Powerful Politicians, Political Costs, and Income Smoothing: Evidence from a Natural Experiment

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Abstract

This paper investigates whether and how firms receiving benefits through their connections to politicians use accounting discretion to avoid the cost associated with negative publicity. I use a unique setting that captures the change in political costs arising from chairmanship appointments to influential Senate committees. Appointments to committee chairmanship constitute exogenous shocks, scattered across states and years. Preferential treatment of firms in the home state of a promoted chairman is likely to draw public scrutiny, providing these firms with incentives to dampen large profits by smoothing earnings to reduce potential political backlash. Using a difference-in-difference research design, I find evidence that, following the promotion of their senator, home-state firms smooth their earnings over the years of the chairman's tenure. The smoothing behavior reduces in the period after the chairman vacates the office, consistent with a decline in benefits and the associated political scrutiny. Cross-sectional analysis shows that these effects are stronger for firms expected to receive higher political benefits and consequently higher public scrutiny. Overall, the paper provides evidence of the political cost hypothesis using a comprehensive sample of firms across many years and industries. It highlights the role of political connections in shaping firms' financial reporting strategies.

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1. Introduction

This paper investigates whether and how firms receiving benefits through their connections to politicians use accounting discretion to avoid negative publicity. Since political power is associated with potentially negative consequences of scrutiny, it creates incentives for managers to make accounting choices to manage political costs (Watts and Zimmerman 1978). Prior studies test the political cost hypothesis using small-sample or industry-specific settings over short horizons and provide evidence suggesting that firms engage in downward earnings management to minimize expected political costs.[1] In this paper, I use a comprehensive sample of firms to test this hypothesis by exploiting a unique setting that captures the change in firms' political costs arising from chairmanship appointments to influential Senate committees. Besides providing more general rather than industry-specific evidence, this setting provides a natural experiment to test the effect of an exogenous change in political power on firms' discretionary accounting choices.

Promotion to the leadership position bestows additional power on the chairman to influence distributive politics and various policies, and enables him to benefit his constituencies, including companies in his home state. For example, Cohen, Coval, and Malloy (2011) show that a politician's ascension to a committee chair brings in a significant increase in federal funds such as earmarks and government contracts to his state. Preferential treatment of firms in the home state of a promoted chairman is likely to draw public scrutiny and thus make these firms politically visible. The media and public watchdog organizations play a central role in spreading negative publicity against these firms by providing organized information to the public. This negative publicity, in turn, can lead to adverse government and regulatory action, potentially

[1] Settings studied by prior research include anti-trust investigations (Cahan 1992), rapid oil price increases (Han and Wang 1998), cable television industry (Key 1997), and insurance industry (Grace and Leverty 2010).

imposing political costs on companies in the promoted chairman's state. I hypothesize that, given the large value at stake, these firms are likely to take action to minimize the consequences of negative publicity.[2] Specifically, I test whether these firms exploit their financial reporting discretion to reduce their political visibility.[3]

I expect that firms in the home states of the promoted chairs, facing political pressure, will engage in income smoothing to mask the increase in benefits after the promotional shock, consistent with the political cost hypothesis. These firms, already under the public radar, are more likely to draw additional media attention when they report large profits. The sizeable income generated by firms that are geographically connected to powerful politicians may be perceived as benefits accruing from their political ties and may exacerbate public criticism. Therefore, firms have incentives to avoid reporting large profits to reduce the likelihood of potential political backlash.[4] I predict that these firms will attempt to dampen their performance by smoothing earnings over the period of the chairmanship. Average tenure of chairmen of Senate committees is 7.6 years and this multi-period nature of committee chairmanship makes income smoothing a more natural medium to disguise firms' true performance over a longer time horizon than downward earnings management.[5]

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[2] A 2013 report in *McKinsey Quarterly* estimates that this value at stake is about 30 percent of corporate earnings in most industries.

[3] Companies also use other tactics to influence government policies, e.g., lobbying and political contributions. Another example of such tactics is "managing the media." To affect media coverage, firms can hire investor relations firms (Solomon 2012) and/or control the timing of press releases (Solomon and Soltes 2012).

[4] This idea was first suggested by Watts and Zimmerman (1978). Hall (1993) also argues that "the extent of any political backlash depends in part on the size of the reported profits." For example, Halliburton, with its ties to former U.S. Vice President Dick Cheney, was heavily criticized for securing large profits from defense contracts.

[5] Other studies of the political cost hypothesis examine downward earnings management as a one-shot strategy over short horizons (e.g., Ramanna and Roychowdhury 2010). In my setting, downward earnings management is less likely to be sustainable for consecutive years over the longer time horizon covering the chairman's tenure.

Although the home state of the promoted politician is, overall, expected to gain from his increased power (e.g., Cohen et al. 2011), it is important to identify firms that are most likely to benefit from the promotion to increase the power of the test. To identify such firms, I select industries based on the proportion of sales to the U.S. government, since firms in industries reliant on government contracts are likely to benefit the most and, thus, face higher political costs from government disfavor (Karpoff et al. 1999; Mills et al. 2013). Accordingly, my main sample consists of firms in 42 industries with greater than 3% of annual industry sales to the U.S. government from 1971 to 2012.

The chairmanship of U.S. congressional committees is based on seniority. The member from the controlling party with the longest tenure on a committee is promoted to be the chairman when the incumbent is defeated in an election, resigns, dies, or the controlling party changes after an election. Since these events that trigger a change in chairmanship are unpredictable, the appointment of a committee chairman is exogenous (Roberts 1990). Therefore, seniority-based leadership changes in Senate committees provide a natural experiment to test the political cost hypothesis. An advantage of this setting, relative to other industry- or time-specific settings used in the political cost literature, is that these exogenous leadership changes in powerful committees affect numerous states at different times. During the sample period, there were 73 newly promoted chairmen from 43 different states for 10 different Senate committees considered in this study.[6] These scattered promotional shocks enable me to use a difference-in-difference research design which is effective in ruling out the alternative explanation that other concurrent events might drive the results. Specifically, I compare changes in income smoothing from the pre- to the post-promotion periods for firms headquartered in the new chairman's state to changes in income smoothing over the same period for control firms in other states.

[6] My sample includes 103 instances of changes in leadership considering both chairman and ranking minority member (i.e., the senior-most member of the minority party).

I first verify whether sample firms benefit from the home-state senator's promotion to the chairmanship of a Senate committee. I find supporting evidence that the operating performance of the sample firms in the home state improves significantly after the promotion. I also find a significant increase in government contracts to these firms following their senator's rise to power, suggesting that government contracts are used as a channel of the politician's influence consistent with prior political science literature on distributive politics (e.g., Ferejohn 1974). Further, I find improved stock price performance of these firms following their senator's new chairmanship appointment, which suggests that investors too perceive that these firms are likely to benefit from their senator's promotion.

Having established the positive impact of promotion shocks, I then investigate whether the treatment firms engage in income smoothing to dampen the magnitude of their gains. I use two measures of income smoothing that are standard in the literature (e.g., Leuz et al. 2003): ratio of the standard deviation of income before extraordinary items to the standard deviation of cash flows from operations and the correlation between the change in total accruals and the change in cash flow from operations (multiplied by -1 so that higher values indicate higher income smoothing). These two measures are calculated using the current year's and past four years' observations. I also use a composite measure of income smoothing by averaging the reversed fractional rankings of these two measures. I examine whether the firm engages in income smoothing up to seven years after promotion to coincide with the average chairman's tenure. Consistent with the political cost hypothesis, I find that the treatment firms are more likely to smooth earnings after home state senator's ascension to a committee chair. This result is robust to various income smoothing measures and different definitions of powerful committees and promotion shocks. In addition, I find that firm performance as well as the degree of income

smoothing decrease after the chairman vacates the position further corroborating the idea that leadership changes in Senate committees affect firms' reporting choices.

I also investigate whether incentives to smooth earnings vary with different firm- or shock-specific attributes reflecting the magnitude of potential political costs. I find that firms with a higher level of government contract intensity engage in more income smoothing, implying that these firms have greater incentives to dampen high performance as they face greater political costs from the same events. I also show that the tendency to smooth earnings is stronger for firms in constituencies of relatively junior senators promoted to chairman. This is consistent with the notion that additional power and benefits from the promotion are limited for the already powerful senior senators and, thus, firms in constituencies of junior senators are likely to have a relatively greater increase in benefits and therefore will be more exposed to further public scrutiny. Additionally, I find that the increase in income smoothing following the promotion is more pronounced for home-state firms who provide contributions to the promoted chairman's political campaign, supporting the idea that these firms, with stronger ties to the senator, are exposed to higher public attention and political costs. Collectively, these results suggest that firms' incentives to smooth earnings in the presence of negative publicity vary with expected political costs consistent with the political cost hypothesis (Watts and Zimmerman 1978).

This paper makes several contributions to the literature. First, this paper extends the literature on the political cost hypothesis by providing evidence using the setting of a politician's appointment to a powerful position that leads to increased political costs for a broader set of home-state companies. Since promotional shocks are scattered over various states and years, this setting enables me to test a large sample of firms in numerous industries and has the potential to provide sharper evidence on the political cost hypothesis.

Second, this study also contributes to the growing literature on political connections by documenting how firms' geographic ties to politicians affect firm performance as well as financial reporting. Using firm location as the basis for political connection and politician's promotion as the source of exogenous variation in political power for a given firm-politician tie, my results are less susceptible to endogeneity concerns prevalent in empirical studies on political connection.[7] My finding that firms with geographical ties to politicians are more likely to smooth earnings adds to the literature on the effect of political connection on accounting choices.[8] My results propose an additional motivation that may influence a firm's accounting choice and suggest the need to consider firms' incentives to correctly interpret the information in earnings.

The remainder of the paper is organized as follows. Section 2 provides institutional background of the research setting and develops my hypotheses. Section 3 discusses the empirical framework, including sample identification, variable measurement and research design. Empirical results are presented in section 4, and section 5 concludes the paper.

2. Background and Hypotheses Development

2.1 Political power through promotion to chairmanship of Senate committees

The seniority system is used to allocate leadership positions in congressional committees in the U.S. (Roberts 1990). The member with the longest committee tenure from the controlling

[7] Political connection measures used in the prior literature include the presence of former politicians as top officers or board members (Faccio 2006; Houston et al. 2014), political contributions to politicians' (re)election campaigns (Cooper et al. 2010; Duchin and Sosyura 2012), and lobbying (Duchin and Sosyura 2012; Hill et al. 2013). Since firms strategically develop their political ties, endogeneity is a concern for these measures of political connection.

[8] Two studies are notable from this literature. Chaney et al. (2011) use international data to provide evidence that politically connected firms have lower earnings quality. However, the implication of their results to U.S. firms is limited since their result is mainly driven by Japanese firms in the sample. Ramanna and Roychowdhury (2010) show that large political donor firms with outsourcing activities tend to have negative discretionary accruals around the 2004 election.

(non-controlling) party is promoted to be a chairman (ranking member) when the existing chairman (ranking member) vacates his seat. A chairman (ranking member) can leave because he/she is defeated in the election, resigns, or dies or the controlling party changes after the election.[9] The inherent unpredictability of these events, except for a few anticipated election outcomes, makes this transition of chairmanship an exogenous event.[10]

A natural question arises following the promotion to chairman: Does committee leadership provide additional power to the senator beyond his/her committee membership? Roberts (1990) provides compelling evidence in the affirmative. Using stock market reaction to the death of Senator Henry "Scoop" Jackson, ranking member on the Senate Armed Services Committee, in September 1983, he demonstrates that committee leadership endows opportunities to foster constituent interests. Stock prices of companies in the Senator's home state of Washington reacted negatively to the news, whereas the stock prices of firms based in Georgia, the state of Jackson's successor on the committee, Sam Nunn, increased.

There are two channels through which benefits to the home state can arise from the power of committee chairmanship. First, committee chairmanship can bring distributive benefits to the home state. *USA Today*, for example, pointed out that Senator Sam Brownback of Kansas inserted $12.5 million of earmarks for his state in the bill after he was promoted to the chairmanship of the Agriculture Committee (Kelley 2010). Distributive politics literature has also documented that senior members of the Senate obtain a disproportionately high share of federal funds for their constituencies (Boyle and Matheson 2009). More recently, Cohen et al. (2011)

[9] There are occasional exceptions to seniority-based leadership allocation. One of them is when a senator is already holding a chair position of another committee. The U.S. Senate places restrictions on the number of chair positions a senator may hold.

