	Concurrent Change Period Difference (Year t-1, Year t)	Post Change Period Difference (Year t, Year t+1)
Decrease –Increase	0.022635	-0.011328	0.037353
p-value	0.57	0.79	0.40

This table reports the results of estimating Equation (1) for each of three groups and three periods over 2005-2011. Panel A presents the Basu coefficients for each of the periods by group, where groups are formed by examining changes in politician ownership from the prior year. Panels B and C test whether the time-series average of the difference in the coefficient estimates is different from zero. *p*-values are based on standard errors adjusted for firm-level clustering (Petersen, 2009), and are reported below the coefficient estimates. *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.

TABLE 13
THE RELATION BETWEEN CONSERVATISM AND POLITICIAN OWNERSHIP USING FIRM-LEVEL CLUSTERING OF STANDARD ERRORS

Panel A: Conditional Conservatism

	Predicted Sign	(1)		(2)		(3)	
		Coeff.	*p-value*	*Coeff.*	*p-value*	*Coeff.*	*p-value*
INTERCEPT		0.050393	0.00	0.049677	0.00	0.045195	0.00
RET_{it}		0.031964	0.00	0.033094	0.00	0.033987	0.00
NEG_{it}		0.010845	0.05	0.015058	0.00	0.013127	0.02
$RET_{it}*NEG_{it}$	+	0.111507	0.00	0.132449	0.00	0.136078	0.00
$POLOWN_{it-1}$		0.002899	0.36			0.000139	0.97
$LPOLOWN_{it-1}$				0.004764	0.32		
$DPOLOWN_{it-1}$				0.003864	0.24		
$RET_{it}* POLOWN_{it-1}$		0.007669	0.30			0.003783	0.62
$RET_{it}* LPOLOWN_{it-1}$				0.005381	0.63		
$RET_{it}* DPOLOWN_{it-1}$				0.003601	0.64		
$NEG_{it}*POLOWN_{it-1}$		0.001490	0.78			-0.003414	0.51
$NEG_{it}*LPOLOWN_{it-1}$				-0.008370	0.27		
$NEG_{it}*DPOLOWN_{it-1}$				-0.000762	0.89		
$RET_{it}*NEG_{it}*POLOWN_{it-1}$	?	**-0.071551**	**0.00**			-0.078547	0.00
$RET_{it}*NEG_{it}*LPOLOWN_{it-1}$	?			**-0.132130**	**0.00**		
$RET_{it}*NEG_{it}*DPOLOWN_{it-1}$	?			**-0.076403**	**0.00**		
$CONTROLS_{it-1}$		Included		Included		Included	
$NEG_{it}*CONTROLS_{it-1}$		Included		Included		Included	
$RET_{it}*CONTROLS_{it-1}$		Included		Included		Included	
$RET_{it}*NEG_{it}*MV_{it-1}$	-	-0.000002	0.00	-0.000002	0.00	-0.000002	0.00

	Predicted Sign	Coeff.	p-value	Coeff.	p-value	Coeff.	p-value
$RET_{it}*NEG_{it}*MB_{it-1}$	-	-0.008157	0.00	-0.008112	0.00	-0.007736	0.00
$RET_{it}*NEG_{it}*LEV_{it-1}$	+	0.313810	0.00	0.310677	0.00	0.284591	0.00
$RET_{it}*NEG_{it}*LIT_{it-1}$	+	0.091501	0.00	0.087395	0.00	0.067184	0.00
$RATING_{it-1}$	?					0.015948	0.00
$RET_{it}*NEG_{it}*POLOWN_{it-1}*RATING_{it-1}$	**-**					**-0.021881**	**0.08**
$RET_{it}*NEG_{it}*LPOLOWN_{it-1} < RET_{it}*NEG_{it}*DPOLOWN_{it-1}$				**0.00**			
N		7,707		7,710		7,709	
Adjusted R^2		0.27		0.28		0.26	

