

EARNINGS MANAGEMENT METHODS AND CEO POLITICAL AFFILIATION

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ABSTRACT

This paper examines whether CEO risk aversion – proxied by their political affiliation – explains the method used to manage earnings. We argue that, even though real earnings management can have severe long-term consequences for firm performance, Republican managers are likely to prefer real over accruals-based earnings management because the former incurs significantly lower litigation risk costs than the latter and is relatively more difficult to detect. Based on a sample of more than 20,000 firm-year observations, we find that firms led by Republican (i.e. more risk averse) CEOs tend to manage their earnings through real activities manipulation, while those led by Democratic (i.e. more risk taking) CEOs tend to favor accruals-based earnings management. We also show that the positive (negative) relation between Republican-leaning managers and real (accruals-based) is more positive (less negative) for CEOs whose compensation is more oriented towards risk-taking.

Keywords: Accruals earnings management, CEO Risk Aversion, Political affiliation, Political donations, Real activities manipulation.

Data availability: Data are available from the public sources cited in the text.

Jel Code: M41.

1. INTRODUCTION

Over the last twenty years, frequent corporate governance scandals raised serious concerns over the integrity of the accounting information shared with investors. To ensure investors' confidence in firms' reporting, regulators, investors and academics alike constantly look for the factors that influence a firm's financial reporting quality, such as age (Huang et al. 2012), tenure (Ali and Zhang 2015), career concerns (Chen et al. 2017; Arslan-Ayaydin et al. 2020; Yan et al. 2021) or equity compensation (Bergstresser and Philippon 2006). Recently, Notbohm et al. (2019) highlight the role played by a manager's political affiliation on earnings quality. In particular, the authors argue that the political affiliation of managers gauges their level of risk-taking. In line with the notion that Republicans tend to be more conservative and less risk-taking, the authors show that the probability of restatements and discretionary accruals is lower for Republican managers. However, firms not only manage earnings through discretionary accruals, but also through other techniques of which real activities manipulation is arguably the most popular (e.g. Badertscher 2011; Graham et al. 2005; Vidal 2010). Given that managers have been shown to use real activities manipulation and accrual-based earnings management as substitutes for each other (Zang 2012), solely examining accrual-based earnings management cannot lead to definitive conclusions. In this paper, we set out to contribute to the literature by uncovering the influence of a manager's risk aversion, as approximated by their political affiliation, on the *method* used to manipulate earnings. This question is central in better understanding the role played by CEO-specific characteristics on the quality of reported earnings, as the method to manage earnings has implications for both the detectability of the manipulation of earnings and the future valuation of the firm.

Accruals-based earnings management reflects artificial changes to earnings that obscure the actual economic performance by modifying accounting methods or estimates within the Generally Accepted Accounting Principles (Dechow and Skinner 2000). Real-based earnings management, on

the contrary, alters the execution of real transactions (Roychowdhury 2006). By manipulating the timing or structure of real transactions, firms modify their operating activities to meet or beat short-term earnings targets, which has direct cash flow implications and potential long-term consequences for the firm's economic value. In fact, relative to accruals-based earnings management, real-based earnings management practices have been shown to have costly implications (Graham et al. 2005; Braam et al. 2015; Dumas 2017).¹ On the flipside, the advantages of real-based earnings management are that it is more difficult to detect relative to accruals-based earnings management (Graham et al. 2005; Gunny 2010) and incurs significantly lower litigation costs (Gunny 2010; Karpoff et al. 2008).

Consistent with Notbohm et al. (2019), we proxy a manager's risk aversion by its political affiliation. There is extensive evidence in prior literature that managers with conservative ideologies are more risk averse, place more value on delayed gratification and hard work, and they are more focused on strict rule adherence than their more liberal counterpart (Goren et al. 2009). In fact, recent studies in accounting and finance explore how executives' political ideologies relate to managers' risk aversion (see e.g., Chin et al. 2013; Francis et al. 2016; Unsal et al. 2016). For example, Christensen et al. (2014) show that a manager's political orientation is an *ex ante* measure of risk aversion and find that Republican-leaning managers tend to conduct more financially conservative policies and tend to engage less in tax avoidance. Other studies confirm that managers' political affiliation can proxy for risk aversion, which is reflected in lower levels of corporate leverage (Hutton et al. 2014) and less risky investments (Elnahas and Kim 2017). Building on the risk-aversion attribution and rule adherence of Republicans, we expect Republican managers to favor the

¹ For example, Graham et al. (2005) show that most corporate managers are inclined to sacrifice positive long-term investment opportunities in order to meet short-term earnings targets such as consensus analysts' forecasts. This finding is empirically supported by other studies (e.g. Bereskin et al. 2017). However, recently, increasing evidence supports the fact that real activities manipulation could actually be an indicator of higher future performance (see e.g. Gunny 2010; Al-Shattarat et al. 2018). Regardless of its impact on future performance, real activities manipulation remains a relatively less detectable way of managing the earnings benchmark, and, to some extent, costlier in that it is a more time-consuming practice (Graham et al. 2005). This tension on the impact of real-based earnings management on future firm performance is out of the scope of this paper and we leave it for future research.

relatively costly real earnings management strategy because of its higher secrecy and adherence to GAAP rules. Similarly, we expect Democratic managers to conduct the less costly, but more detectable accruals-based earnings management strategies.

We follow prior studies (e.g. Hong and Kostovetsky 2012; Hutton et al. 2014; Notbohm et al. 2019) and collect individuals' political party donations from the Federal Election Commission (FEC), and map these to the CEOs of publicly listed firms. Consistent with our expectations, we find that, compared to Democratic managers, Republican CEOs tend to rely significantly more on real-based earnings management, while they limit their use of accrual-based earnings management. These results are consistent with political affiliation influencing the manner in which managers respond to capital market pressures. Altogether, we find that ideological conservatism constitutes a vehicle through which CEOs balance the risk of detectability through accruals management, with the potential long-term value destruction of real activities manipulation.

After documenting an average effect of managers' risk aversion on the method of earnings management, we examine how the CEOs' degree of conservatism interacts with their incentives to engage in risk-taking behavior. To do this, we examine changes in managers' compensation to changes in stock price volatility (vega) (e.g. Core and Guay 2002; Coles, Daniel and Naveen 2006; Low 2009). We find that risk-based incentives tend to magnify (diminish) the use of accruals-based (real-based) earnings management, which is consistent with accruals-based earnings management being riskier. However, we show that this positive (negative) impact of vega on the use of accruals-based (real-based) earnings management is mitigated by manager's level of risk aversion. Overall, our results highlight that the impact of risk-based compensation on accounting choices is contingent on the inherent risk preferences of the CEO and that managerial risk aversion is a determinant factor in establishing managers' equity incentives.

To ensure that our results are not driven by confounding factors, we conduct a series of identification tests for alternative explanations. In particular, we exploit a quasi-natural experiment of CEO changes to analyze whether the CEO's political affiliation causes firms to adopt different conservative financial reporting practices. More specifically, we use CEO turnover as a form of firm-specific shock and analyze a sample of firms where a Republican (Democratic) CEO is replaced by a Democratic (Republican) CEO. Such a setting allows us to test whether the observed differences in the accounting reporting quality are caused by CEOs' political affiliation. We find that, for the observations where the former CEO was Republican and the new CEO is Democratic, there exists a substantial increase in the absolute value of discretionary accruals, but no significant difference in terms of real earnings management. When the CEO change is from Democratic to Republican, we find a substantial decrease in accruals earnings management, alongside a substantial increase in earnings management through real activities manipulation. Overall, these results evidence the impact of CEOs' risk aversion on the method used to manage earnings.

We contribute to the existing literature in several ways. First, we provide a clear and holistic contribution to the literature on the impact of CEO-specific attributes on firms' reporting quality (e.g. Hambrick and Mason 1984). Instead of focusing on whether managers' risk aversion tends to explain accruals-based earnings manipulation as in Notbohm et al. (2019), we complete the question by examining both real- and accruals-based earnings management. Firms that implicitly highlight their short-term performance may shift management's attention to forecasted targets and distract the market's attention away from the firm's long-term prospects. This, in turn, may attract short-term investors and speculators (Bushee 1998). Altogether, by having a granular look at the relationship between managerial behavior and political affiliation, our results provide a more holistic understanding of the consequences of the CEO's personal ideology on financial reporting quality.

Second, from an empirical perspective, the use of executive's personal political donations as an *ex ante* proxy for a manager's attitude towards risk has a number of advantages relative to other proxies used in prior literature. Proxies used in prior literature to estimate a manager's attitude to risk such as CEO age (Huang et al. 2012) and gender (Liu et al. 2015) tend to be noisy. Other proxies such as narcissism (Chatterjee and Hambrick 2007) tend to be more difficult to observe *ex ante*. In contrast, a manager's political affiliation is a proxy for a manager's behavior that is more likely to be cleaner than demographic proxies. Support for a political party reflects an individual's motivated social cognition (Jost et al. 2003), an individual's deliberate decision and represents one's "set of beliefs" (Erikson and Tedin 2003, p. 64). Furthermore, according to Jost (2006 p. 654 emphasis added), the left-right or liberal-conservative distinction "has been the *single most useful* and parsimonious way to classify political attitudes for more than 200 years", and the ideological divide between the two parties has been increasing over the past few decades (Hetherington 2009). Our findings indicate that political affiliation captures risk aversion beyond traditional metrics such as age and gender.