[10] It is difficult to predict a change in the controlling party, which results from the combination of the entire election outcome as well as the primaries. For example, previous poll numbers were inaccurate in predicting one of the most dramatic upsets in congressional history, the defeat of Eric Cantor, the then House majority leader, in the primary in June, 2014. Even for relatively predictable elections, uncertainty about the outcome still exists.

documented that appointment as a powerful committee chair results in a significant increase of federal money, in the form of procurement contracts, earmark spending, and government transfers, flowing into the chairman's home state.

The second channel is the chairman's ability to influence various policies, including his authority to control the agenda. The U.S. Senate website (www.senate.gov) emphasizes the influence of the chairman in the committee system by stating that "the chair primarily controls a committee's business" and "the indispensable role of committees in the legislative process places great power in the hands of their individual chairmen" (Congressional Research Service 1994). By setting the legislative agenda, the chair can affect which legislation is brought to vote, how much time to spend on each topic, what hearings to hold, or who to call to testify (Gropper et al. 2013).

It is well documented both anecdotally as well as in the academic literature that companies headquartered in the committee leader's home state can benefit from their senator's rise to these powerful positions. Politicians have incentives to advance the interests of local firms, and hence, the local economy, to enhance their future electoral chances. It is not uncommon to find news articles discovering these cases. *The New York Times*, for instance, reported that Senator Trent Lott, the Republican majority leader, put an amendment to the bill on product liability standard to protect his home state company (Lewis 1998). Indicating the close relation between the Senator and the local company, Henry "Scoop" Jackson, the Senator in Roberts (1990) study, was famously labeled the "Senator from Boeing" (Vest 2002). Gropper et al. (2013) also provide evidence that commercial banks headquartered in the home state of the chairman of the Senate and House banking committees are more profitable.[11] Overall, empirical and anecdotal

[11] See also Faccio and Parsley (2009) and Kim et al. (2012) who examine the influence of politicians on the performance of firms head-quartered in the home state.

evidence suggests that the appointment as a powerful committee chair can have a positive effect on companies headquartered in the home state through the chair's influence on distributive benefits and various policies.[12]

2.2 Role of media and watchdog organizations

The media can play an important role in influencing government policy including regulatory process since it provides a large part of the information people use in their voting decisions (e.g., Besley and Burgess 2002; Strömberg 2004; Dyck et al. 2013). Mass media can reduce voters' costs of becoming informed by collecting, reviewing, and summarizing facts and, thus, help to overcome the rational voter ignorance problem (Dyck et al. 2013). An informed electorate is likely to put political pressure on elected officials who may be forced to respond by making policy changes. A growing body of literature in economics has documented the effect of mass media on policy outcomes, including public spending (Strömberg 2004), foreign aid (Eisensee and Strömberg 2007), and government accountability (Besley and Burgess 2002).

The press performs its role not only by originally investigating and analyzing issues but also by rebroadcasting information from other intermediaries (Miller 2006). Among various information sources, it is the public watchdog organizations that can assist and empower citizens as well as the media to monitor and affect government policies by providing organized information, research, and insights. These organizations maintain a database of information on government contracts, earmarks and money in politics that can be easily accessed by the media and the general public and they often publish reports to ignite public awareness. For example,

[12] I acknowledge that companies not headquartered but with significant operations in a state may also reap political benefits through Senate chair appointments. Similar to other related studies discussed above, my sample does not include such companies because company-specific data on proportionate operations by state is not readily available. Moreover, the exclusion of these companies from the treatment sample is likely to bias against finding income smoothing effects following a shock to political visibility.

Center for Responsive Politics, a nonprofit group which tracks money in politics, provides a comprehensive resource for campaign finances and lobbying data and has been frequently cited in the media. Another watchdog group that monitors wasteful government spending, *Citizens Against Government Waste*, sends out periodic publications to the news media to highlight spending habits of lawmakers and hold them accountable. The work of *Taxpayers For Common Sense* also illustrates the role of watchdog organizations in legislation: by creating and maintaining publicly available databases of earmark spending, it successfully put pressure on Congress to require increased disclosure of the earmarking process.[13]

Media's interest generally focuses on the newsworthiness of topics, those that are out of the ordinary, novel, and conflict-filled (Dyck et al. 2013; Miller 2006). Firms' ties to politicians and their preferential treatment are topics with such attributes and have attracted media and public attention. For example, Halliburton, with its ties to former U.S. Vice President Dick Cheney, was severely criticized for obtaining a major defense contract during the Iraq war (Fifield 2013). More recently, Duke Energy is at the center of a political scandal due to accusations of being protected from expensive environmental penalties by Governor McCrory of North Carolina, its former employee of 28 years (Biesecker 2014). In the academic literature, Ramanna and Roychowdhury (2010) also indicate that press coverage on firms' outsourcing was much higher for political donor firms than other firms of similar size in the same industry, consistent with political connections attracting greater media interest.

Increase in earmarks flowing into the home states of chairmen of Senate committees also draws media attention and public scrutiny. *USA Today*, for instance, reported such cases and criticized the system of earmarks as being "fundamentally flawed" citing Steve Ellis of *Taxpayers for Common Sense* (Kelley 2010). Government procurement contract policies also suffer

[13] From the highlights of activities of *Taxpayers For Common Sense* website: http://www.taxpayer.net/about/history-accomplishments.

significant weaknesses as identified in the report published by the Government Accountability Office (*New York Times* 2010). These instances provide the basis for the public's skeptical view on distributive politics. For example, the survey results of the Rasmussen report reveal that 66% of people believe that most government contracts are given to companies with political connections. This negative public view of firms profiting from their political associations, shaped by information provided by media and watchdog groups, puts pressure on lawmakers and can influence the policy-making process. The ban on earmarks in 2010, for instance, is one example of the consequences of such pressure as acknowledged in a statement by House Republican Leader, John Boehner (*The Wall Street Journal* 2010).

2.3 Hypotheses development

In their exposition of the positive accounting theory, Watts and Zimmerman (1978) proposed political considerations as one of the factors that determine managers' accounting choices. The political cost hypothesis predicts that, to the extent a firm is subject to potential wealth transfers in the regulatory process, its managers have incentives to make accounting choices to reduce the likelihood of adverse political actions and their expected costs. Politically visible firms are more likely to attract public scrutiny when they report large profits. Their sizeable income can be viewed as benefits accruing from their political ties and can exacerbate public criticism. As a result, managers of these firms have incentives to use accounting discretion to avoid reporting large profits, thereby reducing expected political costs.

Prior studies testing the political cost hypothesis usually examine whether politically sensitive firms manage earnings downward through discretionary accruals to avoid political costs in specific settings where there is heightened regulatory scrutiny. For example, Cahan (1992) analyzes accrual choices of 48 firms under anti-trust investigation, while Key (1997) and Han and

Wang (1998) look into the cable television and oil industry respectively during periods of heightened scrutiny. More recently, Grace and Leverty (2010) find that insurance companies over-estimate their loss reserves in the presence of stringent rate regulation, consistent with the hypothesis that managers use accounting discretion to reduce the political costs associated with rate regulation. Similarly, Ramanna and Roychowdhury (2010) document that politically-connected firms with more outsourcing activities use income-decreasing discretionary accruals to reduce the cost associated with political scrutiny around the 2004 Congressional elections. Overall, prior studies provide supporting evidence that firms make financial reporting choices to minimize expected political costs. However, as these studies are based on a small set of industry-specific firms, there is limited evidence in support of the political cost hypothesis using a more comprehensive sample. Moreover, as pointed out by Watts and Zimmerman (1990), regulatory actions are endogenous events and underlying economic conditions may drive both the heightened scrutiny and the incentives to choose particular accounting choices in some settings.

A senator's rise to the influential position of a committee chair provides an exogenous setting to test the political cost hypothesis using a broader sample of firms. Firms geographically connected to the promoted chairman likely gain political capital and benefit from the increased power of the politician through various channels. Meanwhile, these politically connected firms and the promoted politicians are exposed to greater public scrutiny. While already under the public radar, these firms are more likely to draw media attention when they report large profits (Watts and Zimmerman 1978).[14] Negative public opinion fueled by the revelation of large profits can trigger political backlash. Hall (1993) argues that "the extent of any political backlash

[14] There is empirical evidence supporting this argument. For example, Bamber (1986) and Engelberg and Parsons (2011) demonstrate that greater unexpected earnings trigger higher trading volume, which is an indirect measure of investor attention. In addition, Solomon and Soltes (2012) provide direct evidence that earnings surprises spark more press coverage.

depends in part on the size of the reported profits." Consequently, I expect that firms are more likely to mask the benefits from political connections to avoid negative consequences by engaging in income smoothing after the promotion of their home state politician. My first hypothesis stated in the alternative form is the following:

H1*: Firms are more likely to engage in income smoothing after their home state senator is promoted to the chairmanship of a powerful Senate committee.*

My hypothesis considers promotions to a powerful position in the Senate but not such promotions in the House. Senate committees are considered to be more influential than House committees in disbursing federal funds. For example, the average earmarks obtained by Senate Committees are two to three times larger in magnitude than those obtained by House Committees (*Center for Responsive Politics*).[15] Senators also receive higher amounts of political contributions than House Representatives on average (Grier and Munger 1993). Promotions to Senate committees therefore constitute a powerful setting for testing the political costs hypothesis relative to promotions to House committees.[16]

I focus on firms' income smoothing behavior because the benefits accruing from Senate committee chairmanship are likely to occur over a long time horizon. In my sample, the average tenure of a Senate committee chair is 7.6 years. The multi-period nature of this setting makes income smoothing a natural medium to disguise firms' true performance over a prolonged period; the use of one-shot income-decreasing accounting choices will not be as effective since their effect is likely to reverse in subsequent periods.[17] Income smoothing is defined as an attempt by

[15] http://www.opensecrets.org/cmteprofiles/earmarks.php

[16] Consistent with this argument, I do not find a significant increase in home-state firms' ROA after the promotion of a congressman as a House committee chair.

[17] Dou, Hope, and Thomas (2013) likewise investigate income smoothing behavior due to the multi-period nature of supplier-customer relationships.

managers to reduce fluctuations in firms' publicly reported net income (Beidleman 1973), which includes both inflating reported net income when it is low and reducing reported income when it is too high. In years with large profits, firms may use income-decreasing techniques to dampen their reported profitability, e.g., by creating secret reserves such as overestimating a liability. On the other hand, in years with low profits or losses, firms may use income-increasing techniques to report a stable level of profitability, e.g., by withdrawing from secret reserves. In addition, firms may use income-increasing techniques in years of low profits or losses to avoid jeopardizing the grant of government contracts and/or to avoid political backlash by reporting poor performance having obtained government contracts through their political connections.[18]

Firms' incentives to smooth earnings are likely to increase with the level of expected political costs. In cross-sectional analyses, I first test this prediction using the variation in expected political costs resulting from firms' government contract intensity. This is consistent with Mills et al. (2013) who show that firms with larger government contracts and greater reliance on government contracts pay more taxes in order to deflect scrutiny that could lead to negative government reactions.

H2*: The increase in income smoothing after the promotion of a home-state senator is more pronounced for firms with higher government contract intensity.*

Second, I examine whether the increase in firms' tendency to smooth earnings is more pronounced when the promoted politician is relatively junior. It has been well documented that senior politicians are more powerful than juniors (e.g., Roberts 1990). When a senior senator becomes a new chairman of the committee, the incremental power and benefits from the chairmanship can be marginal. In contrast, a junior senator who is promoted to the leadership position likely experiences a more substantial increase in political power. Accordingly, the

[18] Moreover, firms may not be able to use income-decreasing techniques in years with low profits or losses because it may not be possible to sustain the creation of secret reserves in many consecutive years.

increase in political capital and thus public scrutiny is more pronounced for firms that are geographically connected to a relatively junior promoted senator. I therefore expect that the increase in incentives to smooth earnings is more pronounced for firms in the home state of the promoted chairman with relatively lower seniority.

