U.S. Congressional Committees and Corporate Financial Misconduct

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ABSTRACT

We document that firms with powerful representation on U.S. congressional committees that oversee the Securities and Exchange Commission (SEC) are less likely to face regulatory scrutiny for financial misconduct relative to other firms. An exogenous decrease in firms' powerful committee representation results in an *increase* in the likelihood that those firms will subsequently face SEC enforcement actions. Furthermore, conditional on receiving SEC enforcement action, the same firms also receive materially smaller monetary penalties relative to other transgressing firms. Our findings appear to be driven by firm-side efforts to supply higher quality financial reports rather than because of political capture. In sum our study highlights a direct effect on financial reporting from political representation on specific U.S. congressional committees.

Keywords: Political Economy; Corporate Governance; SEC Investigation; Senate Committee on Banking, Housing, and Urban Affairs; House Committee on Financial Services

JEL Codes: G34; M42; M48

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1. Introduction

The United States Congress plays a critical role in shaping government policy and governing corporate behavior because of the power assigned to it via Article I of the U.S. Constitution. Congressional tasks are divided and delegated to committees that have specialized legislative and regulatory oversight responsibilities. Despite Congress's influence on virtually all elements of the U.S. economy, there is relatively little empirical evidence about the impact of congressional representation on SEC regulatory enforcement activity against corporations. In this paper, we attempt to provide insights about this topic in the context of regulatory enforcement against corporate financial misconduct. We focus on the congressional committees charged with oversight of the Securities and Exchange Commission (SEC) and specifically investigate whether political representation on these congressional committees (hereafter "influential committees") affects SEC enforcement efforts against constituent firms.[1]

We posit two possible reasons why political representation on influential committee representation negatively affects SEC enforcement activities against financial misconduct by constituent firms: 1) political capture; and 2) firms' efforts to limit political costs from financial misconduct. First, arguments under political capture or "capture theory" (Stigler, 1971; Laffont and Tirole, 1991) suggest that influential committee members have incentives to pressure the SEC to reduce enforcement actions against constituent firms because of financial and political support from those firms.[2] Committee members (and politicians in general) are assumed to value political support in order to maximize their probability of winning re-election (Stigler, 1971;

[1] The committees are the U.S. Senate Committee on Banking, Housing, and Urban Affairs and the U.S. House of Representatives Financial Services Committee.

[2] We implicitly assume that influential committee politicians are most concerned about SEC enforcement action against firms within their jurisdictions, relative to enforcement against firms in other jurisdictions. This is feasible because publicity surrounding SEC enforcement action against constituent firms is likely to be most visible to the politician's constituents, all else equal.

Peltzman, 1976). Influential committee members rationally anticipate that the filing of an enforcement action against a constituent firm or the imposition of large penalties may reduce future political support from the affected firm and from other firms which no longer believe that the politician has a reputation of acting in constituent interests (Correia, 2014).

Furthermore, influential committee members also have the *capability* to influence the SEC's enforcement activities. Congressional control theory argues that the relation between Congress and regulatory agencies is a principal-agent problem and that politicians can incentivize regulatory agencies to act in the politician's interests via monitoring and disciplining mechanisms such as congressional oversight and budget appropriations (Weingast and Moran, 1983; Weingast, 1984) and the threat of dismissal for the regulator's leadership (Shotts and Wiseman, 2010).

Empirical and anecdotal evidence provides support for congressional control theory. Hunter and Nelson (1995) document that the Internal Revenue Service undertakes fewer audits in states with House Oversight Committee representation. Faith et al. (1982) and Weingast and Moran (1983) find that firms with political representation on committees that oversee the Federal Trade Commission are more likely to receive favorable antitrust review outcomes.[3]

Second, firm efforts to improve financial reporting quality can also result in a negative relation between influential committee representation and SEC enforcement actions against

[3] Anecdotal comments by former SEC Chairman Arthur Levitt further illustrate the power of congressional committees over regulators:

"…the congressional committee that oversees the SEC that has a chokehold on the existence of the SEC, that can block SEC funding, that can block SEC rulemaking, that can create a constant pressure in terms of hearings and challenges and public statements, that can absolutely make life miserable for the commission." And *"[The politicians] kept the heat on me by telephone calls, by letters, by congressional hearings, and ultimately by threatening the funding of the agency by threatening its very existence. I mean, we were at that point struggling [to receive] the same compensation as other financial regulators… and certain members of this committee suggested to me that getting that pay parity was out of the question while we were proceeding with this issue. So we were really being held, well, an attempt was made to hold us captive."(http://www.pbs.org/wgbh/pages/frontline /shows/regulation/interviews/levitt.html)*

financial misconduct. Higher quality financial reporting mechanically reduces the likelihood of financial misconduct and thus enforcement against financial misconduct, all else equal. There are at least two reasons why firms with influential committee representation might choose to supply higher quality financial reports: investor concerns and political costs.