In the next section, we discuss our hypothesis development. Section 3 describes the research design, and presents our sample and descriptive statistics. We display the results of our multivariate tests in Section 4, alongside robustness tests and supplemental analyses. Section 5 concludes.

2. LITERATURE REVIEW

2.1. Earnings management and managerial characteristics

Drawing upon the Upper Echelon theory (Hambrick and Mason 1984), prior studies extensively examine the role played by CEOs' characteristics in influencing the company's degree of financial reporting quality. For instance, Ali and Zhang (2015) examine the change in CEOs' incentive to manage earnings during their tenure. They find that earnings overstatements are greater during the beginning of the tenure, compared to later years of the CEO's service. Liu et al. (2015) further

investigate the relationship between the manager's gender and earnings management and find that female managers exhibit significantly lower accruals- and real-based earnings management compared to male managers. Other studies cover the impact of other attributes, such as CEO compensation (Bergstresser and Philippon 2006) and religious background (McGuire et al., 2012). Overall, in line with the upper-echelon theory, the characteristics of the CEO directly influence the propensity of the firm to manipulate earnings.

Even if CEOs are not directly involved in the firm's financial reporting, it is important to note that the risk appetite of upper-level management is expected to result in pressures towards middle (and lower) management to engage in such manipulation. This notion is emphasized in a speech by the SEC Director Steven Cutler: "if employees see managers bend the rules, they'll bend the rules" (SEC 2004). In this regard, Babenko et al. (2016) show that CEOs systematically influence their employees' political choices. Using a large sample of S&P 1500 firms between 1999 and 2014, they find that in federal elections, employees direct approximately three times more of their campaign contributions to political candidates supported by their firm's CEO than to other candidates. Although several papers study CFO characteristics because of their proximity to the financial and accounting decisions (see Jiang et al. 2010), Feng et al. (2009) posit that CFOs simply undertake the wishes of CEOs regarding earnings manipulations.

2.2. Political affiliation and the liberal-conservative spectrum

The key issue with the risk aversion proxies used in prior literature is that they tend to be noisy (Christensen et al. 2014). For this reason, recent research started investigating other measures to proxy for managers' attitude towards risk such as the manager's political affiliation. In contrast to age, tenure or gender, one's political orientation, represents an *ex ante* measure of an executive's attitude toward risk that may be cleaner than demographic proxies.

The use of a manager's political affiliation to predict their managerial decisions presents several advantages. First, individuals differ strongly across their political beliefs (Jost 2006) which serve as a lens through which to view the world around oneself (Tedin 1987). They influence how people "think, feel, and behave ... even if they are not perfectly articulate about their ideological proclivities" (Jost et al. 2008, p. 127). Second, political views of a person may somewhat shift over time, however the literature finds that one's political beliefs generally solidify by adulthood (e.g., Sears and Funk 1999; Green et al. 2002; Jost 2006). In fact, Burris (2001, p. 378) concludes that political ideology is relatively stable over one's lifetime. Third, a partisan affiliation is voluntary. As a result, it is deemed to be a more informative measure of individual attitudes and belief structures than, for example, knowing someone's religion or age (Westwood et al. 2018).

Traditionally, individuals are categorized in terms of their political beliefs based on the 'conservative-liberal' spectrum. Prior literature argues that such a simple dichotomy serves as an important metric for understanding individuals' central values (Poole and Rosenthal 1984). Political conservatism provides substantial explanatory power to predict political affiliation in the U.S. setting. For example, survey analysis, such as the Gallup poll, indicates that Republicans are roughly three times more likely than Democrats to identify themselves as conservative (Saad 2010). This finding is consistent with trends shown in the political science literature, suggesting that more conservative people have increasingly been aligning themselves with the Republican Party (Layman et al. 2006). According to Jost (2006 p. 654 emphasis added), the left-right or liberal-conservative distinction "has been the *single most useful* and parsimonious way to classify political attitudes for more than 200 years", and the ideological divide between the two parties has been increasing over the past few decades (Hetherington 2009).²

² Westwood et al. (2018, p. 353) support this phenomenon by indicating that "defined in terms of affect, voters' sense of partisanship seems to represent a dominant divide in modern democracies and the strongest basis for group polarization".

Overall, individuals with liberal ideologies tend to hold a similar stance with regard to policies and social issues, such as a higher concern for the environment and a clear preference for egalitarianism (see e.g., Jost et al. 2003). Conservative individuals are more likely to value tradition, express greater adherence to rules and attach more importance to social norms (Conover and Feldman 1981; Altemeyer 1998; Jost 2006). Political conservatism not only explains an individual's view on proper governance of society, but it also helps explain economic outcomes (Jost et al. 2009). In particular, their research concludes that political conservatives tend to fear losses, value financial and job security, and have greater aversion to ambiguity and uncertainty than those who are less politically conservative. Thus, we view CEOs' political orientation to be relatively stable, to reflect underlying discrepant attitudes toward risk. This proxy may therefore help in assessing an executive's propensity for managing earnings and, more importantly, identify the *method* used to achieve this manipulation.

2.3. *Managerial risk aversion and earnings management method*

All executives operate under pressure from capital markets to meet (beat) the earnings targets (McGuire et al. 2012). In fact, through extensive survey analysis, Graham et al. (2005) find that managers fear to be labeled as a 'managerial failure' if they are unable to meet the earnings benchmarks. Such pressure may ultimately result in a need for managers to alter accounting disclosures or business practices to achieve the earnings goals (Mard 2004; Vidal 2010). One can therefore expect the manager's political affiliation, which reflects their risk perception, to explain managers' propensity to manage earnings. For instance, Notbohm et al. (2019) investigate the relation between managers' personal ideologies and financial reporting quality. They find that the absolute value of discretionary accruals decreases in the degree to which firms' managers have

conservative ideologies. They conclude that when a firm's manager has more conservative personal ideologies, financial reporting quality is higher.

However, accruals-based earnings management is not the sole method used by managers to manipulate earnings. Managers have been shown to engage in other forms of earnings management, such as real activities manipulation (Cohen et al. 2008; Cohen and Zarowin 2010). Accruals-based earnings management involves the deviation from GAAP rules (for example by changing the timing of asset write-offs), whereas, real-activities based earnings management are alterations of firm activities that result in the deviation from best practices, such as providing customers with discounts to temporarily increase sales volume, changing advertising expenditures or decreasing research and development costs (Roychowdhury 2006). Real-based earnings management is therefore more difficult to detect than accruals earnings management (Cohen and Zarowin 2008). This is not surprising, given that operating decisions are controlled by the manager, whereas accounting treatments must meet the requirements of auditors. As a result, earnings management through real activities manipulation is more difficult to control for *ex post* (Lo 2008).

In turn, accruals-based earnings management leads to a higher risk for SEC scrutiny and, therefore, incurs a higher risk of class action litigation (Gunny 2010). The consequences of this class action litigation may have significant economic consequences for the firm that misstates its earnings. For instance, Karpoff et al. (2008) examine the penalties imposed on the firms targeted by SEC enforcement actions for financial misrepresentation and find that the penalty on firms through the legal system is, on average, only \$23.5 million per firm. However, the penalties imposed by the market are, in contrast, substantially larger. They find that the loss in the present value of future cash flows due to lower sales and higher contracting and financing costs is over 7.5 times the sum of all penalties imposed through the legal and regulatory system. In fact, for each dollar that a firm misleadingly inflates, they find that its market value, on average, loses this dollar when the

misconduct is revealed, plus an additional \$3.08. Desai et al. (2006) further report that the risk of management turnover increases with the detection of misstatements, with the manager having difficulty in finding future employment.

Overall, given that, relative to real-based earnings management, accruals-based earnings management is easily detectable and incurs a higher litigation cost, managers tend to view real-activities earnings management as less risky (Bruns and Merchant 1990; Graham et al. 2005). Yet, the flipside of real activities manipulation is its potentially higher cost in the long term (Braam et al. 2015; Dumas 2017; Graham et al. 2005). By actively changing firm practices (such as production or R&D expenditures) to meet earnings targets in the short term, firms can significantly alter revenue streams for a longer period into the future, which is detrimental for long-term shareholder value (Roychowdhury 2006; Cohen et al. 2008). More specifically, Bereskin et al. (2017) show that firms reducing R&D expenditures as a real earnings management strategy are granted less patents and experience lower future innovative efficiency. This ultimately affects the firm's long-term revenue stream. In other words, by resorting to relatively less detectable non-accounting based methods, managers may jeopardize shareholder value maximization by sacrificing future cash flows. In contrast, accruals are reversible and only affect results in the short-run.