H3*: The increase in income smoothing after the promotion of a home-state senator is more pronounced for firms in the home state of a relatively junior senator.*

Third, I investigate whether home-state firms who provide contributions to the promoted chairman's political campaign have stronger incentives to smooth earnings. Consistent with Ramanna and Roychowdhury (2010), corporate contributors have stronger ties to their senators compared to the average home-state firm and are therefore likely to draw higher political scrutiny leading to higher exposure to political costs. Thus, I expect that the increase in incentives to smooth income following the promotion will be more pronounced for political donor firms headquartered in the home state of the promoted chairman.

H4*: The increase in income smoothing after the promotion of a home-state senator is more pronounced for firms who provide contributions to the promoted chair's political campaign.*

3. Research Design, Sample Selection, and Descriptive Statistics

3.1 Benefits from political connections

I examine the effect of an increase in political capital on a home-state firm's sales to the government and profitability. Specifically, I estimate the following equations:

$$LogSalesGov_{i,j,t} = \alpha_i + \alpha_t + \beta Promote\_Shock_{j,t} + \gamma Controls_{i,j,t} + \varepsilon_{i,j,t} \quad (1)$$

$$ROA_{i,j,t} = \alpha_i + \alpha_t + \beta Promote\_Shock_{j,t} + \gamma Controls_{i,j,t} + \varepsilon_{i,j,t} \quad (2)$$

where i indexes firms, j indexes the state of firms' headquarters, t indexes year, and α_i and α_t represent firm and year fixed effects. I follow Tahoun (2014) and use *LogSalesGov*, the logarithm

of one plus total sales to the U.S. government, as the dependent variable in equation (1). In equation (2), I use *ROA*, return on assets, as a measure of firm profitability following Amore and Bennedsen (2013).

Equations (1) and (2) represent a difference-in-difference approach by including firm and year fixed effects, as explained by Bertrand and Mullainathan (2003) and Armstrong et al. (2012).[19] This regression methodology accounts for the fact that promotion shocks are scattered over time across different states and also allows for control variables to vary at the firm-year level. The regressions are estimated using home-state firms that experience a promotion shock in a given year, along with control firms in states that did not experience a promotion shock in that year.

Following Cohen et al. (2011), I set $Promote\_Shock_{j,t}$ to be one in the year the senator of a given state is promoted to be the chairman of an influential Senate committee and in the following six years. Given that the average tenure of the committee chairmanship is 7.6 years, I assume that the effects of promotion shocks persist for seven years.[20] As in Cohen et al. (2011), I examine promotions in up to ten most powerful Senate committees: Finance, Veterans Affairs, Appropriations, Rules, Armed Services, Foreign Relations, Intelligence, Judiciary, Budget, and Commerce in the order named (Edwards and Stewart III 2006). Different promotion shock variables are constructed based on promotions in top 3, top 5, and top 10 committees respectively. For example, *Promote_Top3ChairOnly* is equal to one if the senator of a given state is newly appointed as the chairman of one of top three committees, Senate Finance, Veterans Affairs, and Appropriations Committees. I also employ an alternative definition of promotion shocks which

[19] Armstrong et al. (2012) provides a detailed discussion of how β captures the causal effect using the passage of antitakeover law as an example.

[20] Cohen et al. (2011) assume that the effects of promotion shocks persist for six years in their main analysis. As a robustness check, I use alternative windows, assuming the promotion effects last for five, six, or eight years. The results are qualitatively similar.

include elevation to either the chair or the ranking minority member – the most senior committee member from the non-controlling party. Accordingly, *Promote_Top3Chair_Rank*, for instance, is set to one if the senator of a given state is newly promoted to either a chairman or a ranking minority member of the top three Senate Committees. β captures the causal effect of promotion shocks on firms' sales to the government and profitability. To the extent that home state firms benefit from their senator's promotion, I expect β to be positive in both equations.

In equation (1), I control for other determinants of government contracts documented in Goldman et al. (2013) and Tahoun (2014). Specifically, these variables include firm size (*LNSIZE*), book-to-market ratio (*BM*), Herfindahl index (*HF*), capital expenditure (*CAPX*) scaled by sales, and *ROA*. In equation (2) with *ROA* as the dependent variable, I include the lagged value of book-to-market ratio (BM_{t-1}) and the lagged value of log assets ($LNASSETS_{t-1}$) as control variables (Amore and Bennedsen 2013). The Appendix provides detailed definitions of all variables used in this study.

3.2 Test of income smoothing

To test my main hypothesis that home-state firms are more likely to engage in income smoothing following their senator's promotion, I use a difference-in-difference specification similar to equations (1) and (2) and employ income smoothing measures as the dependent variable. Specifically, I estimate the following regression:

$$Income\ Smoothing_{i,j,t} = \alpha_i + \alpha_t + \beta\ Promote\_Shock_{j,t}^{IS} + \gamma Controls_{i,j,t} + \varepsilon_{i,j,t} \quad (3)$$

where i indexes firms, j indexes the state of firms' headquarters, t indexes year, and α_i and α_t represent firm and year fixed effects. If home-state firms have a greater incentive to smooth earnings following their senator's promotion, I expect β to be positive.

I use three measures of *Income Smoothing*. One, *IS1,* is the ratio of the standard deviation

of income before extraordinary items to the standard deviation of cash flows from operations, multiplied by -1 (Lang et al. 2012). This measure is constructed based on the argument that if firms use accruals to manage earnings, reported earnings will be smoother relative to cash flows (e.g., Leuz et al. 2003; Lang et al. 2006). Two, *IS2*, is the contemporaneous correlation between the change in total accruals and the change in cash flow from operations, multiplied by -1 (Leuz et al. 2003; Burgstahler et al. 2006). In good times, with high operating cash flows, managers can manipulate earnings by understating accruals and creating reserves for the future. These reserves will then be reversed to boost earnings in bad times when operating cash flows are low. Thus, accruals and cash flows will be more negatively correlated when managers engage in earnings smoothing. Both *IS1* and *IS2* are calculated using the current year's and past four years' observations. As in Tucker and Zarowin (2006) and Lang et al. (2012), I choose rolling windows of five years. Three, my main income smoothing measure, *IS*, is the average of the reversed fractional rankings of *IS1* and *IS2*, where fractional ranking equals the raw rank divided by the number of observations. Higher values of the three measures represent more income smoothing.

Income smoothing measures computed using rolling windows of five years are contaminated for the promotion year and the three years right after the promotion. For example, for the year after the promotion (event year +1), the income smoothing measures are computed over the period from three years before the promotion to one year after the promotion (i.e., from event years -3 to +1). Three years out of the five-year window come from the pre-promotion period and the resulting income smoothing measures may not pick up changes in financial reporting. To avoid the contamination while not losing too many observations, I drop observations in the promotion year and in the first two years after the promotion (i.e., event years 0 to +2). Similarly, for the post-event years +7 and +8, the calculation of income smoothing measures over a five-year window includes some observations from event years (i.e., +3 to +6),

thus contaminating the post-event level of income smoothing. Consequently, I also drop event years +7 and +8 to increase the power of the tests. Thus, $Promote\_Shock_{j,t}^{IS}$, equals one for years +3 to +6 relative to the promotion year.

Following the prior literature (e.g., Dou et al. 2013; Lang et al. 2012), I control for factors that affect smoothness of earnings such as profitability, growth options, differences in financing choices, and volatility in the operating environment. Specifically, I include firm size (*LNASSETS*), leverage (*LEV*), book-to-market ratio (*BM*), operating volatility (*STD_SALES*), proportion of loss years (*PCTLOSS*), sales growth (*SG*), capital intensity (*OPLEV*), cash flows from operations (*AVGCFO*), firm age (*AGE*), and standard deviation of stock returns (*STD_RET*) as control variables.

3.3 Sample selection

I use Senate committee data from Nelson (2005) and Stewart and Woon (2011) to identify the instances of promotion to a powerful committee chair.[21] I obtain financial data from Compustat, stock return data from CRSP, and data on firms' sales to the U.S. government from the Compustat Segment Files.[22] Since Compustat data is available from 1967 and I require five years of data to compute income smoothing measures, my sample starts in 1971 and ends in 2012.

To construct a more powerful test, I focus on firms that are most likely to receive political benefits and thus attract public attention after the promotion of their home state senator. Considering the committee chair's influence on the distribution of federal funds, I identify firms that are likely to face increased political costs as firms in industries with significant sales to the

[21] Congressional committee data is available as early as 1947 and I thank Charles Stewart III for providing this data on his web page http://web.mit.edu/17.251/www/data_page.html#0.

[22] Since Compustat Segment Files are available from 1976, analysis requiring sales to the government data are based on the sample firms from 1976 to 2012.

U.S. government.[23] I focus on industry-level rather than firm-level identification because tax structure, political pressure, and regulatory policy often vary at the industry level (Watts and Zimmerman 1978).[24] This approach also allows me to include firms that do not have the government as a major customer prior to the promotion shock but have the potential to obtain more government contracts after an increase in political capital. To the extent that procurement contracts increase firm profitability (e.g., Lichtenberg 1992; McGowan and Vendrzyk 2002), the value of political ties will be higher for firms in industries more dependent on government contracts (e.g. Houston et al. 2014). Firms in these industries are also more politically visible and bear higher political costs from government disfavor (Karpoff et al. 1999; Mills et al. 2013). Using the information from the Federal Procurement Report, I only include U.S. firms in industries with higher than 3% of total sales to the U.S. government as my main sample.[25] I exclude firms in the financial industry (SIC 6000- 6799) due to the uniqueness of their accounting practices. To be included in the sample, I require observations to have all the information for computing the control variables. My final sample consists of 2,012 firms and 16,494 firm-years from 1971 to 2012. Table 1, Panel A, describes the sample industry composition based on the two-digit SIC code. My sample has a greater concentration of firms in the electronics, instruments and business service industries (including computer, data processing and security systems services) relative to the Compustat population.

I link each of the newly promoted politicians to firms headquartered in his state using the location information on Compustat. As prior studies note (e.g., Kim et al. 2012; Heider and

[23] Cohen et al. (2011) document that public funds crowd out private investment and thus reduce firm sales growth. However, the authors show that firms with existing government contracts who are likely to gain from increased federal spending do not downsize after an infusion of public funds.

[24] Consistent with this, earlier studies testing the political cost hypothesis focus on specific industries such as oil refining (Hall 1993), cable television (Key 1997), and insurance (Grace and Leverty 2010).

[25] The Federal Procurement Report is provided by the U.S. General Services Administration's Federal Procurement Data System. https://www.fpds.gov/fpdsng_cms/index.php/en/reports.html.

Ljungqvist 2013), Compustat provides only the most recent address information rather than the historical location of firms. Therefore, I use address information extracted from each year's 10-K filings for a firm from the SEC's EDGAR database to obtain historical location information.[26] Since electronic filing data is only available after 1994 (required after 1996), I use the earliest available address information from 10-K filings for my sample firm-years prior to 1994.

3.4 Descriptive statistics

Table 1, Panel B, reports summary statistics for the main variables I use in this study. My sample includes 73 newly promoted chairmen from 43 different states for 10 different Senate committees in the sample period from 1971 to 2012. When promotions to a ranking minority member as well as a chairman position for the top 10 committees are considered, my sample includes 103 cases. Firm-year observations based on firms headquartered in states represented by a senator promoted to a chairman (or a ranking minority member) of the top 3, 5, and 10 powerful committees are 5.8%, 11%, and 20.8% (9.5%, 15.4%, and 29.5%) of the total sample.

Panel C reports summary statistics of firm characteristics of my sample and the Compustat universe. On average, my sample firms have $46 million sales (8.5% of total sales) made to the government.[27] The median total assets (*ASSETS*) equal $172 million and median return on assets (*ROA*) is 5.3% for the sample firms. The sample includes relatively larger and more profitable firms relative to all Compustat firms, consistent with higher profitability reported by large firms with major government contracts (Lichtenberg 1992; McGowan and Vendrzyk 2002). The sample firms are older and have relatively stable operations as indicated by the

[26] I thank Bill McDonald for providing the 10-K header filing data on his website.