Investors in firms with political connections may demand higher quality financial reports in order to alleviate concerns about the diversion of corporate resources (Watts and Zimmerman, 1983; Dyck and Zingales, 2004). Guedhami et al. (2014) find empirical support for this argument in an international setting: firms with political connections are more likely to appoint a Big 4 auditor to alleviate outside investor concerns about wealth expropriation by insiders.

In addition, firms may determine the political costs of financial misconduct such as greater regulation or increased government intervention into the firm's business activities (e.g. Watts and Zimmerman, 1986; Piotroski et al., 2014) outweigh the benefits of relatively more opaque financial reporting. This is especially likely in the time period examined in our study because of numerous high-profile corporate failures that resulted in widespread public dissatisfaction with corporate financial reporting regulation and oversight (Strier, 2006). Consistent with this argument, prior research finds that firms make accounting and disclosure choices in response to political factors (e.g., Jones, 1991; Petroni, 1992; Han and Wang, 1998; Ramanna and Roychowdhury 2010; Chaney et al., 2011; Piotroski et al., 2014).

Despite the arguments above, it is not obvious that influential committee representation will have a negative effect on SEC enforcement actions against financial misconduct. Politicians trade off the benefits of supporting captured firms against the costs of being identified as supporters of transgressing firms and the adverse effects on reelection prospects. Politicians are also concerned about broader reputational effects from the perspective of future employment

opportunities. Recent evidence suggests lawmakers considered as effective and ethical are more likely to obtain lucrative post-congressional employment opportunities such as ambassadorships, federal executive positions, or non-executive corporate board directorships (Fenno, 1973; Parker, 2005). Given these conflicting arguments, the effect of influential committee politician representation on SEC enforcement actions against constituent firms is an empirical question.

To explore this issue, we undertake empirical tests using a panel dataset that links publicly listed firms with state-level Senate and district-level House congressional representation data. The dataset consists of 17,017 firm-year observations over the 2001 to 2010 period. Results from multivariate tests indicate that the power of a constituent firm's influential committee representation is negatively related to the likelihood that the firm will be subject to an enforcement action for financial misconduct relative to other firms. In economic terms, firms headquartered in a powerful influential committee member's electoral district have a 14% lower likelihood of receiving a financial misconduct-related Accounting and Auditing Enforcement Release (AAER), relative to other firms.

To establish identification, we examine exogenous politician departures from influential committees as a mechanism to identify variation in shocks to SEC enforcement and penalties across states and congressional districts. We expect that only turnover events related to politician departures for a more prestigious opportunity (or death) are likely to be truly exogenous because politicians typically do not control the timing of the turnover event. Examples include appointment to a presidential cabinet position or an ambassadorship, or a transfer to a more prestigious congressional committee.[4] Since committee members represent a particular state or

[4] Other turnover cases are unlikely to be exogenous (i.e., reelection losses or resignations) if some unobserved variables affect both the turnover and the likelihood of SEC enforcement activity. For example, weak state-level economic conditions could cause an incumbent politician to lose a reelection campaign and increased SEC

district, a member's exogenous departure from the committee should only affect SEC enforcement efforts against the departing politician's constituents.

Empirical results show that firms are 50% more likely to be subject to SEC enforcement action for financial misconduct after the exogenous departure of an influential committee representative, relative to a matched sample of out-of-state firms that experience no shocks to their influential committee representation. Importantly, the documented effect is concentrated for cases in which the departing politician is a senior (and therefore powerful) influential committee member at the time of departure. This is important because it alleviates endogeneity concerns related to a politician's decision to self-select onto an influential committee. Under a self-selection argument, we would not expect the effect of influential committee member departures on SEC enforcement actions to vary with a committee member's seniority.[5]

Further we undertake two falsification tests using: 1) departures of junior and therefore less powerful influential committee members; and 2) departures of powerful politicians serving on other important congressional committees that have no jurisdiction over the SEC. The results indicate that these departures have no statistical effect on the likelihood of SEC enforcement actions, which helps rule out the possibility that our main findings are influenced by unobserved omitted variables that affect firm incentives to engage in financial misconduct (for instance, state- or district-level economic downturns).