We extend on the research of Notbohm et al. (2019) by examining the impact of a manager's risk aversion on the use of accruals- and real-based earnings management. Contrary to their work, we do not investigate whether managerial risk aversion has an impact on earnings management. Instead, we assume that, regardless of the CEO's aversion to risk, all firms face the pressure to meet/beat the earnings benchmark, which provides a substantial incentive to engage in earnings management (McGuire et al. 2012). This leads us to be more interested in providing a holistic understanding of the impact of a managers' attitude to risk on the choice of earnings management method. In particular, in a situation where earnings management is likely to be used, we expect risk averse managers to be

more inclined to substitute accruals-based earnings management with real-based earnings management strategies than less risk averse CEOs. Real-based earnings management allows risk-averse managers to take advantage of not being detected and to maintain their own and the firm's reputation in the short run at the potential cost of the firm's long-term revenue stream.

Our hypothesis that managerial risk aversion influences the method to manage earnings relies on the assumption that real-based earnings management is relatively less detectable than accruals-based earnings management, which has been increasingly debated in prior literature on earnings management. Arguing that accruals-based earnings management is effectively less detectable than real-based earnings management effectively means that appropriate models to identify the management of earnings have been defined. However, prior research has increasingly criticized the standard models used in prior literature to identify earnings management. Many limitations are raised. For instance, Dechow et al. (2012) discuss that existing techniques for measuring earnings management lack power and are often misspecified due to correlated omitted variables in samples with extreme financial performance. Relatively few improvements have been suggested since Dechow et al. (1995) and most models in the literature rely on the same assumptions. Alternative techniques have been proposed for modeling accruals (e.g., Dechow and Dichev 2002), but whether they provide improvements for the detection of earnings management – either real or accruals-based – remains questionable (e.g., Dechow et al. 2012; Wysocki 2009).³ In turn, whether accruals-based earnings management is, in fact, more detectable than real-based earnings management remains to be investigated. If the real-based earnings management is equally or more detectable than accruals-based earnings management, this leads us to expect managerial risk aversion to be unrelated to the method to manage earnings. Against this backdrop, the relationship between managerial risk aversion

³ The definition of robust methods to identify firms that manage earnings is an interesting question, but out of the scope of this paper.

and the method to manipulate earnings remains to be investigated. We pose the following hypotheses:

H1a: Ceteris paribus, Republican CEOs engage more in real earnings management relative to Democratic managers.

H1b: Ceteris paribus, Democratic CEOs engage more in accrual-based earnings management relative to Republican managers.

3. RESEARCH DESIGN

Below, we provide a summary of our sample, data sources, models and the variables used to perform the analysis. Table A1 in Appendix contains the definitions of each variable.

3.1. Sample selection

Our dataset consists of annual firm-data, stemming from the U.S. S&P 1500 (Compustat / ExecuComp) universe between 1996 and 2016. Of all these firms, we collect data on political donation activity for their CEOs and follow prior studies in computing their respective degree of conservatism (Chin et al. 2013; Christensen et al. 2014). All political donations of more than \$200 are required to be recorded and are made publicly available by the Federal Election Commission (FEC). The FEC provides information on both the donation itself (amount, date, recipient name, and recipient party) and the donor (name, address, occupation, employer, and job title). We focus on contributions to candidates for federal or state offices, their campaign finance committees, and political action committees.

Using the Levenshtein distance, we conduct an initial automated search that matches first and last names, as well as employer names in the ExecuComp database and the FEC political donation database. We then manually examine the matched sample, disregarding ambiguous associations. We applied these two steps to political contribution data covering 11 U.S. election cycles between 1996 and 2016, which ensures that we accurately measure CEOs' stable ideological motivations. After merging with other relevant independent and control variables, explained hereafter, we obtain a final sample of 21,672 observations of 1,342 firms, with 2,386 CEOs, of which 46% have made at least one donation throughout this period.⁴ We report a breakdown of the sample collection in Table 1.

< Insert Table 1 about here. >

3.2. Political ideology

Following prior research, we proxy the CEO's political affiliation by examining their donations to the two major parties in the U.S. (see e.g., Hutton et al. 2014; Christensen et al. 2014). Prior research shows that personal political donations are overwhelmingly motivated by individuals' support for a particular ideology (Ansolabehere et al. 2003; Ensley 2009). Corporations may make donations with the goal of receiving private benefits (Grier et al. 1994), but, as argued by Ansolabehere et al. (2003, p. 117–118 emphasis added), “the tiny size of the average contribution made by private citizens suggests that little private benefit could be bought with such donations. Instead, individuals give because they are *ideologically motivated*.”

We construct an overall measure of political affiliation (*POLAFF*) which equals to the spread in the total dollar amount donated to the Republican Party (or direct contributions to Republican affiliated individuals) and to the Democrats, divided by the total amount donated:

⁴ Note that, the largest amount of observations are lost by not having all available control variables. We provide a breakdown of our sample selection in Table A1.

$$POLAFF = \frac{DONATION_{REP} - DONATION_{DEM}}{TOTAL\ DONATION}.$$

(1)

This spectrum-based measure of political affiliation that ranges from -1 (Democrat) to +1 (Republican). We consider the CEO's political ideology as time-invariant, consistent with political psychology research showing that political ideology is stable once individuals reach adulthood (Sears and Funk 1999; Jost 2006). The stability of ideology is also evidenced by recent studies showing that executives' political contributions, and specifically their ideological orientations, are highly consistent over time (Chin et al. 2013; Fremeth et al. 2013; Christensen et al. 2014). We therefore aggregate all available donations made by an individual in the 1996–2016 period. Note that, following prior studies (Chin et al. 2013; Christensen et al. 2014), we assign a score of zero (indicating a moderate orientation) to CEOs for whom no donation data were found, as well as for

CEOs who donate equal amounts to the Republican and Democratic Party.⁵ We qualify such CEOs as *neutrals*. To show that our conclusions do not depend upon the (ex)inclusion of such CEOs, we report throughout our analyses the results for both the full sample (Full Sample), as well as the sample excluding neutral CEOs (REP/DEM Sample).⁶

3.3. Measures of financial reporting quality and earnings management

To test our hypothesis, we follow prior literature and construct two measures of earnings management: the absolute value of discretionary accruals and real activities manipulation, derived through abnormal production expenses and abnormal discretionary expenses.

3.3.1. Accruals earnings management

We follow prior literature and use the absolute value of the discretionary accruals as computed by the modified Jones (1991) model of Dechow et al. (1995) (e.g. Cohen et al. 2008; Myers et al. 2003; Frankel et al. 2002). Discretionary accruals are the difference between the firm's actual level of accruals, and the normal level. The firm's actual level of accruals is estimated by using the following model (where the firm's industry is defined using a two-digit SIC code):

$$\frac{TA_{ijt}}{ASSETS_{ijt-1}} = k_{1t} \cdot \frac{1}{ASSETS_{ijt-1}} + k_{2t} \cdot \frac{\Delta REV_{ijt}}{ASSETS_{ijt-1}} + k_{3t} \cdot \frac{PPE_{ijt}}{ASSETS_{ijt-1}} + \varepsilon_{it} \quad (2)$$

In Equation (2), TA_{ijt} represents the total accruals for firm i at year t , with two-digit sic code j , defined as the difference between the earnings before extraordinary items and discontinued

⁵ Although our primary focus is on the CEO, we do acknowledge that other managers might influence financial reporting decisions as well. Therefore, we repeat our main analyses for the CFOs' political affiliation and find qualitatively similar results, which are available upon request.

⁶ We thank the Reviewer for this suggestion.

operations, and the operating cash flows. $ASSETS_{ijt-1}$ are the total assets of the firm in the previous year, ΔREV_{ijt} are the changes in revenue, relative to the preceding year, and PPE_{ijt} is the gross value of property, plant and equipment. Our final measure of accruals earnings management (AEM) is the absolute value of the error term of Equation (2).

3.3.2 Real earnings management

We construct our measure of real activities manipulation following Roychowdhury (2006), as the sum of (i) activities manipulation by reducing the cost of goods sold by overproducing inventory, and (ii) cutting discretionary expenditures, including R&D, advertising, and selling, general, and administrative (SG&A) expenditures.⁷ We first obtain the normal level of production costs ($\prod \hat{c}_{ijt}$) as:

$$\begin{aligned} \frac{\prod \hat{c}_{ijt}}{ASSETS_{ijt-1}} = & k_1 \cdot \frac{1}{ASSETS_{ijt-1}} + k_2 \cdot \frac{SALES_{ijt}}{ASSETS_{ijt-1}} \quad (3) \\ & + k_3 \cdot \frac{\Delta SALES_{ijt}}{ASSETS_{ijt-1}} + k_4 \cdot \frac{\Delta SALES_{ijt-1}}{ASSETS_{ijt-1}} + \varepsilon_{it}. \end{aligned}$$

In Equation (3), $\prod \hat{c}_{ijt}$ is the sum of the cost of goods sold for firm i in year t , and the change in inventory from $t-1$ to t . $SALES_{ijt}$ is the net sales in year t ; $\Delta SALES_{ijt}(\Delta SALES_{ijt-1})$ is the change in net sales from year $t-1$ ($t-2$) to t ($t-1$). The estimated residual of Equation (3) proxies for production related activities manipulation ($RM_{\prod \hat{c}}$).