[27] These government sales are conservative estimates since the Compustat Segment file reports data for major customers only.

volatility of earnings and returns compared to the Compustat population.[28]

4. Empirical Results

4.1 The impact of promotion shocks on firms' sales to the government and ROA

An important maintained hypothesis for the increased political costs following the ascension to the chair of a powerful committee is that the new chair with increased power provides benefits to his constituencies including the firms headquartered in his/her state. Hence, before testing the main hypothesis of income smoothing, I investigate whether sample firms in the home state of the new chair (or the ranking minority member) in fact benefit from their senator's increased power. First, I look into the impact of promotion shocks on firms' sales to the government. As Cohen et al. (2011) show in their state-level analysis, the channels of distributive politics include earmarks, government transfers, as well as government contracts. However, data on earmarks and government transfers are only available at the state-level. Thus, I examine firm-level benefits in the form of sales to the government made by home-state firms using data obtained from the Compustat Segment file. One limitation of using this data is that it only provides sales information when the government is a major customer of the firm. Consequently, the impact of promotion shocks on firms who do not have the government as a major customer is not captured in this analysis so that the estimated effect on benefits will be conservative. I also examine the overall effect of promotion shocks on treatment firms' operating performance captured by return on assets (*ROA*). This summary measure will likely reflect not only distributive benefits but also other advantages received by treatment firms through the promoted senator's influence on various policies.

[28] The differences in means and medians of my sample relative to the Compustat population (excluding my sample) are significant at the 1% level for all variables except for an insignificant median difference for the average CFO variable.

The estimation results reported in Table 2 are consistent with the argument that the new leadership of powerful Senate committees has a positive effect on the performance of home-state firms. Panel A presents the estimation results of equation (1) using the logarithm of one plus aggregate sales to the government (*LogSalesGov*) as the dependent variable (consistent with Tahoun 2014). I only include firm-year observations reporting the U.S. government as a major customer for this analysis. The results show that firms experience a significant increase in sales to the government following the promotion of their home-state senator to the chairman of the top 3 or 5 Senate committees. Including promotions to the ranking minority member as a promotion shock along with promotions to the chairman position also gives similar results. Alternatively, I also run a tobit regression with all firm-years, including firm-years without the U.S. government as a major customer, and find a similar positive impact of promotion shocks (untabulated).

Panel B presents the estimation results of equation (2) using ROA as the dependent variable. The results indicate that promotion shocks give rise to an increase in profitability of home-state firms. New chairmanship of powerful committees results in a significant increase in the ROA of home-state firms over the subsequent seven years in the range of 0.4% to 0.6% per year. Given the average ROA of 4.2% for the sample, the impact represents an economically significant increase of 10% to 14%. Note that, to the extent treatment firms are more likely to utilize their accounting discretion to conceal high profits as predicted by H1, their reported ROA will be lower than the "unmanaged" ROA, so that the observed effect of the promotion shock on the increase in ROA (i.e., 10%-14%) will be understated. As I broaden the definition of promotion shocks by adding promotions of ranking minority members, the effects become insignificant. This is consistent with results on earmarks in Cohen et al. (2011) who show that ranking members are less influential than chairs of the same committee. Overall, the empirical findings suggest that new leadership of powerful Senate committees provides significant benefits

to firms in the senator's home state.

4.2 Stock returns around promotions

While I document an increase in sales to the government and ROA of the home-state firms, it is likely that home-state firms receive a wide range of other political benefits which are difficult to identify due to the lack of available information. Following the prior literature (e.g., Fisman 2001; Faccio 2006; Faccio and Parsley 2009), I use stock returns to capture the overall value of the political benefits arising from the home-state senator's promotion.

First, I use event study methodology to see whether a senator's promotion has positive impact on home-state firms' stock returns. Although the appointment of the new chairman (or the ranking minority member) takes effect on the first day of each Congress session, the upcoming change is known when the incumbent dies, resigns, or is defeated in the election. I search and identify the exact dates of 41 cases of promotion to chairman or ranking minority member of the top 10 Senate committees. Examples of these cases include sudden death of the existing chairman or the ranking minority member and the election which causes the change in the chairmanship.[29] Event date is defined as the date of the sudden death or one day after the election date when the election outcome is determined. The cumulative abnormal return (CAR) is calculated by summing the difference between the firm's stock return and the value weighted market return over the event window beginning one day prior to the event date on which the promotion is determined and ending one and three trading days after the event.

Table 3, Panel A, reports CARs around the promotions using the event windows (-1, +1), and (-1, +3). The table shows that the determination of the promotion results in a statistically

[29] I was unable to identify precise event dates when the incumbent chairman (or the ranking minority member) resigns or decides to relinquish a leadership position in one committee to chair a different committee.

significant increase in stock price of the home-state firms in my sample. The average abnormal returns are 0.64% in the (-1, +1) event window and 0.83% in the (-1, +3) event window.[30] The positive stock price reaction suggests that the stock market perceives that home-state firms receive benefits from their home-state senator's promotion to powerful Senate committees.

Next, I analyze the long term stock price performance of home-state firms following the appointment of the new chairman (or the ranking minority member). Since there are many cases of promotions for which I cannot identify the exact event dates, the short-window analysis in Panel A is based on a limited number of observations. By using one-year stock returns from the first day of each Congress after the new leader takes control of the committee, I am able to include all promotion cases in this analysis. I regress log returns on the indicator variable for the promotion shock year. Specifically, I define $PromoteYr\_Shock_{j,t}$ to be one in the year the senator of a given state is promoted to be the chairman (or the ranking minority member) of an influential Senate committee and zero otherwise. Firm and year fixed effects are included and I control for firm size (LNASSET), financial leverage (LEV), stock return volatility (STD_RET), ROA, and capital intensity (CAPITAL_INTENSITY) following Leuz and Oberholzer-Gee (2006).

The estimation results of long-window stock returns following the promotion are reported in Panel B of Table 3. All the coefficient estimates on the promotion shock year variable are positive and three of them are significant. This suggests that a senator's promotion to the committee chair (or the ranking minority member) has a significantly positive effect on the one-year stock returns for the home-state firms in my sample. The results are similar when I use the returns over two years following the promotion (untabulated). Overall, the positive long-window

[30] This increase is comparable to the three-day abnormal returns of -0.6% suffered by firms upon the sudden death of politicians from the same city, documented in Faccio and Parsley (2009).

return performance provides corroborative evidence that new leadership of powerful Senate committees provides significant benefits to firms in the senator's home state.

4.3 The impact of promotion shocks on income smoothing

Having shown that firms benefit from the promotion of their home-state senators, I now examine whether these firms engage in income smoothing to dampen their profits following the promotion. To test my main hypothesis, I estimate equation (3) using the three income smoothing measures discussed in section 3.2.

Table 4, Panel A, reports the coefficient estimates (and t-statistics) using the composite measure, *IS,* as the income smoothing proxy. Across all measures of promotion shocks (i.e., Top 3, 5, and 10 committees, and with or without ranking member), I find that the estimated coefficients on promotion shocks are significantly positive. This suggests that treatment firms are more likely to engage in income smoothing after the promotion of their home-state senator than control firms in other states that are unaffected by the promotion. Panel B and Panel C report the results with *IS1* and *IS2* as alternative measures of income smoothing, respectively. Similar to the results in Panel A, the coefficient estimates on promotion shocks remain positive and significant for both measures as reported in Panels B and C.[31]

Taken together, the documented increase in income smoothing following the home-state senator's rise to a powerful position is consistent with managers of treatment firms utilizing their accounting discretion to avoid public scrutiny and the ensuing negative publicity arising from the political benefits they receive.

[31] To select sample industries to test the impact of promotion shocks on income smoothing, I also use alternative cut-offs in place of ≥3% government sales. When I employ 1% (5%) cut-off, the sample has 33,902 (9,191) firm-year observations. Using the 1% cut-off gives substantially similar results, while results using the 5% cut-off are slightly weaker due to the smaller sample size (untabulated).

4.4 Cross-sectional variation in the effect of promotion shocks on income smoothing

4.4.1 Effect of promotion shocks and government contract intensity

Next, I investigate whether the increase in income smoothing following a promotion shock is more pronounced for firms with higher government contract intensity. This is because firms with high government contract intensity are likely to be more politically visible and hence exposed to higher political costs. I follow Mills et al. (2013) to measure a firm's contract intensity (*CI*) as a product of the relative size of government contracts and the importance of government contracts to the firm. The relative size of government contracts is an indicator variable that equals one if the level of a firm's government contracts is in the top 10% of the distribution of government contracts over the previous three years. The importance of government contracts to the firm is measured as the percentage of the firm's sales made to the government averaged over the previous three years. The contract intensity measure (*CI*) recognizes that firms with huge procurement contracts are likely to catch public attention and the political costs from such negative publicity can vary with the importance of the contracts to the firm (Mills et al. 2013).

I estimate the following OLS regression by adding contract intensity (*CI*) and its interaction with the promotion shock indicator ($Promote\_Shock_{j,t}^{IS} * CI_{i,j,t}$) to equation (3).

$$IS_{i,j,t} = \alpha_i + \alpha_t + \beta_1 Promote\_Shock_{j,t}^{IS} + \beta_2 Promote\_Shock_{j,t}^{IS} * CI_{i,j,t} + \beta_3 CI_{i,j,t} + \gamma Controls_{i,j,t} + \varepsilon_{i,j,t} \quad (4)$$

Table 5, Panel A, presents the results of estimating equation (4) using *CI* as the measure of the firm's contract intensity. I find that, in five out of six specifications, the coefficient estimate on the interaction of *CI* and the promotion shock is significantly positive. This suggests that the incentive to smooth earnings following promotion shocks is particularly strong for firms with greater exposure to political costs as indicated by the intensity of their dealings with the government. These results provide further corroborating evidence of the main hypothesis.

4.4.2 Effect of promotion shocks and committee seniority

In this section, I examine whether the extent of the increase in political power as captured by the seniority of the promoted chairman (or the ranking minority member) influences the relation between promotion shocks and incentives to smooth earnings. Committee seniority is the number of continuous years the senator has spent on the committee he/she chairs (Nelson 2005; Stewart and Woon 2011). In my sample, the average committee seniority of a new chairman on the date of appointment is 17 years. Given that senior senators are more powerful than junior senators in general, senior senators are likely to convey fewer incremental benefits to their constituencies after their promotion relative to junior senators. Consequently, following the promotion shock, firms in the home state of a junior senator will experience greater increase in political benefits and thus political costs. I therefore predict that the increase in the incentive to smooth earnings following the promotion will be more pronounced in these firms than in firms from a state where a senior senator is promoted. I define *JUNIOR* as one if the committee seniority of the promoted chairman (or ranking minority member) is below the median committee seniority across all the promoted chairmen (or ranking minority member) of the top 10 Senate committees and zero otherwise.[32] I estimate the following OLS regression by adding an interaction variable of promotion shock and the committee seniority indicator ($Promote\_Shock^{IS}_{j,t} * JUNIOR_{i,j,t}$) to equation (3).

$$IS_{i,j,t} = \alpha_i + \alpha_t + \beta_1 Promote\_Shock^{IS}_{j,t} + \beta_2 Promote\_Shock^{IS}_{j,t} * JUNIOR_{i,j,t} + \gamma Controls_{i,j,t} + \varepsilon_{i,j,t} \quad (5)$$

Table 5, Panel B, presents the results of estimating equation (5) using *JUNIOR* as the indicator variable of the chairman's committee seniority. In five out of the six specifications, the coefficient estimate on the interaction of *JUNIOR* and the promotion shock variable is

[32] Median committee seniority is 17 years.

significantly positive. This suggests that the promotion of a junior senator has a stronger impact on income smoothing incentives relative to the promotion of an already powerful senior senator. The evidence that the extent of change in political capital influences income smoothing incentives further strengthens my inference about the relation between political costs and the use of a firm's accounting discretion.