Our results are also robust to numerous sensitivity tests and specifications. The findings hold across alternative measures of committee power, the inclusion of a large set of control

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enforcement activity if in-state firms engage in financial manipulation to hide worsening performance. Irrespective, untabulated results are robust to the inclusion of these cases.

[5] A politician's ascension within an influential committee (and thus the politician's seniority and power) only occurs as other more senior committee members depart the committee over time. Such turnover events are likely to be driven by political circumstances in other states/districts, meaning that a given politician's seniority in a committee is unrelated to events in his or her own state/district.

variables including political contributions, lobbying, political connections, and the inclusion of firm-level and state-level fixed effects. In sum, the evidence suggests that powerful influential committee representation has a statistically and economically significant effect on SEC enforcement against financial misconduct by constituent firms.

Next, we also find that influential committee representation is associated with the magnitude of regulatory penalties. Conditional on receiving an enforcement action for financial misconduct, firms with powerful committee representation have significantly smaller penalties relative to other transgressing firms, after controlling for the magnitude of the alleged financial misconduct. A one standard deviation increase in the seniority of a firm's influential committee representation is associated with a $1.3 million reduction in financial misconduct-related regulatory penalties.

The findings above provide evidence that influential committee representation affects SEC enforcement actions against constituent firms. Next, we examine the channel through which this relation manifests by examining changes in firms' financial reporting characteristics around exogenous turnover in firms' influential committee representation. Under a capture theory based explanation, firms that experience influential committee member turnover have incentives to subsequently improve financial reporting quality because of the loss of protection against SEC investigations. Alternatively, under an investor demand for financial reporting or political cost explanation, influential committee turnover decreases the firm's benefits from supplying relatively higher quality financial reports and can result in greater financial reporting opacity. Empirical results are consistent with the latter explanation. The loss of senior influential committee representation results in a subsequent *decline* in constituent firm financial reporting quality (down to sample average levels).

In sum, the cumulative evidence suggests that firms in the constituencies of influential committee members cannot, on average, use their political affiliations to prevent or dampen penalties for financial reporting transgressions. In contrast, the evidence indicates that influential committee members have a direct disciplining role for constituent firm financial reporting behavior.

Our study is related to three streams of research. The first examines the role of political economy for information environments and financial reporting practices. Watts and Zimmerman (1978) argue that accounting choices are influenced by the expected political benefits and costs associated with given financial reporting outcomes. Recent studies examine both U.S settings (e.g. Jones, 1991; Petroni, 1992; Han and Wang, 1998; Ramanna and Roychowdhury 2010) and international settings (e.g. Bushman et al., 2004; Bushman and Piotroski, 2006; Gul, 2006; Wang et al., 2008; Guedhami et al., 2009; Chaney et al., 2011; Hung et al., 2015; Piotroski et al., 2015). Our study builds on this prior work by examining a specific mechanism through which political influence affects firm financial reporting behavior. To the best of our knowledge, we are one of the first to document the direct governance role of U.S. congressional committees on corporate financial reporting practices.

Second, our study is important for an evolving literature that examines the effects of congressional committee representation on firm outcomes. Prior work examine the effects on state-level federal expenditure allocations (Levitt and Poterba, 1999), constituent firm performance and value (Cohen et al., 2011), financial institution risk-taking and leverage (Kostovetsky, 2015), tax audit likelihood (Hunter and Nelson, 1995; Young et al., 2001), FTC anti-competition and deceptive trade practice reviews (Faith et al., 1982; Weingast and Moran, 1983), stock ownership in constituent firms (Tahoun, 2014), and resolving uncertainty about tax

legislation (Wellman, 2015).

Finally, our study is relevant for literature that investigates the determinants of SEC enforcement actions (e.g., Kedia and Rajgopal, 2011; Heese, 2015; Yu and Yu, 2011). Correia (2014) finds that firms with long-term political connections are less likely to be involved in SEC enforcement actions and face lower penalties if prosecuted by the SEC. Our study builds on this work by documenting the causal role of firm actions and behaviors on SEC enforcement actions and penalties.

We proceed as follows. The next section describes the data and methodology. Section 3 presents descriptive evidence and the main results. In Section 4, we discuss the mechanisms that can explain our findings. Section 5 contains robustness analyses. We conclude in Section 6.

2. Data, Political Power Variables, and Methodology

In this section we describe the data sources and procedure used to generate our sample. We then discuss the construction of key variables and outline the methodology used in empirical tests.