Panel B: Unconditional Conservatism

		(1)		(2)		(3)	
	Predicted Sign	Coeff.	p-value	Coeff.	p-value	Coeff.	p-value
$INTERCEPT$	?	0.001155	0.32	0.000523	0.86	0.001377	0.24
$POLOWN_{it-1}$	?	**-0.002326**	**0.05**	**-0.000171**	**0.09**		
$LPOLOWN_{it-1}$	?					**-0.005808**	**0.00**
$DPOLOWN_{it-1}$	?					**-0.002437**	**0.04**
MV_{it-1}	-	-0.000000	0.00	-0.000000	0.14	-0.000000	0.00
MB_{it-1}	-	0.000134	0.02	0.000139	0.02	0.000135	0.03
LEV_{it-1}	+	-0.002459	0.02	-0.002459	0.02	-0.002478	0.02
LIT_{it-1}	+	0.014111	0.00	0.013966	0.00	0.014212	0.00
CFO_{it-1}	+	0.114704	0.00	0.116105	0.00	0.113790	0.00
N		7,546		7,570		7,541	
Adjusted R^2		0.12		0.12		0.12	

The table reports the results of estimating Equations (2), (3), and (4) using pooled OLS regressions over 2005-2011. p-values are based on standard errors adjusted for clustering on firm (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.

TABLE 14
THE RELATION BETWEEN CONDITIONAL CONSERVATISM AND POLITICIAN OWNERSHIP INCLUDING FIRM AND YEAR FIXED EFFECTS

	Predicted Sign	(1) Coeff.	(1) p-value	(2) Coeff.	(2) p-value	(3) Coeff.	(3) p-value
$INTERCEPT$		0.079278	0.00	0.079267	0.00	0.073993	0.01
RET_{it}		0.036083	0.00	0.036158	0.00	0.035842	0.00
NEG_{it}		0.016441	0.01	0.016415	0.01	0.016532	0.01
$RET_{it}*NEG_{it}$	+	0.089886	0.00	0.089615	0.00	0.092639	0.00
$POLOWN_{it-1}$		-0.003222	0.40			-0.003038	0.42
$LPOLOWN_{it-1}$				-0.006300	0.30		
$DPOLOWN_{it-1}$				-0.002774	0.47		
$RET_{it}* POLOWN_{it-1}$		-0.000839	0.93			-0.000965	0.92
$RET_{it}* LPOLOWN_{it-1}$				0.000046	0.99		
$RET_{it}* DPOLOWN_{it-1}$				-0.001047	0.92		
$NEG_{it}*POLOWN_{it-1}$		0.001089	0.86			0.000600	0.92
$NEG_{it}*LPOLOWN_{it-1}$				-0.007133	0.39		
$NEG_{it}*DPOLOWN_{it-1}$				0.002111	0.74		
$RET_{it}*NEG_{it}*POLOWN_{it-1}$	?	**-0.051182**	**0.04**			-0.045264	0.09
$RET_{it}*NEG_{it}*LPOLOWN_{it-1}$	?			**-0.112037**	**0.00**		
$RET_{it}*NEG_{it}*DPOLOWN_{it-1}$	?			**-0.042643**	**0.10**		
$CONTROLS_{it-1}$		Included		Included		Included	
$NEG_{it}*CONTROLS_{it-1}$		Included		Included		Included	
$RET_{it}*CONTROLS_{it-1}$		Included		Included		Included	
$RET_{it}*NEG_{it}*MV_{it-1}$	-	-0.000001	0.01	-0.000001	0.01	-0.000001	0.01
$RET_{it}*NEG_{it}*MB_{it-1}$	-	-0.008680	0.00	-0.008728	0.00	-0.008603	0.00

$RET_{it}*NEG_{it}*LEV_{it-1}$	+	0.189476	0.00	0.189319	0.00	0.186634	0.00
$RET_{it}*NEG_{it}*LIT_{it-1}$	+	0.078763	0.00	0.079362	0.00	0.071833	0.01
$RATING_{it-1}$	?					0.005282	0.42
$RET_{it}*NEG_{it}*POLOWN_{it-1}*$ $RATING_{it-1}$	**-**					**-0.014676**	**0.19**
$RET_{it}*NEG_{it}*LPOLOWN_{it-1} < RET_{it}*NEG_{it}*DPOLOWN_{it-1}$				**0.00**			
Firm Fixed Effects		YES		YES		YES	
Year Fixed Effects		YES		YES		YES	
N		7,666		7,672		7,663	
Adjusted R^2		0.68		0.65		0.64	

The table reports the results of estimating Equations (2) and (3) using pooled OLS regressions over 2005-2011. *p*-values are based on standard errors adjusted for clustering on firm (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.