4.4.3 Effect of promotion shocks and political contributions

In this section, I test whether the increase in income smoothing after the promotion of a home-state senator is more pronounced for firms that provide contributions to the promoted chairman's political campaign. Using corporate political contributions data from the U.S. Federal Election Commission (FEC) for the period 1989 to 2012, I define *PC* as one if the firm contributed to the political campaign of the promoted chairman over the period from seven years before the promotion to seven years after the promotion and zero otherwise. I estimate the following OLS regression by adding political contribution indicator variable (*PC*) and its interaction with the promotion shock indicator ($Promote\_Shock_{j,t}^{IS} * PC_{i,j,t}$) to equation (3).

$$IS_{i,j,t} = \alpha_i + \alpha_t + \beta_1 Promote\_Shock_{j,t}^{IS} + \beta_2 Promote\_Shock_{j,t}^{IS} * PC_{i,j,t} + \beta_3 PC_{i,j,t} + \gamma Controls_{i,j,t} + \varepsilon_{i,j,t} \quad (6)$$

Table 5, Panel C, presents the results of estimating equation (6) using *PC* as the indicator variable for political contributors. Although the power of this test is reduced with the limited sample size and the limited number of firms who contributed to the political campaign of the specific promoted chairman or the ranking minority member, I find that the coefficient estimates on the interaction of *PC* and the promotion shock variable are significantly positive in two out of six specifications. This suggests that the increase in income smoothing after the promotion is more pronounced for political donor firms with stronger ties to the new chairman (or ranking

minority member). This evidence is consistent with the idea that corporate contributors, facing higher public scrutiny, use accounting discretion to manage the political costs associated with negative publicity (Ramanna and Roychowdhury 2010).[33]

4.5 The impact of exit shocks on ROA and income smoothing

So far I have focused on the promotion of senators as a source of exogenous increase in political power to examine firms' incentives to smooth earnings. If the ascension to a leadership position brings in additional benefits and public scrutiny, these will cease to exist following the departure of a committee chair (or a ranking minority member). The relinquishment of chairmanship, hence, would discontinue the incentives to smooth earnings. As a natural extension of my main analyses, I examine whether the departure of the committee leadership (i.e., an exit shock) has a negative impact on firm performance and income smoothing.

In my sample, about 3% (6% and 11%) of firm-years are in states whose senator vacates a chair position of a top 3 (top 5 and top 10) committee. Panel A of Table 6 presents the results of estimating a variation of equation (2) by regressing ROA on exit shocks instead of promotion shocks. An exit shock occurs if the senator of a given state, who once was a chairman of an influential Senate committee, vacates the leadership position (either chairman or ranking minority member). I set the exit shock variable (*Exit_TopNChairOnly*) as one in the year of the leader's departure and in the subsequent four years, assuming that the effect of the exit shock persists for

[33] Another plausible cross-sectional difference in the effect of promotion shocks could arise when the committee of which the senator is a new chair has jurisdiction over specific industries. To test this possibility, I use the information on Senate committee jurisdiction from Ovtchinnikov and Pantaleoni (2012). Among the top 10 Senate committees included in this study, only Finance, Armed Services, and Commerce committees have clear industry jurisdiction. For example, Armed Services committee is likely to have greater influence on the defense industry. Other committees such as Appropriations, Judiciary, and Rules, do not have industry specific jurisdiction. Since firms in the financial industry are not included in my sample, I can only use promotion shocks related to Armed Services and Commerce committees. However, the power of the test is too low to proceed with the estimation since the matched observations are too few (only five firms) when I link these two committees with firms in the related industries.

four years. The coefficient estimates on exit shocks in all specifications are negative and two out of three of them are significant, indicating that treatment firms' operating performance decreased following the departure of their connected senator from the leadership position. These coefficient estimates, ranging from -0.003 to -0.007, are comparable in magnitude to the positive coefficients on the promotion shocks in Panel B of Table 2. This result suggests that the benefits firms receive during the tenure of their senator's chairmanship largely disappear after the exit shock.[34]

Panel B of Table 6 presents the results of estimating equation (3) by regressing the income smoothing measure, *IS*, on exit shocks. Given that I use five-year rolling windows for computing the income smoothing measure, I define exit shocks for income smoothing tests ($Exit\_TopNChairOnly^{IS}$) to be one in the years +3 to +5 relative to the year in which the senator relinquishes his leadership. I exclude the year of the exit, years +1 and +2, and year +6 in my analysis due to the contamination of the income smoothing measure in these years. The remaining sample years of firms experiencing the exit shock, along with the firm-years of non-treatment firms, constitute the control sample. The coefficient estimates on exit shocks are negative for all specifications and two out of three of them are significant. The results suggest that, in response to the reduced public scrutiny following their senator's departure from the position of a Senate committee chair, firms are less likely to smooth earnings relative to when their senator is in power. In summary, this test provides confirming evidence that changes in the leadership position of an influential Senate committee (both promotion and departure) affect the level of political benefits and hence home-state firms' incentives to smooth earnings.

[34] I also test whether exit shocks have a negative impact on sales to the government by regressing *LogSalesGov* on exit shocks for the sample of firms with the government as a major customer. Untabulated results indicate a negative but insignificant impact of exit shocks on government contracts. Perhaps this reflects the long-term nature of government contracts which cannot be easily terminated on the chair's departure.

4.6 Robustness tests

4.6.1 Alternative definition of benefit period after promotion shocks

I follow Cohen et al. (2011) and measure the effects of promotion shocks over a fixed period of time (i.e., seven years following promotion) to ensure the exogeneity of the setting. There may be a concern that, examining the effects over a fixed period after all promotion shocks rather than over the actual tenure of individual promoted chairs may introduce measurement error in estimating the effect of the shock. For example, if a senator continues as chairman for twenty years, measuring the effect of promotion shocks over seven years will wrongly classify years after the seventh year of the promotion as non-treatment years.

To address this issue, I adopt an alternative definition of promotion shocks based on the actual tenure of each chair as in Snyder and Welch (2014). Specifically, the historical promotion shock is defined as one in the years when the senator of a given state is a chairman (or a ranking minority member) of a powerful committee and zero otherwise.[35] Results based on this alternative definition of the benefit period are substantially similar (even stronger) relative to those reported in Table 3 (untabulated).

The use of actual leadership tenure to define the benefit period has been criticized by Cohen et al. (2014) in response to Snyder and Welch (2014). Cohen et al. (2014) argue that actual leadership tenure is endogenous since the continuation of leadership/reappointment depends on the re-election results of the senator which might be correlated with his state's economic condition. In such a scenario, it is possible that the state's economy could drive the performance of firms as well as their incentives to smooth earnings over the actual tenure of the chairman. Due to this ongoing debate in the literature, although my results remain unchanged, I do not use the

[35] I additionally require the chairman to maintain tenure for at least five prior years to calculate the income smoothing measure. The same criteria for inclusion or exclusion of firm-years are applied as in the main tests discussed in section 3.2.

actual tenure of individual chairs to define the benefit period in my main analyses.

4.6.2 The impact of promotion shocks on report readability

Bloomfield (2002) argues that managers make strategic choices motivated, at least partly, by a desire to make it harder for financial statement users to uncover information that managers wish to remain undisclosed. The results, thus far, provide evidence that firms smooth earnings to mask their true performance. In this section, I examine whether firms try to obfuscate information in their annual reports by making them more difficult and complicated to read, in addition to engaging in income smoothing. Following Li (2008), I use the *Fog* index (*Fog*) as a measure of annual report readability.[36] Similar to equations (1) and (2), *Fog* is regressed on promotion shocks, control variables, and firm and year fixed effects. I control for other potential determinants of readability used in the literature, namely book to market ratio (*BM*), firm size (*LNASSETS*), earnings volatility (*VOLROE)*, return volatility (*STD_RET*), firm age (*AGE*), and special items scaled by total assets (*SI*).

Panel A Table 7 presents the results of this analysis using the sample firm-years from 1993 to 2012 when the *Fog* index is available. The coefficient estimates on promotion shocks are mostly positive but significant in one of the specifications, indicating that the impact of promotion shocks on report readability is marginal for the entire sample firm-years from 1993 to 2012. Therefore, I increase the power of my test by focusing on firms with the strongest incentives to obfuscate information - firms with higher political visibility as indicated by their government contract intensity. Panel B presents the results using the sample firm-years with higher government contract intensity from 1993 to 2012. The coefficient estimates on promotion shocks are significantly positive in four out of six specifications, indicating that, for the sample of

[36] I thank Feng Li for providing the *Fog* index data on his web page.

firms with greater contract intensity, annual reports become more complicated to read after the home state senator's promotion to a powerful Senate committee.[37] This result suggests that firms receiving political benefits attempt to obfuscate information to avoid political costs in addition to engaging in income smoothing.

4.6.3 Other robustness tests

I conduct a variety of additional robustness tests. Cohen et al. (2011) document the effect of increased federal spending on corporate retrenchment, arguing that public expenditures crowd out private investments. A possible alternative explanation of my findings is that the effect of promotion shocks on income smoothing is a manifestation of their negative impact on firm investment. However, in untabulated results, I find that promotion shocks do not have a negative impact on capital expenditure, R&D, payout ratio, employment level, or sales growth for the sample of firms in government-dependent industries that I examine in this study. This is consistent with the discussion in Cohen et al. (2011) that firms with valuable procurement contracts do not downsize following the increase in public spending. Nevertheless, I repeat my main analyses by adding capital expenditure (*CapExp*), R&D expenditure (*RD*), payout ratio (*Payout*), and the change in the number of employees (*EmployChange*) as control variables. My results are substantially similar suggesting that the evidence in this paper cannot be explained by the effects of reduced investment documented by Cohen et al. (2011).

Another potential alternative explanation for my results is that the observed increase in income smoothing might be due to the changed nature of the firms' business after their home state senator's ascension to a committee chair. As shown in Panel A of Table 2, home state firms

[37] I also examine the log of file size of the 10K report for these firms as an alternative measure of readability of annual reports. The results are in general weaker, with the coefficient estimate being significantly positive in two specifications.

receive more government contracts after the promotion. If having the government as a major customer provides more stable source of income compared to having a private customer, then increased government contracts, rather than manager's intentional actions, may generate smooth earnings after the promotion. To rule out this alternative explanation, I include sales to the government (LogSaleGov) as an additional control variable in equation (3). The results are robust to the inclusion of this variable (untabulated).

5. Conclusion

This paper examines whether firms receiving benefits through their connections to politicians smooth earnings to reduce public scrutiny. I use exogenous changes in Senate committee leadership to identify changes in political costs to firms headquartered in the constituency of the promoted chairman. Using a difference-in-difference research design, I find that home-state firms are more likely to smooth earnings after their senator's promotion to a committee chair, consistent with the political cost hypothesis (Watts and Zimmerman 1978). Cross-sectional analyses show that these effects are stronger for politically sensitive firms that are exposed to higher political costs, including firms with higher government contract intensity and firms who provide contributions to the promoted chair's political campaign. The increase in the tendency to smooth earnings is more pronounced for firms in the constituency of relatively junior chairmen, consistent with the idea that junior senators are likely to obtain higher incremental power from the promotion. Lastly, I supplement the analysis by providing evidence that, following the leadership change, politically sensitive firms have annual reports that are more difficult to read as measured by the *Fog* index, suggesting that besides engaging in income smoothing, these firms may attempt to obfuscate information to avoid political costs.

To summarize, this paper provides evidence of the political cost hypothesis using a

natural experiment with exogenous political shocks that are scattered over time and states. My results show that firms respond to the increase in political costs by using their accounting discretion to conceal their profits. The inferences apply to a comprehensive sample of firms in various industries and hence are more generalizable relative to some prior studies that focus on industry-specific, small-sample, and short horizon effects. Overall, my results highlight the role of political pressure in determining firms' discretionary accounting choices and shaping the information environment.

Table 1: Sample Composition and Descriptive Statistics

This table presents the sample distribution across industries and descriptive statistics of the sample. The sample consists of 16,494 observations in non-financial industries with at least 3% of total sales to the U.S. government between 1971 and 2012. Panel A presents the frequency distribution of sample firms by the 2-digit SIC code along with the Compustat universe (in the last column). Panel B presents the descriptive statistics of main variables used in the tests. Panel C presents the comparison of sample firm characteristics with the Compustat universe (excluding the financial industry). All continuous variables are winsorized at the 1st and 99th percentiles. The data on sales to the government are available from 1976 to 2012 and the *Fog* data are available from 1993 to 2012. Detailed variable definitions are provided in the Appendix.