⁷ Roychowdhury (2006) additionally considers the abnormal cash flows from operations as a measure of real activities manipulation. However, Roychowdhury (2006) expresses that this practice may have a different directional effect. In untabulated results we consider an aggregate measure of real earnings management, which includes R_CFO (as per Cohen et al. 2008), and find qualitatively similar results, which are available upon request. We refer to Roychowdhury (2006) for details on the computation of R_CFO .

Similarly, we proxy the real activities manipulation through changes in discretionary expenditures (RM_{DISX}) as the deviation from the normal level of expenditures, measured by the residual term of the following model:

$$\frac{DISCX_{ijt}}{ASSETS_{ijt-1}} = k_1 \cdot \frac{1}{ASSETS_{ijt-1}} + k_2 \cdot \frac{SALES_{ijt}}{ASSETS_{ijt-1}} + \varepsilon_{it} \quad (4)$$

where, $DISCX_{ijt}$ are the discretionary expenditures for firm i in industry j in period t , defined as the sum of advertising expenses, R&D expenses, and SG&A. Consistent with Zang (2012), we multiply the residuals of Equation (4) by -1 such that higher values indicate greater amounts of discretionary expenditures cut by firms to increase reported earnings. Ultimately, we obtain the overall proxy for real earnings management (REM) as the sum of RM_{Π} and RM_{DISX} .

3.4. Models

In this paper, we test whether, in order to meet the earnings benchmark, Republican leaning CEOs rely more on real earnings management, rather than accruals-based earnings management. This is because the latter is riskier as it requires maneuvering within the GAAP realm. In contrast, earnings management through real activities manipulation is harder to be detected as it results from making real changes to the firm (e.g. temporary discounts or a reduction in administrative expenses). We construct the following linear regression model:

$$EM_{it} = \alpha + \beta_1 \cdot POLAFF_i + \gamma_1 \cdot POL_{CONit} + \gamma_2 \cdot \text{Leverage}_{it} + \gamma_3 \cdot BTM_{it} + \gamma_4 \cdot ROA_{it} + \gamma_5 \cdot LOSS_{it} + \gamma_6 \cdot LEV_{it} + \varepsilon_{it}$$

where ε are Newey–West standard errors, corrected for heteroskedasticity and autocorrelation.⁸ The dependent variable (EM) refers to our two measures of earnings management, e.g. accruals- (AEM) and real-based earnings management measures (REM). Note that each variable in the model is winsorized at a 1% and 99% for each year.

We first include POL_{CON} to control for the degree of firm political connectedness. Wu et al. (2016) and Chaney et al. (2011) suggest that political connections reduce the incidence of enforcement action against corporate fraud, which leads firms with political connections to have a lesser need to respond to market pressures to increase the quality of information. Inspired by prior literature (Chaney et al. 2011), we classify a company as politically connected if, at some point between 1996 and 2016, at least one of its top directors (CEO, chairman of the board, president, vice-president) is a member of parliament, a minister or a head of state, or is tightly related to a politician or party. This information was manually researched using Lexis-Nexis, and political connectedness (POL_{CON}) takes a value of ‘1’ if a company is considered politically connected, 0 otherwise. We also include several control variables that capture specific firm characteristics: (i) the book-to-market ratio to control for the firm’s growth, (ii) the firm’s operational performance (ROA), (iii) the firm’s long-term debt (LEV) (see Maurice et al. 2020; Campa 2020) and (iv) the firm’s market capitalization (MC).

Our sample includes firms of various sizes, with a variety of internal governance structures. We therefore include an array of variables to control for such differences. First, prior literature has shown that accounting quality is inversely related to the paid audit fees, since it proxies for the auditor’s risk assessment of the firm (e.g. Frankel et al. 2002). We therefore include an indicator variable ($BIG4$) that takes the value of ‘1’ if the firm has a BIG4 auditor, and control for the audit risk by taking the logarithm of the audit fees ($AUDIT_{FEES}$). Second, board independence is also

⁸ Our main results continue to hold if we (i) cluster at the firm level, (ii) adopt a two-way clustering (firm and year quarter, and state and year quarter) (Gow et al. 2010; Petersen 2009), (iii) use the Huber White standard error without clustering or (iv) cluster at the state level.

related to a reduced propensity to manage earnings (Chen et al. 2015). We therefore include the proportion of independent members of the board of directors ($BOARD_{IND}$). Another mechanism to increase board independence is to separate the Chairman of the board from the company's CEO, thereby avoiding CEO duality. For instance, Zhao and Chen (2008) show that when the manager is both the CEO and Chairman, the chances of accounting fraud increase. To control for the effect, we define CEO_{CHAIR} as a dummy variable that takes the value of one if the CEO is also the Chairman of the company and expect CEO_{CHAIR} to be positively related with earnings management. We also add $FEMALE$ as control variable, which is a dummy variable that takes the value of one if the CEO is female and zero otherwise. While Liu et al. (2015) find a positive relationship between female CEOs and the probability of accounting quality, Peni and Vahamaa (2010) do not find a significant relationship between accounting fraud and CEO gender. Finally, we control for CEO risk through the inclusion of the CEO's age (CEO_{AGE}).

We also control for firm's propensity to meet (or beat) the earnings benchmark (HAB_{BEAT}) which is an indicator variable, taking the value '1' if the firm has met (or exceeded) the analysts' consensus expectations in at least three of the four quarters preceding the fiscal year end, t . To control for the trade-off between real- and accruals-based earnings management, we add the firm's propensity to manage real activities (REM) when the dependent is the accruals-based measure of earnings management (AEM). Similarly, we control for AEM when REM is the dependent. We also control for the analyst coverage by including the logarithm of the number of analysts (NOA) (see Garel et al. 2021). Furthermore, to control for the time periods, we include year fixed effects. Lastly, we control for industry fixed effects by relying on two-digit SIC codes.

3.5. Summary statistics

In Table 2, we present the summary statistics of different dependent variables, as well as our independent regressors. Panel A shows that about 30.5% of the CEO's in our total sample lean conservative ($POLAFF > 0$), whereas about 14% are liberal leaning ($POLAFF < 0$). A little less than 2% of the CEOs have donated an equal amount to both parties and are categorized as neutral, alongside the remaining 54% that do not donate ($POLAFF=0$). Panel B of Table 2 reports the summary statistics for the full sample, where we find that firms led by Republican CEOs have lower accruals than firms led by Democratic CEOs. However, firms led by Republican CEOs tend to have a statistically higher degree of earnings management through real activities manipulation. This is in line with our hypothesized relationship that conservative-leaning individuals are less-risk taking, which reflects on accounting choices.

The remainder of Table 2 presents the summary statistics of the control variables. On average, the *BTM* ratio in our sample is below one, indicating that firms in our sample are overvalued. The firms are profitable on average (*ROA*) and have a long-term debt of 17% (*LEV*). There is a high standard deviation in terms of size, indicating that the sample includes both small, as well as larger firms. The vast majority (84%) of the firms has a *BIG 4* auditor, and the average firm is followed by roughly 15 analysts. We also find that for 71% of our observations, CEOs are also Chairmen. Less than 4% of our sample contains firms with a female CEO, while the average board contains about 73% independent members. About 40% of our observations have a CEO that habitually meets (beats) the analysts' earnings target. We further find that conservative-leaning CEOs lead larger firms, have lower debt, and are more profitable on average than their liberal counterpart. These results are consistent with those of Hutton et al. (2014).

< Insert Table 2 about here. >

We display the correlation of our main dependent and regressors in Table 3. We find that *POLAFF* is negatively correlated with the absolute value of the discretionary accruals, and positively with the earnings management through real activities manipulation. We further find that *POLAFF* is positively associated with *ROA* and *LEV*, and negatively with *LEV*, which is consistent with our findings of Panel B of Table 2. The largest correlation among the control variables is between *LEV* and *AUDIT_{FEES}* (about 65%), however subsequent tests in the multivariate analysis do not indicate that multicollinearity is present. Altogether, our relevant regressors are significantly correlated with one another, making multivariate regressions an appropriate means of analysis.

< Insert Table 3 about here. >

4. RESULTS

4.1. Political affiliation and earnings management

Hereafter, we analyze the method conducted by Republican and Democratic managers to manage earnings numbers. In order to corroborate our argument that firms led by more risk averse (i.e. Republican) CEOs would be less likely to breach GAAP rules, we investigate whether these CEOs engage more in real activities manipulation. We report the results of Equation (5) in Table 4. In the first column, we confirm that more Republican-leaning CEOs have substantially lower accruals (*AEM*). Conversely, we find that firms led by more Republican CEOs engage in higher levels of real earnings management. Our findings are in line with both *H1a* and *H1b*, and thus indicate that conservative-leaning individuals rely more on changing the discretionary expenditures and manipulation through the cost of goods sold. Overall, the economic size of the coefficient loading on *POLAFF* stemming from the linear regression is economically sizeable. That is, an increase from a

zero-value (i.e. a firm led by a neutral CEO) to one (i.e. a firm led by a Republican CEO) decreases the absolute value of the discretionary accruals by 22% on average, and increases the level of real activities manipulation by about 51%, relative to the sample mean.⁹ Panel B shows that our results are robust if we remove the CEOs contributing equally to both parties and CEOs that make no donations.

