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The financial reporting consequences of proximity to political power

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ABSTRACT

In this study, we apply a new concept, corporate proximity to political power, to accounting research and examine its consequences on corporate financial reporting. Prior literature shows that higher proximity to political power leads to higher policy risk, i.e., uncertainty regarding the impact of future administration policies on the cash flow of the firm. An increase in policy risk implies an increase in the opaqueness of the information environment and in the expected volatility of future operating profitability; we argue that these effects both encourage and facilitate earnings management. Drawing on recent research in finance and political science, we use a measure of the alignment along party lines between politicians elected at the state level and the federally elected President as our main measure of proximity to political power. We find a significant positive association between the political alignment of firms' home states and their level of absolute discretionary accruals. Consistent with the idea that firms engage in corporate political activities (lobbying and financial contributions) to hedge against policy risk, our results only hold for firms not engaging in such activities.

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1. Introduction

Does political geography, i.e. the dynamic evolution of the political map as it emerges from federal and state-level elections, matter for financial reporting? Changes in political geography result in exogenous shifts of firms' proximity to powerful politicians. Kim et al. (2012) and Pantzalis and Park (2014) showed that proximity to political power implies greater exposure to uncertainty about the impact of future policy initiatives on firms. Such policy risk can translate into higher cost of equity (Kim et al., 2012) and debt capital (Bradley et al., forthcoming).[1] In this paper, we posit that, in addition to its potential cost of capital implications, exposure to policy risk can make firms' economic environment more volatile and less transparent, creating both incentives and opportunities for firms to engage in earnings management.

Our analysis introduces a metric of political geography to accounting research by adopting the measure of corporate proximity to political power proposed by Kim et al. (2012) which focuses on the political alignment of firms' home states with the federally elected president. We find that proximity to political power is positively and significantly associated with earnings management, measured by the absolute value of discretionary accruals calculated using the Jones (1991) model as modified by Dechow et al. (1995).

To corroborate the robustness of our results, we employ alternative proxies for both our dependent and independent variables and provide numerous other robustness analyses. The main results remain unchanged when using alternative discretionary accrual models (Jones, 1991; Kothari et al., 2005), taking into account exogenous business shocks (Owens et al., forthcoming), including a more extensive set of control variables and estimating our main regression model in changes. In addition, following the approach proposed by Pincus and Rajgopal (2002), we document that the observed earnings management efforts are partly driven by smoothing considerations. Based on ideology measures taken from Berry et al. (1998), we also calculate two measures of ideological proximity to political power; using these metrics, the results are comparable to the ones obtained with our main measure of proximity to political power.

We furthermore investigate the relation between political geography and earnings management conditional on more direct types of political connectedness. We test whether firms actively pursuing political strategies via lobbying expenditures and contributions to political action committees are different from other firms (i.e., those not politically active but merely relying on passive political connections) when it comes to implications of proximity to political power. Consistent with the idea that actively pursuing corporate political strategies constitutes a hedge against policy risk stemming from exogenous variation in political geography (Bradley et al., forthcoming), we find that earnings management is not significantly associated with proximity to political power for firms which engage in political strategies but is positively and significantly associated for firms that do not. Taken together, our results strongly suggest that political geography has effects on firms' financial reporting decisions and that more proximity to political power leads to more earnings management. We furthermore document that different forms of political connectedness have different effects on financial reporting outcomes and affect firms' reporting choices in a substitutive manner.

Our results contribute to the literature on the effects of political forces on financial reporting (Watts, 1977; Watts and Zimmerman, 1978). In recent years, a number of studies have investigated the effects of corporate political connections on the strictness of accounting enforcement, audit quality and earnings quality (Batta et al., 2014; Bliss et al., 2011; Chaney et al., 2011; Correia, 2014; Guedhami et al., 2014; Gul, 2006). Similarly to Chaney et al. (2011), we use a discretionary-accruals-based measure of earnings management as our dependent variable. Our research goes beyond the existing literature by using a political-geography-based metric of corporate proximity to political power as our independent variable of interest. This measure, in essence, depicts a firm's

[1] Kim et al. (2012) provide evidence on the causal relationship between proximity to political power and risk, by regressing lagged changes in proximity on changes in systematic risk (ΔBeta). They show that the coefficient of (ΔBeta) is positive and significant at the 1% level. Bradley et al. (forthcoming) use the same measure of proximity to political power and find that it is negatively related to corporate bond ratings and positively related to firms' cost of debt.

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