Panel A: Sample composition by industry

Two-digit SIC code		# of firms		# of firm-years		
		Count	Sample (%)	Count	Sample (%)	Compustat
16	Heavy Construction	23	1.14%	286	1.73%	0.27%
25	Furniture and Fixtures	35	1.74%	212	1.29%	0.58%
31	Leather and Leather Products	18	0.89%	183	1.11%	0.3%
34	Fabricated Metals	159	7.9%	2,094	12.7%	1.64%
36	Electronics	244	12.13%	1,891	11.46%	6.48%
37	Transportation Equipment	169	8.4%	2,005	12.16%	2.03%
38	Instruments	332	16.5%	2,632	15.96%	5.1%
39	Misc. Manufacturing	71	3.53%	593	3.6%	0.98%
44	Water Transportation	18	0.89%	205	1.24%	0.45%
51	Wholesale Durables	40	1.99%	188	1.14%	1.37%
73	Business Services	368	18.29%	2,769	16.79%	8.46%
80	Health Services	124	6.16%	743	4.5%	1.41%
82	Educational Services	30	1.49%	226	1.37%	0.3%
87	Engineering Services	140	6.96%	1,178	7.14%	1.5%
	Others	241	11.99%	1,289	7.81%	69.13%
Total		2,012	100%	16,494	100%	100%

Panel B: Descriptive statistics of main variables

Variables	N	Mean	Median	Std.Dev.
Income Smoothing				
IS (composite)	16,494	0.510	0.514	0.266
IS1	16,494	-0.692	-0.556	0.527
IS2	16,494	0.775	0.927	0.352
Promotion_Shock				
Promote_Top3ChairOnly	16,494	0.058	0	0.233
Promote_Top3Chair_Rank	16,494	0.095	0	0.293
Promote_Top5ChairOnly	16,494	0.110	0	0.313
Promote_Top5Chair_Rank	16,494	0.154	0	0.361
Promote_Top10ChairOnly	16,494	0.208	0	0.406
Promote_Top10Chair_Rank	16,494	0.295	0	0.456

Panel C: Comparison of sample firm characteristics with Compustat

		Sample Firms			Compustat	
Variables	N	Mean	Median	Std.Dev.	Mean	Median
ROA	16,494	0.042	0.053	0.107	-0.005	0.042
SalesGov ($m)	15,016	46.399	0	137.796	12.115	0
Contract Intensity	14,178	0.082	0	0.191	0.027	0
Fog	5,085	19.575	19.481	1.671	19.497	19.386
BM	16,494	0.827	0.829	0.305	0.778	0.779
ASSETS ($m)	16,494	979.746	171.719	2,814.76	1,182.046	132.815
MVE ($m)	16,494	1,088.568	124.688	5,939.413	1,461.911	104.284
Herfindahl_Index	16,494	0.106	0.075	0.100	0.083	0.056
CAPX/Sales	16,491	0.051	0.034	0.075	0.123	0.044
LEV	16,494	0.168	0.141	0.158	0.211	0.174
STD_SALES	16,494	165.967	35.657	430.937	185.854	33.201
PCTLOSS	16,494	0.183	0.000	0.255	0.242	0.000
SalesGrowth(SG)	16,494	0.118	0.097	0.170	0.192	0.108
OPLEV	16,494	0.251	0.230	0.156	0.338	0.274
AVG(CFO/Assets)	16,494	0.073	0.076	0.081	0.064	0.075
AGE	16,494	18.187	16	8.844	13.365	11.000
VOLROE	14,644	2.386	0.108	15.512	3.956	0.135
STD_RET	16,494	0.123	0.109	0.066	0.138	0.119
Special Items/Assets	15,925	-0.014	0	0.181	-0.016	0

Table 2: The Impact of Promotion Shocks on Firms' Sales to the Government and ROA

This table presents OLS regressions of sales to the government and ROA on promotion shocks. Panel A reports the results with *LogSalesGov* as the dependent variable for firms having the government as a major customer and Panel B reports results with *ROA* as the dependent variable. All variables are defined in the Appendix. All models include firm and year fixed effects. Standard errors are clustered at the state-year level and t-statistics are included in parentheses below the coefficients. All continuous variables are winsorized at the 1st and 99th percentiles. *, **, and *** represent significance at the 10%, 5%, and 1% levels, respectively.

Panel A: The impact of promotion shocks on firms' sales to the government

$$LogSalesGov_{i,j,t} = \alpha_i + \alpha_t + \beta\, Promote\_Shock_{j,t} + \gamma Controls_{i,j,t} + \varepsilon_{i,j,t} \quad (1)$$

	Dependent Variable: *LogSalesGov*					
	(1)	(2)	(3)	(4)	(5)	(6)
Promote_Top3ChairOnly	0.096**					
	(1.96)					
Promote_Top5ChairOnly		0.120***				
		(3.12)				
Promote_Top10ChairOnly			0.024			
			(0.85)			
Promote_Top3Chair_Rank				0.114***		
				(3.09)		
Promote_Top5Chair_Rank					0.108***	
					(3.49)	
Promote_Top10Chair_Rank						0.024
						(0.96)
LNMVE	0.404***	0.406***	0.406***	0.403***	0.405***	0.406***
	(18.14)	(18.19)	(18.05)	(18.07)	(18.14)	(18.07)
BM	0.671***	0.676***	0.669***	0.667***	0.670***	0.669***
	(8.18)	(8.25)	(8.13)	(8.18)	(8.21)	(8.14)
HF	-0.164	-0.172	-0.150	-0.161	-0.176	-0.150
	(-0.73)	(-0.77)	(-0.66)	(-0.72)	(-0.78)	(-0.66)
CAPX/Sales	-1.313***	-1.309***	-1.317***	-1.305***	-1.305***	-1.314***
	(-6.35)	(-6.34)	(-6.33)	(-6.30)	(-6.33)	(-6.31)
ROA	-0.373**	-0.375**	-0.371**	-0.372**	-0.379**	-0.373**
	(-2.31)	(-2.32)	(-2.29)	(-2.30)	(-2.36)	(-2.31)
Observations	3,730	3,730	3,730	3,730	3,730	3,730
R-squared	0.929	0.930	0.929	0.930	0.930	0.929

Panel B: The impact of promotion shocks on firms' ROA

$$ROA_{i,j,t} = \alpha_i + \alpha_t + \beta\, Promote\_Shock_{j,t} + \gamma Controls_{i,j,t} + \varepsilon_{i,j,t} \quad (2)$$

	Dependent Variable: *ROA*					
	(1)	(2)	(3)	(4)	(5)	(6)
Promote_Top3ChairOnly	0.006**					
	(2.22)					
Promote_Top5ChairOnly		0.005**				
		(2.42)				
Promote_Top10ChairOnly			0.004**			
			(2.24)			
Promote_Top3Chair_Rank				0.001		
				(0.33)		
Promote_Top5Chair_Rank					0.002	
					(0.85)	
Promote_Top10Chair_Rank						-0.000
						(-0.20)
BM_{t-1}	-0.129***	-0.129***	-0.129***	-0.129***	-0.129***	-0.129***
	(-27.82)	(-27.81)	(-27.78)	(-27.83)	(-27.83)	(-27.82)
$LNASSETS_{t-1}$	-0.014***	-0.014***	-0.014***	-0.014***	-0.014***	-0.014***
	(-7.21)	(-7.22)	(-7.23)	(-7.24)	(-7.23)	(-7.24)
Observations	16,493	16,493	16,493	16,493	16,493	16,493
R-squared	0.588	0.588	0.588	0.588	0.588	0.588

Table 3: Stock Returns around Promotions

Panel A: Cumulative abnormal returns (CARs) around promotions

CAR is calculated by summing the difference between the firm's stock return and the value weighted market return over the event window beginning one day prior to the event date on which the promotion is determined and ending one and three trading days after the event. Exact event dates include the date of sudden death of the existing chairman and the day after the date of the election which results in the change in chairmanship. All continuous variables are winsorized at the 1st and 99th percentiles. *, **, and *** represent significance at the 10%, 5%, and 1% levels, respectively.

	Event Window	
	(-1,+1)	(-1,+3)
Mean	0.64%***	0.83%***
p-value	0.009	0.009
N	315	315

Panel B: Return performance for the year following the promotion

This panel presents OLS regressions of log returns on the promotion shock variables. *LogRet* is the logarithm of one plus the return over a year following the promotion. $PromoteYr\_Shock_{j,t}$ is one in the year the senator of a given state is promoted to be the chairman (or the ranking minority member) of an influential Senate committee and zero otherwise. All variables are defined in the Appendix. All models include firm and year fixed effects. Standard errors are clustered at the state-year level and t-statistics are included in parentheses below the coefficients. All continuous variables are winsorized at the 1st and 99th percentiles. *, **, and *** represent significance at the 10%, 5%, and 1% levels, respectively.

	Dependent Variable: *LogRet*					
	(1)	(2)	(3)	(4)	(5)	(6)
PromoteYr_Top3ChairOnly	0.034					
	(0.77)					
PromoteYr_Top5ChairOnly		0.034				
		(1.24)				
PromoteYr_Top10ChairOnly			0.037**			
			(2.03)			
PromoteYr_Top3Chair_Rank				0.019		
				(0.69)		
PromoteYr_Top5Chair_Rank					0.051**	
					(2.17)	

PromoteYr_Top10Chair_Rank						0.041**
						(2.39)
LNASSETS	-0.145***	-0.145***	-0.145***	-0.145***	-0.145***	-0.145***
	(-14.68)	(-14.69)	(-14.69)	(-14.69)	(-14.67)	(-14.67)
LEV	0.110**	0.111**	0.111**	0.110**	0.109**	0.110**
	(2.42)	(2.42)	(2.43)	(2.42)	(2.40)	(2.41)
STD_RET	-0.160	-0.160	-0.159	-0.160	-0.159	-0.157
	(-1.50)	(-1.49)	(-1.48)	(-1.49)	(-1.49)	(-1.46)
ROA	-0.140*	-0.141*	-0.141*	-0.140*	-0.140*	-0.139*
	(-1.90)	(-1.91)	(-1.91)	(-1.90)	(-1.89)	(-1.88)
CAPITAL_INTENSITY	0.122***	0.122***	0.121***	0.122***	0.121***	0.122***
	(3.77)	(3.76)	(3.75)	(3.78)	(3.76)	(3.76)
Constant	1.215***	1.215***	1.215***	1.215***	1.214***	1.213***
	(16.04)	(16.05)	(16.06)	(16.04)	(16.03)	(16.03)
Observations	15,718	15,718	15,718	15,718	15,718	15,718
R-squared	0.358	0.358	0.358	0.358	0.358	0.358

Table 4: The Impact of Promotion Shocks on Income Smoothing

$$IS\_measure_{i,j,t} = \alpha_i + \alpha_t + \beta\, Promote\_Shock^{IS}_{j,t} + \gamma Controls_{i,j,t} + \varepsilon_{i,j,t} \quad (3)$$

This table presents OLS regressions of income smoothing measures on promotion shocks. All variables are defined in the Appendix. All models include firm and year fixed effects. Standard errors are clustered at the state-year level and t-statistics are included in parentheses below the coefficients. All continuous variables are winsorized at the 1st and 99th percentiles. *, **, and *** represent significance at the 10%, 5%, and 1% levels, respectively.

Panel A: Using *IS* as the income smoothing measure

IS is the average of the reversed fractional rankings of two standard measures of income smoothing (*IS1* and *IS2*).