< Insert Table 4 about here. >

In addition, the control variables in our sample display similar results to those of the literature. For instance, we find a negative and significant coefficient for LEV in terms of the discretionary accruals, and a positive and significant coefficient in terms of real earnings management, which is consistent with prior literature (Zang 2012). Moreover, we find lower levels of accruals as boards become more independent and as the CEOs are older, which is consistent with prior research (Huang et al. 2012).

4.3. Additional analysis and robustness tests

4.3.1. Risk incentives

The premise of our hypotheses is that political affiliation proxies for the CEO's risk aversion. However, there are also exterior incentives for CEOs to amplify their risk-taking behavior, regardless of their inherent risk aversion levels. Many studies show that equity incentives (portfolio delta, or sensitivity of the manager's wealth to changes in stock price) can substantially alter the CEOs' level of risk-taking (e.g., Coles et al. 2006; Low 2009). In an elaborate study on CEO incentives, Armstrong et al. (2013) find that, in terms of financial misreporting, a CEO's compensation sensitivity to changes in the stock price volatility of the firm (also referred to as the vega) mostly

⁹ In particular, this is calculated as $\beta_{(1)}/\text{mean}(AEM) = -0.012/0.054 = -0.22$ and $\beta_{(2)}/\text{mean}(REM) = 0.054/-0.106 = -0.509$.

provides a larger incentive to engage in accounting-based misreporting, than the portfolio delta. The underlying intuition is that, all else equal, managers with a high vega are incentivized to engage more in risky projects than managers with a low vega. In turn, managers with a high vega will be incentivized to adopt risky corporate decisions, such as investing in R&D, reducing PPE investments, employing higher levels of corporate leverage and engaging more in earnings management (Coles et al. 2006; Armstrong et al. 2013, p. 330). The question remains however whether the sensitivity of the manager's portfolio to changes in the stock price volatility interacts with the CEO's personal degree of risk-aversion in explaining the method used to manage earnings.

We extend our dataset to include the sensitivity of the manager's wealth to changes in the stock price volatility, or *VEGA*. Data on CEO equity incentives is made freely available by Coles et al. (2006), for which about 17,000 observations remain.¹⁰ We introduce the variable *VEGA*, which equals to one plus the logarithm of the vega measure (Armstrong et al. 2013) into Equation (5), as well as the interaction variable between *VEGA* and *POLAFF* and report the results in Table 5. While we find that the sign of the *POLAFF* coefficient remains consistent with our earlier results, *VEGA* encourages managers to rely on accruals-based earnings management and reduces the use of real-based methods to manage earnings. This result is consistent with prior evidence showing that accruals-based earnings management is more detectable and, therefore, riskier. Yet, this positive (negative) effect of *VEGA* on the use of accruals-based (real-based) earnings management is mitigated by managers' risk aversion, as we find that the interaction term $POLAFF \cdot VEGA$ is significantly negative for accruals-based earnings management and positive for real-based earnings management. Overall, our evidence shows that risk-based incentives effectively have an influence on accounting choices, but it is important to highlight that this influence is mitigated by the CEO's

¹⁰ Note that the data provided by Coles et al. (2006) is currently updated to be available up to 2014 at <https://sites.temple.edu/lnaveen/data/>. This implies that we lose about two years of our sample. However, the control variables in Table 5 have similar coefficients in both size and direction with the full sample, indicating that reducing the sample size through merging did not result in a significant sample bias. In untabulated results we repeat all analyses with the reduced sample and find qualitatively similar results to the full sample. These results are available upon request.

inherent risk aversion. In turn, risk-based incentives should be carefully tailored and consider managers' risk aversion in order to encourage/discourage specific accounting decisions.

< Insert Table 5 about here. >

4.3.2 Robustness tests

Alternative measures of earnings management

In order to better understand how managers engage in earnings management, and to verify the findings presented in Table 6, we repeat the results of Equation (5) by using alternative proxies for accruals earnings management and earnings management through real activities manipulation.

Regarding accruals-based earnings management, we first look at the actual signed discretionary accruals from the modified-Jones model (*DA*), rather than the absolute value reported in Table 5. Consistent with our initial results, Column 1 of Panel A of Table 6 shows that *POLAFF* remains negative and significant at a 95% confidence level. If we further split the sample based on the sign of the *DA*, Column 2 and 3 show that Republican CEOs tend to engage less in income increasing earnings management through accruals. Interestingly, we however observe a small significant difference regarding income-decreasing earnings management. In Column 4, we further show that after correcting *DA* for the firm's performance (Kothari et al., 2005), our results remain qualitatively similar. Overall, these tests indicate that, regardless of the method used to define the accruals, Republican CEOs tend to manipulate earnings through accruals less, relative to Democratic CEOs.

< Insert Table 6 about here. >

Concerning real-based earnings management, we conduct several robustness tests. First, we split our measure into positive real activities manipulation and negative real activities manipulation (Columns 5 and 6). We find that our results remain consistent in both subsamples. Next, we split our measure of real earnings management into (i) real activities management through abnormal production – AB_{Π} , as defined in Equation (4) – (ii) through abnormal discretionary expenditures – AB_{DISX} , as defined in Equation (5) – and (iii) consider the additional possibility of real earnings management through abnormal cash flow of operations (AB_{CFO}). As shown in Columns 7 to 9, the coefficient loading on $POLAFF$ remains significantly positive in terms of real activities manipulation through production and discretionary expenditures, and is positively associated with AB_{CFO} . This means that firms led by Republican CEOs substantially alter their production and expenditures to meet the earnings target. Yet, there exists only a marginal substantial difference in terms of cash flow changes, compared to Democratic CEOs, as indicated by the 90% confidence level.

Second, we investigate if performance-matched measures of real-earnings management influence our results. The motivation stems from Skinner (1993), who argues that “there is reason to believe that accounting procedure choice is related to how well or badly firms are performing.” In fact, we observe a significant difference of performance between firms managed by Republican CEOs and firms managed by Democratic CEOs, which requires us to isolate the effects of firm performance on models that try to estimate earnings management. To measure performance-matched real earnings management metrics, we follow the procedure in Cohen et al (2020). For each abnormal REM measure (i.e. cash flow from operations, discretionary expenses and production costs), we calculate a performance-matched version for a given “treatment” firm in a given year by matching it to another firm in the same 2-digit SIC code whose ROA is within ten percent. The performance-matched REM measure is the difference between the REM measures of the treatment firm and its

matched control firm. Column 10 to 12 of Panel A of Table 6 show that our results hold once we control for performance. In Panel B, we report the results for the sample where we exclude the neutral CEOs. Overall, we find consistent evidence with Panel A, with the exception that the negative discretionary accruals, positive real earnings management, as well as the performance adjusted discretionary expenditures are no longer statistically significant.

Altogether, the results of the multivariate analyses confirm our findings of increased leniency of Democratic CEOs towards their interpretation of GAAP, which is reflected in higher accruals earnings management. This finding remains consistent when alternative methods to measure abnormal accruals are used. Secondly, we find that firms led by Republican CEOs managers engage more in real activities manipulation. More specifically, there is a significant and positive relationship between the CEOs Republican orientation and the manipulation of activities through abnormal production as well as through abnormal discretionary expenditures.

Endogeneity concerns

Our analyses above find a robust positive association between managers' political affiliation and earnings management practices. However, one form of the endogeneity concern in our setting is that some omitted variables might drive both earnings management and managers' political affiliation. To mitigate this concern, we follow Mard and Marsat (2012) and exploit a quasi-natural experiment where we consider CEO turnovers from a Democratic-leaning manager to Republican-leaning manager, and vice-versa. Intuitively, we expect the degree of accruals earnings management to increase with a change from Republican CEO to Democrat CEO. On the contrary, we expect the use of accruals earnings management to decrease with a change from a Democrat to a Republican manager.

We conduct our experiment by removing all observations for which there is no change in CEO throughout the sample. In Panel A of Table 7, we construct a variable *TREATMENT*, which takes the value of one for the observations where the former CEO is Republican ($POLAFF > 0$) and the current CEO is Democrat ($POLAFF < 0$). Next, we construct a dummy variable *POST*, which takes a value of one for the year following the CEO change; zero otherwise. The interaction variable $TREATMENT \cdot POST$ then isolates the observations for Democratic-leaning CEOs in the year after the CEO change, given that the former CEO was Republican-leaning. We inverse this process in Panel B by taking CEO changes from Democratic to Republican.

Altogether, we find 49 and 78, instances of Republican-to-Democrat and Democrat-to-Republican CEO changes respectively.¹¹ We repeat Equation (5) where we input *TREATMENT*, *POST*, and their interaction variable, and report the results in Table 7. We find that, for the observations where the new CEO is Democratic, there exists a substantial increase in the absolute value of discretionary accruals, but no significant difference in terms of real earnings management. In Panel B, where *TREATMENT* is defined as a change from Democrat to Republican, we find a substantial decrease in accruals earnings management, alongside a substantial increase in earnings management through real activities manipulation. Overall, these results evidence that a direct change in CEO political ideology results in a change in the earnings management behavior of firms.