	Dependent Variable: *IS*					
	(1)	(2)	(3)	(4)	(5)	(6)
Promote_Top3ChairOnly^{IS}	0.037***					
	(3.03)					
Promote_Top5ChairOnly^{IS}		0.023**				
		(2.20)				
Promote_Top10ChairOnly^{IS}			0.027***			
			(3.43)			
Promote_Top3Chair_Rank^{IS}				0.023**		
				(2.28)		
Promote_Top5Chair_Rank^{IS}					0.025***	
					(2.82)	
Promote_Top10Chair_Rank^{IS}						0.022***
						(3.22)
LNASSETS	0.002	0.002	0.002	0.003	0.003	0.002
	(0.47)	(0.44)	(0.47)	(0.71)	(0.57)	(0.44)
LEV	0.046**	0.044**	0.045**	0.057***	0.059***	0.070***
	(2.28)	(2.21)	(2.07)	(2.86)	(2.93)	(3.21)
BM	-0.026**	-0.027***	-0.028**	-0.023**	-0.025**	-0.025**
	(-2.56)	(-2.60)	(-2.53)	(-2.28)	(-2.35)	(-2.22)
STD_SALES	0.000	0.000	0.000	0.000	0.000	0.000
	(1.36)	(1.46)	(1.44)	(1.14)	(1.30)	(1.04)
PCTLOSS	-0.386***	-0.391***	-0.398***	-0.380***	-0.385***	-0.394***
	(-28.38)	(-28.25)	(-27.61)	(-27.46)	(-27.45)	(-26.39)
SG	0.045***	0.043***	0.044***	0.044***	0.049***	0.045***
	(2.90)	(2.73)	(2.72)	(2.79)	(2.98)	(2.61)
OPLEV	-0.062**	-0.065**	-0.063**	-0.066**	-0.060**	-0.064*
	(-2.09)	(-2.17)	(-1.98)	(-2.22)	(-1.97)	(-1.95)
AVGCFO	-0.376***	-0.400***	-0.421***	-0.348***	-0.380***	-0.409***
	(-7.01)	(-7.29)	(-7.21)	(-6.51)	(-6.91)	(-6.89)
AGE	0.001	0.001	0.001	0.001	0.001	0.001
	(1.02)	(1.00)	(0.94)	(1.00)	(0.87)	(0.90)
STD_RET	-0.149***	-0.148***	-0.135***	-0.144***	-0.150***	-0.143***
	(-3.97)	(-3.83)	(-3.29)	(-3.88)	(-3.89)	(-3.51)

Constant	0.611***	0.614***	0.612***	0.593***	0.602***	0.606***
	(11.39)	(11.21)	(11.06)	(11.44)	(11.21)	(11.19)
Observations	15,868	15,335	14,246	15,475	14,827	13,374
R-squared	0.546	0.547	0.552	0.552	0.554	0.562

Panel B: Using *IS1* as the income smoothing measure

IS1 is the ratio of the standard deviation of income before extraordinary items to the standard deviation of cash flows from operations, multiplied by -1 so that higher values indicate higher income smoothing.

	Dependent Variable: *IS1*					
	(1)	(2)	(3)	(4)	(5)	(6)
Promote_Top3ChairOnly^{IS}	0.060**					
	(2.25)					
Promote_Top5ChairOnly^{IS}		0.020				
		(0.94)				
Promote_Top10ChairOnly^{IS}			0.036**			
			(2.48)			
Promote_Top3Chair_Rank^{IS}				0.041**		
				(1.96)		
Promote_Top5Chair_Rank^{IS}					0.027	
					(1.41)	
Promote_Top10Chair_Rank^{IS}						0.025*
						(1.84)
LNASSETS	-0.001	-0.003	-0.004	-0.001	-0.001	-0.004
	(-0.14)	(-0.32)	(-0.42)	(-0.09)	(-0.09)	(-0.32)
LEV	0.105**	0.101**	0.104**	0.123***	0.117**	0.157***
	(2.27)	(2.17)	(2.09)	(2.60)	(2.45)	(3.04)
BM	-0.035	-0.041*	-0.048**	-0.024	-0.030	-0.033
	(-1.62)	(-1.85)	(-2.05)	(-1.11)	(-1.36)	(-1.37)
STD_SALES	0.000***	0.000***	0.000***	0.000***	0.000***	0.000***
	(3.10)	(3.24)	(3.44)	(2.88)	(2.95)	(2.71)
PCTLOSS	-0.602***	-0.611***	-0.628***	-0.587***	-0.598***	-0.621***
	(-19.24)	(-19.14)	(-18.73)	(-18.43)	(-18.62)	(-18.05)
SG	0.023	0.018	0.017	0.028	0.034	0.021
	(0.69)	(0.51)	(0.47)	(0.81)	(0.96)	(0.54)
OPLEV	-0.092	-0.094	-0.086	-0.095	-0.093	-0.133*
	(-1.48)	(-1.49)	(-1.28)	(-1.51)	(-1.46)	(-1.93)
AVGCFO	-0.782***	-0.851***	-0.883***	-0.704***	-0.778***	-0.814***
	(-6.52)	(-6.85)	(-6.71)	(-5.95)	(-6.39)	(-6.33)
AGE	-0.008***	-0.007***	-0.007***	-0.007***	-0.007***	-0.007***
	(-3.56)	(-3.37)	(-3.34)	(-3.56)	(-3.46)	(-3.22)
STD_RET	-0.292***	-0.312***	-0.266***	-0.281***	-0.297***	-0.274***
	(-3.51)	(-3.68)	(-2.95)	(-3.35)	(-3.41)	(-2.97)
Constant	-0.274***	-0.256***	-0.250***	-0.322***	-0.313***	-0.288***
	(-3.20)	(-2.91)	(-2.78)	(-3.97)	(-3.77)	(-3.32)
Observations	15,868	15,335	14,246	15,475	14,827	13,374
R-squared	0.503	0.507	0.512	0.509	0.513	0.523

Panel C: Using *IS2* as the income smoothing measure

IS2 is the correlation between the change in total accruals and the change in cash flow from operations, multiplied by -1 so that higher values indicate higher income smoothing.

	Dependent Variable: *IS2*					
	(1)	(2)	(3)	(4)	(5)	(6)
Promote_Top3ChairOnly^{IS}	0.015					
	(1.26)					
Promote_Top5ChairOnly^{IS}		0.027**				
		(2.12)				
Promote_Top10ChairOnly^{IS}			0.027***			
			(2.84)			
Promote_Top3Chair_Rank^{IS}				-0.002		
				(-0.18)		
Promote_Top5Chair_Rank^{IS}					0.024**	
					(2.43)	
Promote_Top10Chair_Rank^{IS}						0.016**
						(2.10)
LNASSETS	0.026***	0.024***	0.023***	0.027***	0.028***	0.026***
	(3.94)	(3.59)	(3.31)	(4.07)	(4.08)	(3.54)
LEV	0.025	0.020	0.017	0.033	0.032	0.021
	(0.87)	(0.69)	(0.57)	(1.13)	(1.07)	(0.66)
BM	0.002	-0.002	-0.006	0.003	0.005	0.001
	(0.14)	(-0.13)	(-0.40)	(0.19)	(0.34)	(0.06)
STD_SALES	0.000	0.000	0.000	0.000	0.000	0.000
	(0.43)	(0.41)	(0.16)	(0.20)	(0.46)	(0.32)
PCTLOSS	-0.380***	-0.385***	-0.385***	-0.375***	-0.382***	-0.385***
	(-19.11)	(-19.02)	(-18.10)	(-18.30)	(-18.42)	(-17.39)
SG	0.002	0.000	-0.000	-0.001	0.002	-0.010
	(0.08)	(0.00)	(-0.01)	(-0.03)	(0.06)	(-0.40)
OPLEV	-0.070*	-0.074*	-0.068	-0.072*	-0.058	-0.049
	(-1.79)	(-1.81)	(-1.58)	(-1.83)	(-1.42)	(-1.14)
AVGCFO	0.093	0.069	0.056	0.105	0.085	0.033
	(1.16)	(0.90)	(0.70)	(1.29)	(1.03)	(0.38)
AGE	-0.010***	-0.010***	-0.010***	-0.010***	-0.010***	-0.010***
	(-8.22)	(-8.23)	(-8.01)	(-8.54)	(-8.52)	(-7.94)
STD_RET	-0.166***	-0.164***	-0.166***	-0.166***	-0.166***	-0.165***
	(-2.94)	(-2.79)	(-2.64)	(-2.89)	(-2.80)	(-2.58)
Constant	0.906***	0.921***	0.930***	0.890***	0.886***	0.903***
	(18.67)	(18.38)	(17.92)	(18.66)	(17.93)	(17.14)
Observations	15,868	15,335	14,246	15,475	14,827	13,374
R-squared	0.564	0.564	0.565	0.568	0.570	0.575

Table 5: Cross-sectional Variation in the Effect of Promotion Shocks on Income Smoothing

This table presents OLS regression of the income smoothing measure on promotion shocks and their interactions with contract intensity (*CI*). Contract Intensity (*CI*) is calculated as the product of the relative size of government contracts and the importance of government contracts to the firm. All variables are defined in the Appendix. All models include firm and year fixed effects. Standard errors are clustered at the state-year level and t-statistics are included in parentheses below the coefficients. All continuous variables are winsorized at the 1st and 99th percentiles. *, **, and *** represent significance at the 10%, 5%, and 1% levels, respectively.

Panel A: Effect of promotion shocks and contract intensity

$$IS_{i,j,t} = \alpha_i + \alpha_t + \beta_1 Promote\_Shock^{IS}_{j,t} + \beta_2 Promote\_Shock^{IS}_{j,t} * CI_{i,j,t} + \beta_3 CI_{i,j,t} + \gamma Controls_{i,j,t} + \varepsilon_{i,j,t} \quad (4)$$

	Dependent Variable: *IS*					
	(1)	(2)	(3)	(4)	(5)	(6)
Promote_Top3ChairOnly^{IS}	0.020					
	(1.42)					
Promote_Top3ChairOnly^{IS}*CI	0.325***					
	(5.02)					
Promote_Top5ChairOnly^{IS}		0.019*				
		(1.69)				
Promote_Top5ChairOnly^{IS}*CI		0.114***				
		(2.63)				
Promote_Top10ChairOnly^{IS}			0.027***			
			(2.96)			
Promote_Top10ChairOnly^{IS}*CI			0.056			
			(1.44)			
Promote_Top3Chair_Rank^{IS}				0.018*		
				(1.67)		
Promote_Top3Chair_Rank^{IS}*CI				0.181***		
				(3.01)		
Promote_Top5Chair_Rank^{IS}					0.029***	
					(3.01)	
Promote_Top5Chair_Rank^{IS}*CI					0.061*	
					(1.68)	
Promote_Top10Chair_Rank^{IS}						0.018**
						(2.23)
Promote_Top10Chair_Rank^{IS}*CI						0.073**
						(2.12)
CI	0.031	0.044	0.063**	0.031	0.057*	0.078**
	(1.11)	(1.55)	(2.05)	(1.09)	(1.93)	(2.34)
Control Variables	Included	Included	Included	Included	Included	Included
Observations	13,681	13,150	12,061	13,289	12,652	11,285
R-squared	0.572	0.573	0.578	0.579	0.582	0.591

Panel B: Effect of promotion shocks and committee seniority

$$IS_{i,j,t} = \alpha_i + \alpha_t + \beta_1 Promote\_Shock^{IS}_{j,t} + \beta_2 Promote\_Shock^{IS}_{j,t} * JUNIOR_{j,t} + \gamma Controls_{i,j,t} + \varepsilon_{i,j,t} \quad (5)$$

JUNIOR is a dummy variable equal to one if the seniority of the promoted chairman is below the median.

	Dependent Variable: *IS*					
	(1)	(2)	(3)	(4)	(5)	(6)
Promote_Top3ChairOnly^{IS}	0.014					
	(0.73)					
Promote_Top3ChairOnly^{IS}*JUNIOR	0.043*					
	(1.88)					
Promote_Top5ChairOnly^{IS}		-0.013				
		(-1.01)				
Promote_Top5ChairOnly^{IS}*JUNIOR		0.083***				
		(4.96)				
Promote_Top10ChairOnly^{IS}			0.004			
			(0.39)			
Promote_Top10ChairOnly^{IS}*JUNIOR			0.045***			
			(3.46)			
Promote_Top3Chair_Rank^{IS}				0.010		
				(0.75)		
Promote_Top3Chair_Rank^{IS}*JUNIOR				0.029		
				(1.59)		
Promote_Top5Chair_Rank^{IS}					-0.005	
					(-0.43)	
Promote_Top5Chair_Rank^{IS}*JUNIOR					0.064***	
					(4.50)	
Promote_Top10Chair_Rank^{IS}						0.012
						(1.50)
Promote_Top10Chair_Rank^{IS}*JUNIOR						0.029**
						(2.37)
Control Variables	Included	Included	Included	Included	Included	Included
Observations	15,868	15,335	14,246	15,475	14,827	13,374
R-squared	0.546	0.548	0.552	0.552	0.555	0.562

Panel C: Effect of promotion shocks and political contributions

$$IS_{i,j,t} = \alpha_i + \alpha_t + \beta_1 Promote\_Shock^{IS}_{j,t} + \beta_2 Promote\_Shock^{IS}_{j,t} * PC_{j,t} + \beta_3 * PC_{j,t} + \gamma Controls_{i,j,t} + \varepsilon_{i,j,t} \quad (6)$$

PC is an indicator variable equal to one if the firms contributed to the political campaign of the promoted chairman over the period from seven years before the promotion to seven years after the promotion and zero otherwise. The sample for this analysis consists of all firm-years in Compustat from 1989 to 2012.

	Dependent Variable: *IS*					
	(1)	(2)	(3)	(4)	(5)	(6)
Promote_Top3ChairOnly^{IS}	0.022					
	(0.87)					
Promote_Top3ChairOnly^{IS}*PC	-0.041					
	(-0.55)					
Promote_Top5ChairOnly^{IS}		0.027*				
		(1.92)				
Promote_Top5ChairOnly^{IS}*PC		0.050				
		(0.88)				
Promote_Top10ChairOnly^{IS}			0.005			
			(0.44)			
Promote_Top10ChairOnly^{IS}*PC			0.114**			
			(2.52)			
Promote_Top3Chair_Rank^{IS}				0.013		
				(0.86)		
Promote_Top3Chair_Rank^{IS}*PC				-0.012		
				(-0.19)		
Promote_Top5Chair_Rank^{IS}					0.033***	
					(2.71)	
Promote_Top5Chair_Rank^{IS}*PC					-0.011	
					(-0.25)	
Promote_Top10Chair_Rank^{IS}						0.006
						(0.59)
Promote_Top10Chair_Rank^{IS}*PC						0.080**
						(2.27)
PC	0.001	0.007	0.008	-0.011	-0.007	-0.006
	(0.04)	(0.50)	(0.56)	(-0.69)	(-0.48)	(-0.37)
Control Variables	Included	Included	Included	Included	Included	Included
Observations	8,880	8,540	8,487	8,144	7,827	7,474
R-squared	0.621	0.630	0.623	0.632	0.629	0.642

Table 6: The Impact of Exit Shocks on ROA and Income Smoothing

$$ROA_{i,j,t} = \alpha_i + \alpha_t + \beta\, Exit\_Shock_{j,t} + \gamma Controls_{i,j,t} + \varepsilon_{i,j,t}$$

$$IS_{i,j,t} = \alpha_i + \alpha_t + \beta\, Exit\_Shock^{IS}_{j,t} + \gamma Controls_{i,j,t} + \varepsilon_{i,j,t}$$

This table presents OLS regressions of ROA and income smoothing on exit shocks. An exit shock occurs if the senator of a given state, who once was a chairman of an influential Senate committee, vacates the leadership position (either chairman or ranking minority member). I set the exit shock variable (Exit_TopNChairOnly) as one in the year of the leader's departure and in the subsequent four years. Exit shock for income smoothing tests (Exit_TopNChairOnly^{IS}) is defined as one in the years +3 to +5 relative to the year in which the senator relinquishes his leadership. I exclude the year of the exit, years +1 and +2, and year +6 in my analysis due to the contamination of the income smoothing measure in these years. All variables are defined in the Appendix. All models include firm and year fixed effects. Standard errors are clustered at the state-year level and t-statistics are included in parentheses below the coefficients. All continuous variables are winsorized at the 1st and 99th percentiles. *, **, and *** represent significance at the 10%, 5%, and 1% levels, respectively.

Panel A: ROA	Dependent Variable: *ROA*		
	(1)	(2)	(3)
Exit_Top3ChairOnly	-0.003		
	(-0.74)		
Exit_Top5ChairOnly		-0.007**	
		(-2.27)	
Exit_Top10ChairOnly			-0.005**
			(-2.10)
Control Variables	Included	Included	Included
Observations	16,493	16,493	16,493
R-squared	0.588	0.588	0.588

Panel B: Income Smoothing	Dependent Variable: *IS*		
	(1)	(2)	(3)
Exit_Top3ChairOnly^{IS}	-0.025*		
	(-1.83)		
Exit_Top5ChairOnly^{IS}		-0.023**	
		(-2.49)	
Exit_Top10ChairOnly^{IS}			-0.009
			(-1.00)
Control Variables	Included	Included	Included
Observations	15,973	15,563	14,941
R-squared	0.544	0.544	0.548

Table 7: The Impact of Promotion Shocks on Report Readability

$$Fog_{i,j,t} = \alpha_i + \alpha_t + \beta\, Promote\_Shock_{j,t} + \gamma Controls_{i,j,t} + \varepsilon_{i,j,t}$$

This table presents OLS regression of the measure of report readability (the *Fog* index) on promotion shocks. *Fog* is defined as (words per sentence + percent of complex words) * 0.4 where complex words are defined as words with three syllables or more (Li 2008). Control variables include book-to-market ratio (*BM*), firm size (*LNASSETS*), volatility of earnings (*VOLROE*), volatility of stock returns (*STD_RET*), firm age (*AGE*) and special items (*P_SPI*) as control variables. All variables are defined in the Appendix. All models include firm and year fixed effects. Standard errors are clustered at the state-year level and t-statistics are included in parentheses below the coefficients. All continuous variables are winsorized at the 1st and 99th percentiles. *, **, and *** represent significance at the 10%, 5%, and 1% levels, respectively.

Panel A: Sample firm-years from 1993 to 2012

	Dependent Variable: *Fog*					
	(1)	(2)	(3)	(4)	(5)	(6)
Promote_Top3ChairOnly	-0.147					
	(-0.86)					
Promote_Top5ChairOnly		0.031				
		(0.29)				
Promote_Top10ChairOnly			0.011			
			(0.13)			
Promote_Top3Chair_Rank				0.382***		
				(2.62)		
Promote_Top5Chair_Rank					0.131	
					(1.32)	
Promote_Top10Chair_Rank						0.132
						(1.56)
Control Variables	Included	Included	Included	Included	Included	Included
Observations	5,085	5,085	5,085	5,085	5,085	5,085
R-squared	0.458	0.458	0.458	0.459	0.458	0.458

Panel B: Firm-years with high government contract intensity from 1993 to 2012

	Dependent Variable: *Fog*					
	(1)	(2)	(3)	(4)	(5)	(6)
Promote_Top3ChairOnly	-0.528					
	(-1.55)					
Promote_Top5ChairOnly		0.312				
		(1.55)				
Promote_Top10ChairOnly			0.333**			
			(2.01)			
Promote_Top3Chair_Rank				0.445*		
				(1.88)		
Promote_Top5Chair_Rank					0.447***	
					(2.69)	
Promote_Top10Chair_Rank						0.535***
						(3.75)
Control Variables	Included	Included	Included	Included	Included	Included
Observations	1,172	1,172	1,172	1,172	1,172	1,172
R-squared	0.515	0.516	0.517	0.517	0.518	0.522

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Appendix: Variable Definitions

Variable	Definition
INCOME SMOOTHING	
IS	Average of the reversed fractional ranking of *IS1* and *IS2* each year
IS1	The ratio of the standard deviation of income before extraordinary items to the standard deviation of cash flow from operations, both scaled by lagged total assets, multiplied by -1. It is calculated using rolling windows of five years that include the current year and the past four years.
IS2	The contemporaneous correlation between the changes in total accruals and the changes in cash flow from operations, both scaled by lagged total assets, multiplied by -1. It is calculated using rolling windows of five years that include the current year and the past four years. Total accruals are calculated as Δ current assets – Δ current liabilities - Δ cash + Δ short-term debt – depreciation. Cash flow from operations is calculated as income before extraordinary items – total accruals.
PROMOTION SHOCKS	
Promote_TopNChairOnly	An indicator variable equal to one in the year the senator of a given state is promoted to be the chairman of one of the top-N-ranked Senate committees and in the following six years, and zero otherwise. N = 3, 5, or 10 The list of the 10 most influential Senate committees is from Edwards and Stewart (2006) and includes Finance, Veterans Affairs, Appropriations, Rules, Armed Services, Foreign Relations, Intelligence, Judiciary, Budget, and Commerce.
Promote_TopNChair_Rank	An indicator variable equal to one in the year the senator of a given state is promoted to be the chairman or the ranking minority member of one of the top-N-ranked Senate committees and in the following six years, and zero otherwise. N = 3, 5, or 10
PromoteYr_TopNChairOnly	An indicator variable equal to one in the year the senator of a given state is promoted to be the chairman of one of the top-N-ranked Senate committees, and zero otherwise. N = 3, 5, or 10
PromoteYr_TopNChair_Rank	An indicator variable equal to one in the year the senator of a given state is promoted to be the chairman or the ranking minority member of one of the top-N-ranked Senate committees and zero otherwise. N = 3, 5, or 10
$Promote\_TopNChairOnly^{IS}$	An indicator variable equal to one for years +3 to +6 relative to the promotion year that the senator of a given state is newly appointed as a chairman of one of the top-N-ranked Senate Committees, and zero otherwise. I drop event years 0 to +2, +7 and +8. N = 3, 5, or 10
$Promote\_TopNChair\_Rank^{IS}$	An indicator variable equal to one for years +3 to +6 relative to the promotion year that the senator of a given state is newly appointed as a chairman or a ranking minority member of one of the top-N-ranked Senate Committees, and zero otherwise. I drop event years 0 to +2, +7, and +8. N = 3, 5, or 10

Exit_TopNChairOnly	An indicator variable equal to one in the year of the leader's departure and in the subsequent four years. An exit shock occurs if the senator of a given state, who once was a chairman of an influential Senate committee, vacates the leadership position (either chairman or ranking minority member). N = 3, 5, or 10
Exit_TopNChairOnly^{IS}	An indicator variable equal to one in the years +3 to +5 relative to the year in which the senator relinquishes his leadership of a top-N-ranked Senate committee. I exclude the year of the exit, years +1 and +2, and year +6. N = 3, 5, or 10
OTHER VARIABLES	
ROA	Income before extraordinary items divided by previous year's total assets
LogSalesGov	The logarithm of one plus total sales to the U.S. government
Cumulative Abnormal Return (CAR)	Sum of the difference between the firm's stock return and the value weighted market return over the event window beginning one day prior to the event date on which the promotion is determined and ending one and three trading days after the event
LogRet	The logarithm of one plus the return over a year following the promotion
ContractIntensity (CI)	A product of the relative size of government contracts and the importance of government contracts to the firm. The relative size of government contracts is an indicator variable that equals one if the level of a firm's government contracts is in the top 10% of the distribution of government contracts over the previous three years. The importance of government contracts to the firm is measured as the percentage of the firm's sales to the government averaged over the previous three years.
JUNIOR	An indicator variable equal to one if the committee seniority of the promoted chairman (or ranking minority member) is below the median committee seniority across all the promoted chairmen (or ranking minority member) of the top 10 Senate committees and zero otherwise
Political Contributions (PC)	An indicator variable equal to one if the firms contributed to the political campaign of the promoted chairman over the period from seven years before the promotion to seven years after the promotion and zero otherwise.
Fog	(words per sentence + percent of complex words) * 0.4 where complex words are defined as words with three syllables or more
BM	The ratio of book value to market value of equity
LNASSETS	The logarithm of total assets measured in millions of U.S. dollars
MVE	Market value of the equity
Herfindahl_Index (HF)	Herfindahl index calculated as the sum of the squares of the market shares of the firms within the industry
CAPX/Sales	Capital expenditures scaled by sales
LEV	Total debt divided by total assets
STD_RET	Standard deviation of previous 12 month's monthly stock returns
CAPITAL_INTENSITY	The ratio of fixed assets to total assets
STD_SALES	The standard deviation of sales over the last five years

PCTLOSS	The proportion of years that a firm experiences losses over the past five years
SalesGrowth(SG)	The average sales growth measured over the last five years
OPLEV	Net property, plant and equipment divided by total assets
AVGCFO	Average cash flow from operations divided by total assets measured over the last five years
AGE	Years since first appearance in Compustat
VOLROE	Variance of ROE, where ROE is calculated as net income over the book value of equity
Special Items/Assets	Special items divided by total assets