< Insert Table 7 about here. >

11 Alternatively, we also study the cases where *TREATMENT* is defined as the preceding CEO being either neutral or Democrat-leaning (Republican) and the current CEO being Republican (Democrat). This substantially increases the number of changes to about 310 and 367, but this does not qualitatively alter our main results.

Entropy balancing

To ensure that our results are not driven by potential matching and weighting issues and use entropy balancing developed by Hainmueller (2012) to achieve a covariate balance across the subsamples.¹² To do this, we first perform a split dividing our sample into a treatment subsample of firms led by CEOs with a Democratic preference. We then reweight all non-treatment observations (firms led by a CEO with a Republican preference), such that we balance the two subsamples on the first and second moment (mean and variance) of the distribution of all control variables in our baseline model. The results are qualitatively the same as in our previous analysis and suggest that the difference in earnings management is more likely to be due to political affiliation of the CEO and is not likely to be driven by observable characteristics.¹³

< Insert Table 8 about here. >

5. CONCLUSION

This study examines whether the CEO's political affiliation explains how a CEO's political affiliation influences the method used to manage earnings numbers. Prior literature suggests a cost-benefit relationship between accruals and real earnings management in that, as the costs related to accruals earnings management increase, real activities manipulation is preferred to manipulate reported earnings. For example, Cohen et al. (2008) find that the use of accruals (real) earnings management decreased (increased) after the passage of the Sarbanes-Oxley Act (SOX). While we

¹² We thank an anonymous reviewer for this suggestion.

¹³ Alternatively, we employ propensity score matching to balance our data to obtain an equal amount of Democratic, Republican, and neutral CEOs. We do this in two steps. We first match the number of observations of firms led by Democratic CEOs with those of Republican CEOs. In the second step, we match the number of observations of firms led by Democratic CEOs and completely neutral CEOs (i.e. including those who did not donate equally to both parties throughout the sample period). In each of these steps, we rely on one-to-one propensity score matching based on all available control variables. Next, we merge the overall sample together and run Equation (5) again to test H1. Results also hold when excluding the neutral CEOs in the propensity score matching. Results are qualitatively similar and available upon request.

find that Republican managers refrain from using accruals earnings management, we also find that Republican managers use real activities manipulation as a substitute. The reduction in the use of accruals would be perceived as a benefit to the quality of the financial reporting (Lo 2008). However, the increase in real activities manipulation may not be a benefit to investors because of their potential consequences to long-term firm performance.

Our results are a significant contribution to the upper echelon theory literature that considers the importance of managers' characteristics in explaining corporate decisions. Prior literature shows that there exists a strong relationship between financial reporting quality and managers' personal traits, such as age and gender. However, in this paper, we use a relatively new manager-specific characteristic, political affiliation, which constitutes an individual's deliberate decision and reflects one's "set of beliefs" (Erikson and Tedin 2003, p. 64). Managers with conservative ideologies are more risk averse, place more value on delayed gratification and hard work, and are more focused on strict rule adherence than their more liberal counterparts. Our results show that managers' political ideology explains financial reporting quality and methods of earnings management. These results support the idea that personal characteristics of managers can explain reporting decisions and lead to a better understanding of the role that managerial heterogeneity plays in corporate decision making.

More generally, we contribute to the growing number of studies that examine the influence of managers' political affiliation on corporate decision-making (Hutton et al. 2014; Notbohm et al. 2019). Our findings indicate that CEOs' political preferences influence firms in ways that can affect shareholder value; thus, our study should be of interest to investors, managers, boards of directors, and regulators. Investors benefit from higher financial reporting quality, but practices such as real earnings management are more detrimental to long-term shareholder value. This suggests that Republicans lower their exposure to the litigation risk of financial securities fraud and misreporting, but expose investors to future cash flow reductions. As a result, when considering candidates for

management positions, boards of directors may be interested in identifying the managers' personal characteristics such as political affiliation. In addition, our results have implications for the regulators, who aim to identify the factors that explain a firm's reporting quality. Altogether, our paper shows that CEOs' political ideology explains the heterogeneity in financial reporting practices across firms.

Although our paper shows that the managerial political affiliation explains earnings management choices, our research is subject to some limitations. First, our measure of political affiliation depends on the donations made by CEOs. However, it is possible that some CEOs prefer to not make payments and still identify as Democrat or Republican. In addition, it may very well be possible that CEOs do not wish to reveal their political preference through donations for a variety of reasons. As such, an interesting avenue of future research could perhaps finetune such measures, possibly through large-scale survey analysis such as those of Graham et al. (2005). Secondly, some CEOs making political donations may have stronger ties with regulators and are thus subject to lower levels of enforcement through their connections. Although we control for political connectedness in our models, it remains difficult to gauge the exact level of political connectedness of a firm, which could be an alternative explanation of our findings. The literature would therefore benefit from a large-scale network analysis between firms, regulators and politicians and uncover how these components interact with each other.

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Appendix

Table A1: Variable Definitions

Variable	Definition
<i>Dependent variables</i>	
AEM_{it}	The absolute value of the discretionary accruals for firm i in year t . The discretionary accruals are obtained as the error term of an accruals model following the modified-Jones (1991) model from Dechow et al. (1995). See Equation (2) for more details.
REM_{it}	The sum of activities manipulation for firm i in year t through changes in production ($R_{\Pi i}$) and through changes in discretionary expenditures (R_{DISX}), where we multiply the latter term with ‘-1’. $R_{\Pi i}$ and R_{DISX} are computed as the error term of Equation (3) and Equation (4) following Roychowdhury (2006).
<i>Independent variables</i>	
$POLAFF_{it}$	The political affiliation of the CEO of firm i in year t , measured as the difference between the donations the CEO made to the Republican party and the Democratic party between the period of 1996-2016 scaled by the total aggregate amount of donations, see Equation (1).
BTM_{it}	The logarithm of the book-to-market ratio of firm i in year t , measured as the fiscal year end.
ROA_{it}	The return on assets for firm i in year t , computed as the ratio between the firm’s net income and the total assets.
LEV_{it}	The leverage ratio of firm i in year t , computed as the long-term debt, divided over the total assets.
$\ln \ln it \ln$	Logarithm of the market capitalization of firm i on the last day of the fiscal-year end t (in \$ mil), i.e. $P_{it} \cdot CSHO_{it}$, where P_{it} represent the price of firm i on the last day of year t and $CSHO_{it}$ is the number of common shares outstanding of firm i at the end of year t .
$BIG4_{it}$	Dummy variable taking the value ‘1’ if the auditor of firm i in year t is a BIG4 auditor, ‘0’ if it is not.
$AUDIT_{FEESit}$	The logarithm of the dollar amount paid in audit fees by firm i in year t .
HAB_{BEATit}	Dummy variable taking the value ‘1’ if firm i meets or beats the earnings benchmark in at least 3 of the 4 quarters preceding the fiscal year end t .
NOA_{it}	The logarithm of the number of analysts following firm i during the quarter prior to fiscal year end t .
POL_{CONit}	Dummy variable taking the value ‘1’ if firm i is politically connected in year t . The political connectedness of the company is measured as whether or not at least one news article exists identifying the CEO, the chairman of the board, the president, or the vice-president as being a member parliament, a senator, or is tightly related to a specific politician or party. This information was manually researched using Lexis-Nexis.
$LOSS_{it}$	Dummy variable taking the value ‘1’ if the operational performance (ROA_{it}) in year t is lower than zero, zero otherwise.
SD_{ROAt}	The standard deviation of the operational performance during the four-year period preceding year t .
$FEMALE_{it}$	Dummy variable taking the value ‘1’ if the CEO of firm i in year t is female, zero otherwise.
CEO_{AGEit}	Logarithm of the age of the CEO.

$CEO_{CHAIRit}$	Dummy variable taking the value '1' if the CEO of firm i in year t is the chairman of the board, zero otherwise.
$BOARD_{INDit}$	The proportion of independent members on the board of directors of firm i in year t , divided by the total number of board members.
Additional variables	
$EXPT_{MTit}$	The difference between the last earnings per share estimate consensus for firm i prior to the fiscal year end t , and the first estimate at the start of the last quarter preceding the fiscal year end t , as per Das et al. (2011).
D_{ζ}	Dummy variable taking the value '1' if $EXPT_{MTit}$ is strictly larger than zero.
$TREATMENT_{it}$	Dummy variable taking the value '1' if the CEO of firm i in year t has $POLAFF_{it}$ larger (smaller) than zero, whereas the previous CEO had a value for $POLAFF_{it}$ smaller (larger) than zero.
$POST_{it}$	Dummy variable taking the value '1' if the CEO of firm i in year t has $POLAFF_{it}$ larger (smaller) than zero.
$VEGA_{it}$	Natural logarithm of one plus the sensitivity of firm i 's CEO's equity portfolio to a 0.01 change in stock volatility in time t (e.g. Core and Guay 2002; Coles et al. 2006).

All continuous variables are winsorized at the 1% and 99% level.

Tables

Table 1: **Sample Composition**

Criteria	Observations	
Total firm-year observations between 1996 – 2016 (Compustat)	256,18	
	2	
<i>Total number of Donations between 1996 – 2016</i>		21,614,983
<i>Total number of Donations by CEOs in our sample between 1996 – 2016</i>		573,114
Total firm-year observations with all available control variables	34,783	
Total firm-year observations with all available CEO-specific data	27,789	
Total firm-year observations with all available board-level data	21,672	
Final Sample		21,672

Table 1 presents a breakdown of the collected observations and how the final sample was composed.

Table 2: Summary Statistics

Panel A – Political affiliation of data sample					
		Num. Obs	Perc. Obs.	Num. CEOs	Perc. CEOs
REPUBLICAN	POLAFF = 1	1,971	9%	191	8%
	1 > POLAFF > 0	5,848	26.9%	537	22.5%
NEUTRAL	POLAFF = 0	11,477	53%	1,329	55.6%
DEMOCRAT	-1 < POLAFF < 0	1,563	7.2%	228	9.5%
	POLAFF = -1	813	3.9%	101	4.2%
Total:		21,672		2,386	

Panel B – Summary statistics of full sample					
	Mean	SD	Q1	Median	Q3
<i>AEM</i>	0.054	0.071	0.016	0.035	0.067
<i>REM</i>	-0.106	0.316	-0.294	-0.004	0.075
<i>POLAFF</i>	0.101	0.340	0	0	0.181
<i>POL_CON</i>	0.006	0.479	0	0	0
<i>BTM</i> ⁺	0.552	0.348	0.335	0.446	0.634
<i>ROA</i>	0.037	0.089	0.016	0.051	0.086
<i>LOSS</i>	0.173	0.377	0	0	0
<i>SD_ROA</i>	0.423	0.091	0.123	0.042	0.047
<i>LEV</i>	0.172	0.135	0.033	0.172	0.312
<i>SIZE</i> ⁺ (in \$ mil)	5,955	13,298	495	1,306	4,303
<i>BIG4</i>	0.837	0.242	1	1	1
<i>AUDIT_FEES</i> ⁺ (in \$ mil)	2.819	3.442	0.895	2.290	2.796
<i>HAB_BEAT</i>	0.381	0.427	0	0	0.857
<i>NOA</i> ⁺	14.68	5.649	11.5	14	15.75
<i>CEO_CHAIR</i>	0.712	0.411	0	1	1
<i>FEMALE</i>	0.036	0.187	0	0	0
<i>CEO_AGE</i> ⁺	58.520	8.889	53	58	65
<i>BOARD_IND</i>	0.733	0.212	0.504	0.715	0.777

Panel C – Comparison between Republican-led and Democratic-led firms			
	Mean _{REP}	Mean _{DEM}	t-stat
<i>AEM</i>	0.048	0.080	-17.191***
<i>REM</i>	-0.061	-0.160	9.552***
<i>BTM</i> ⁺	0.553	0.577	-1.267
<i>POL_CON</i>	0.000	0.000	14.921***
<i>ROA</i>	0.050	0.034	5.230***
<i>LOSS</i>	0.119	0.234	-8.337***
<i>SD_ROA</i>	0.034	0.046	-6.175***
<i>LEV</i>	0.168	0.185	-3.968***
<i>SIZE</i> ⁺ (in \$ mil)	8,191	7,261	1.901*
<i>BIG4</i>	0.959	0.905	6.455***
<i>AUDIT_FEES</i> ⁺ (in \$ mil)	2.931	3.056	-1.923*
<i>HAB_BEAT</i>	0.414	0.429	-0.965
<i>NOA</i> ⁺	11.636	12.018	-1.812*
<i>CEO_CHAIR</i>	0.709	0.716	-0.491
<i>FEMALE</i>	0.039	0.026	3.631***
<i>CEO_AGE</i>	58.734	58.182	0.035
<i>BOARD_IND</i>	0.733	0.713	1.381

Table 2 presents summary statistics for the sample. Panel A provides an overall breakdown of the data sample, in terms of observations and number of CEOs. Panel B displays the summary statistics of the dependent, independent, and control variables for our sample. ⁺ represents untransformed variables for interpretation purposes. Panel C splits the sample between Democratic and Republican CEOs. *, **, *** denote significance at the 10%, 5% and 1% level respectively, using a Welch Two Sample t-test. See Table 1 for variable definitions.

Table 3: Correlation Table

	REM	POLAFF	BTM	ROA	LEV	SIZE	BIG4	AUDIT_FEES
REM	0.004							
POLAFF	-0.027***							
BTM	-0.154***	0.004						
ROA	-0.428***	0.061***	0.280***					
LEV	-0.023***	-0.035***	0.027***	-0.197***				
SIZE	-0.090***	0.031***	0.247***	0.165***	0.035***			
BIG4	-0.035***	0.054***	0.052***	0.023***	0.142***	0.100***		
AUDIT_FEES	-0.087***	-0.018**	0.061***	0.052***	0.129***	0.651***	0.134***	
HAB_BEAT	-0.061***	-0.002	0.147***	0.144***	-0.070***	0.180***	0.085***	0.127***
NOA	-0.025***	0.012	0.157***	0.096***	0.012*	0.471***	0.087***	0.303***
LOSS	0.318***	-0.084***	-0.247***	-0.741***	0.122***	-0.102***	-0.052***	-0.070***
SD_ROA	0.128***	-0.037***	-0.038***	-0.171***	-0.074***	-0.042***	-0.042***	-0.037***
POL_CON	0.014**	0.013**	-0.001	0.011*	0.027***	0.015**	0.009	-0.000
CEO_CHAIR	-0.010	-0.0078	-0.016**	-0.004	0.006	0.034***	-0.047***	0.104***
FEMALE	-0.015**	0.018**	0.028***	0.020***	0.007	0.047***	0.007	0.000
CEO_AGE	0.033***	0.014**	0.021***	0.083***	-0.283***	0.362***	0.043***	0.069***
PROPIND	-0.047***	0.017**	0.057***	0.031***	0.016**	0.033***	0.021***	0.134***
HAB_BEAT								
NOA	0.206***							
LOSS	-0.143***	-0.042***						
SD_ROA	-0.072***	-0.007						
POL_CON	0.065***	0.169***	-0.041***	-0.033***				
CEO_CHAIR	-0.018**	0.016**	0.011	0.011	-0.016**			
FEMALE	0.022***	-0.017**	-0.023***	-0.023***	-0.009	-0.187***		
CEO_AGE	0.179***	-0.231***	-0.181***	-0.181***	0.029***	-0.001	0.021***	
PROPIND	0.093***	-0.030***	0.009	0.009	0.018**	0.158***	0.021***	0.031***

Table 3 reports the Pearson correlation factors for the different variables used in the paper. Each variable is defined in Table 1. *, ** and *** represent significance at the 10%, 5% and 1% levels, respectively.

Table 4: Earnings Management and Political Affiliation

	Panel A – FULL SAMPLE		Panel B – REP/DEM SAMPLE	
	<i>AEM</i> (1)	<i>REM</i> (2)	<i>AEM</i> (3)	<i>REM</i> (4)
<i>POLAFF</i>	-0.012*** (0.002)	0.054*** (0.009)	-0.019*** (0.002)	0.051*** (0.010)
<i>POL_CON</i>	0.000 (0.001)	0.033*** (0.004)	0.001 (0.001)	0.030*** (0.006)
<i>SIZE</i>	-0.003*** (0.000)	0.011*** (0.002)	-0.001** (0.001)	0.009*** (0.003)
<i>BTM</i>	0.020*** (0.001)	-0.190*** (0.005)	0.023*** (0.002)	-0.198*** (0.009)
<i>ROA</i>	-0.297*** (0.008)	-0.338*** (0.042)	-0.268*** (0.012)	-0.332*** (0.070)
<i>LOSS</i>	0.002 (0.002)	-0.063*** (0.008)	0.007*** (0.002)	-0.038*** (0.013)
<i>LEV</i>	-0.035*** (0.003)	0.150*** (0.014)	-0.038*** (0.004)	0.298*** (0.023)
<i>HAB_BEAT</i>	-0.001 (0.001)	0.010** (0.004)	-0.000 (0.001)	0.010 (0.007)
<i>SD_ROA</i>	0.101*** (0.009)	-0.636*** (0.045)	0.120*** (0.016)	-0.304*** (0.089)
<i>AUDIT_FEES</i>	-0.001** (0.001)	0.003 (0.005)	-0.002*** (0.001)	0.001 (0.005)
<i>AEM</i>		-0.012 (0.037)		-0.042 (0.062)
<i>REM</i>	-0.000 (0.001)		-0.001 (0.002)	
<i>BIG4</i>	0.000 (0.002)	0.005 (0.010)	0.003 (0.003)	0.023 (0.017)
<i>NOA</i>	0.005*** (0.001)	-0.009* (0.005)	0.003*** (0.001)	-0.024*** (0.007)
<i>CEO_CHAIR</i>	0.000 (0.001)	0.014*** (0.005)	-0.000 (0.001)	0.016** (0.008)
<i>BOARD_IND</i>	-0.014*** (0.004)	-0.025 (0.019)	-0.019*** (0.005)	0.037 (0.027)
<i>CEO_AGE</i>	-0.013*** (0.004)	0.113*** (0.012)	-0.017*** (0.003)	0.125*** (0.018)
<i>FEMALE</i>	0.000 (0.002)	-0.018* (0.011)	-0.003 (0.003)	0.013** (0.016)
Industry FE (2 digit SIC)	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes

Table 5: The Impact of Risk-based Compensation

	<i>AEM</i> (1)	<i>REM</i> (2)	<i>AEM</i> (3)	<i>REM</i> (4)
<i>POLAFF</i>	-0.013*** (0.002)	0.089*** (0.012)	-0.021*** (0.002)	0.095*** (0.014)
<i>VEGA</i> ⁺	0.124*** (0.0336)	-1.896*** (0.169)	0.202*** (0.049)	-2.242*** (0.275)
<i>POLAFF</i> · <i>VEGA</i> ⁺	-0.562*** (0.125)	0.956* (0.557)	-0.443*** (0.106)	2.351*** (0.592)
Control Variables	Yes	Yes	Yes	Yes
Industry FE (2 digit SIC)	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Num. Obs.	17,041	17,041	8,232	8,232
Adj. R ²	0.191	0.121	0.223	0.164

Table 5 reports the impact of managers' risk-based compensation on the relationship between *POLAFF* and financial reporting quality. *VEGA* is defined as the natural logarithm of one plus the sensitivity of the CEO's equity portfolio to a 0.01 change in stock volatility. Control variables are included, but omitted for presentation purposes. + indicates that coefficients are multiplied by 1000 for interpretation purposes. *, **, *** denote significance at the 10%, 5% and 1% level respectively, using a two sample t-test. See Table 1 for variable definitions.

Table 6: Alternative Earnings Management Metrics and CEO Political Affiliation

Panel A – Full Sample												
	<i>DA</i>	<i>PDA</i>	<i>NDA</i>	<i>DA_ADJ</i>	<i>REM > 0</i>	<i>REM ≤ 0</i>	<i>AB_PROD</i>	<i>AB_DISX</i>	<i>AB_CFO</i>	<i>PROD_AD</i>	<i>DISX_AD</i>	<i>CFO_AD</i>
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
<i>POLAFF</i>	-0.005** (0.002)	-0.011*** (0.003)	0.006* (0.004)	-0.008*** (0.002)	0.152* (0.093)	0.061*** (0.008)	0.023*** (0.005)	0.030*** (0.005)	0.009* (0.002)	0.006* (0.002)	0.006*** (0.001)	0.003** (0.001)
Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry FE (2 digit SIC)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Num. Obs.	21,672	10,765	10,907	21,672	7,237	12,246	21,672	21,672	21,672	21,672	21,672	21,672
Adj. R2	0.080	0.364	0.250	0.133	0.151	0.273	0.188	0.143	0.340	0.142	0.147	0.143
Panel B – REP/DEM Sample												
	<i>DA</i>	<i>PDA</i>	<i>NDA</i>	<i>DA_ADJ</i>	<i>REM > 0</i>	<i>REM ≤ 0</i>	<i>AB_PROD</i>	<i>AB_DISX</i>	<i>AB_CFO</i>	<i>PROD_AD</i>	<i>DISX_AD</i>	<i>CFO_AD</i>
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
<i>POLAFF</i>	-0.005** (0.002)	-0.018*** (0.003)	-0.004 (0.003)	-0.017*** (0.002)	0.011 (0.007)	0.071*** (0.009)	0.019*** (0.006)	0.029*** (0.006)	-0.011*** (0.003)	0.005*** (0.001)	0.005 (0.004)	0.002* (0.001)
Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry FE (2 digit SIC)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Num. Obs.	10,195	4,839	5,356	10,195	3,964	6,251	10,195	10,195	10,195	10,195	10,195	10,195
Adj. R2	0.092	0.373	0.243	0.153	0.204	0.322	0.187	0.197	0.389	0.215	0.186	0.161
Table 6 reports the relationship between CEO conservatism (<i>POLAFF</i>) and alternative measures of accruals earnings management: (1) the level of discretionary accruals (<i>DA</i>), (2) positive discretionary accruals, (3) negative discretionary accruals, and (4) the performance-adjusted discretionary accruals as per (Kothari et al. (2005) (<i>DA_ADJ</i>)). We further provide a breakdown of real earnings management into its positive component (4) and negative (and equal to zero) component (6). We further provide a breakdown of the separate real earnings management dimensions as per Roychowdhury (2006): (7) <i>R_PROD</i> , (8) <i>R_DISX</i> , and (9) <i>R_CFO</i> as well as their respective performance-adjusted version as per Cohen et al. (2020) (10-12). Panel A represents the results for the full sample, whereas Panel B reports the results for a subsample only containing democrat and republican CEOs (i.e. CEOs without a political affiliation are not included). Control variables are included, but omitted for presentation purposes. *, **, *** denote significance at the 10%, 5% and 1% level respectively, using a two sample t-test. See Table 1 for variable definitions.												

Table 7: CEO Changes

	Panel A – Change REP to DEM		Panel B – Change DEM to REP	
	<i>AEM</i> (1)	<i>REM</i> (2)	<i>AEM</i> (3)	<i>REM</i> (4)
<i>TREATMENT</i>	-0.000 (0.005)	0.001 (0.032)	0.030*** (0.005)	-0.057* (0.029)
<i>POST</i>	0.011*** (0.004)	0.019 (0.022)	-0.001 (0.002)	-0.027*** (0.010)
<i>TREATMENT · POST</i>	0.055*** (0.011)	-0.036 (0.068)	-0.030*** (0.008)	0.166*** (0.046)
<i>POL_CON</i>	0.001 (0.001)	0.008*** (0.000)	0.001 (0.001)	0.006*** (0.001)
<i>SIZE</i>	-0.004*** (0.000)	0.015*** (0.002)	-0.003*** (0.000)	0.017*** (0.002)
<i>BTM</i>	0.017*** (0.001)	-0.193*** (0.006)	0.016*** (0.001)	-0.198*** (0.006)
<i>ROA</i>	-0.201*** (0.008)	0.402*** (0.046)	-0.200*** (0.008)	0.406*** (0.047)
<i>LOSS</i>	0.006*** (0.001)	-0.079*** (0.009)	0.007*** (0.001)	-0.077*** (0.009)
<i>LEV</i>	-0.031*** (0.003)	0.138*** (0.016)	-0.030*** (0.003)	0.141*** (0.016)
<i>HAB_BEAT</i>	0.001 (0.000)	-0.004 (0.005)	0.000 (0.001)	-0.006 (0.005)
<i>SD_ROA</i>	0.063*** (0.009)	-0.686*** (0.051)	0.061*** (0.009)	-0.683*** (0.052)
<i>AUDIT_FEES</i>	0.000 (0.001)	-0.001 (0.003)	0.000 (0.001)	-0.001 (0.003)
<i>AEM</i>		0.009 (0.048)		0.002 (0.049)
<i>REM</i>	0.001 (0.001)		0.000 (0.001)	
<i>BIG4</i>	0.004* (0.002)	0.020* (0.012)	0.004* (0.002)	0.021* (0.012)
<i>NO4</i>	0.003*** (0.001)	-0.008 (0.005)	0.003*** (0.001)	-0.009* (0.005)
<i>CEO_CHAIR</i>	0.000 (0.001)	0.017*** (0.006)	0.000 (0.001)	0.017*** (0.006)
<i>BOARD_IND</i>	-0.007* (0.003)	-0.007 (0.021)	-0.007** (0.004)	-0.008 (0.022)
<i>CEO_AGE</i>	-0.014* (0.007)	0.117** (0.017)	-0.015** (0.007)	0.117** (0.016)
<i>FEMALE</i>	-0.001 (0.002)	-0.012 (0.012)	-0.001 (0.002)	-0.011 (0.012)
Industry Fixed Effects (2 digit SIC)	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Num. Obs. Adj. R ²	14,625 0.188	14,625 0.160	14,625 0.187	14,625 0.162

Table 8: Earnings Management and Political Affiliation: Entropy Balancing

	<i>AEM</i> (1)	<i>REM</i> (2)
<i>POLAFF</i>	-0.016*** (0.002)	0.042*** (0.012)
Control Variables		
Industry FE	Yes	Yes
2 digit SIC	Yes	Yes
Year FE	Yes	Yes
Num. Obs.	10,195	10,195
Adj. R ²	0.266	0.153

Table 8 reports the relationship between *POLAFF* and our two measures of earnings management using an entropy balanced sample between republican and democratic managers. *, **, *** denote significance at the 10%, 5% and 1% level respectively, using a two sample t-test. See Table 1 for variable definitions.