2.1 Data

We collect congressional representation and district data for the 2001 to 2010 period from multiple sources: Charles Stewart's website[6], the U.S. Census Bureau based on the 2000 U.S. Census and from the University of Missouri Census Data Center. All data is publicly available.

The sample window covers the 106th Congress to the 111th Congress. We identify each member's state and/or district of representation and the duration of service in the House or the

[6] We thank Charles Stewart for congressional member data (http://web.mit.edu/17.251/www/data_page.html).

Senate, committee membership assignments, committee membership appointment dates and service period, and party affiliation. The data also allows us to identify the duration of each politician's service on a committee (in years), which allows us to determine committee seniority. We identify the people who serve on the two committees responsible for SEC oversight: the Senate Committee on Banking, Housing, and Urban Affairs, and the House Financial Services Committee.

Next, we link committee members with firms headquartered in their constituencies. While this is relatively straightforward for the members in the Senate because senators represent the entire state, it is less straightforward for those serving in the House of Representatives because each member of the House only represents a district within a state. In order to accurately capture the relation between firms and corresponding House representatives, we explicitly require firms to be headquartered in a House influential committee member's district. In untabulated analyses, we find that our results are qualitatively similar if we 1) link House influential committee members with firms located within a 20-mile radius of the member's district boundaries based on the ZIP Code of the firm's headquarters;[7] and 2) if we link firms and House influential committee members based on state location, rather than district location.

We merge these data with firm-specific financial data from Compustat, Compact Disclosure, and CRSP, political connection data from BoardEx, political contribution data from the Federal Election Commission, lobbying data from the Center for Responsive Politics, and auditor data from Audit Analytics. We identify SEC investigations into financial misconduct between 2001 and December 2013 using Accounting and Auditing Enforcement Release

[7] We use 20 miles because a recent 2009 U.S. Department of Transportation report (http://nhts.ornl.gov/2009/pub/stt.pdf) notes that this is the average commuting distance. As commuting distances are likely to be highly heterogeneous across the U.S., we check alternative distance specifications up to 50 miles and find qualitatively similar results.

(AAERs) data as discussed in Dechow et al. (2011).[8] We identify all cases that involve financial misstatement and focus on the year that the AAER is issued in order to accurately capture the outcomes of regulatory scrutiny. Our AAER sample includes all cases alleging earnings-estimate improprieties, financial misrepresentation, or failure to adhere to U.S. Generally Accepted Accounting Principles (GAAP).

While SEC regulatory efforts span a broad set of activities, there are several advantages of focusing on financial misconduct rather than other SEC enforcement actions against bribes and corruption, illicit insider trading, market manipulation, and/or securities offerings violations. First, we can directly observe changes in a firm's financial reporting characteristics around changes in the risk of SEC investigations. This is not feasible for other types of SEC investigated misconduct such as bribery or insider trading, for which ex post behavior is not easily measurable. Second, the revelation of an AAER is a major event for an investigated firm. Feroz et al. (1991) observe abnormal cumulative average returns (CARs) of -6% over the two-day window around the disclosure of an SEC accounting investigation, even when the accounting transgression was reported earlier.

We impose a number of data restrictions on our sample. First, we remove utility firms and financial services firms (SIC codes between 4900 and 4999; and between 6000 and 6900) because the different accounting requirements for these firms may cause measurement errors in tests examining changes in financial reporting quality. Results from untabulated tests indicate that our findings are qualitatively similar if we include these firms. Second, we remove all firms with foreign headquarters because of the unclear link between those firms and U.S. politicians. Third, we drop all firms audited by Arthur Andersen during the sample period because of

[8] The data is available at http://faculty.haas.berkeley.edu/patricia_dechow/aaer.html

increased regulatory scrutiny against those firms around Arthur Andersen's collapse. Fourth, we remove all firms that are not audited by one of the "Big 6" auditing firms because of differences in the propensity of SEC enforcement action for firms audited by the Big 6 versus Non-Big 6 auditors (Lennox and Pittman, 2010).[9] The clients audited by the Big 6 represent 97.4% of aggregate total assets for all Compustat firms over our sample period. Our results are qualitatively similar if we include Arthur Andersen clients and/or Non-Big 6 audited clients in our sample. After these restrictions, our sample consists of 17,017 firm-year observations, representing 2,641 unique firms.[10] We identify 339 AAERs issued to 120 unique firms during our sample period.

2.2 Measures of Political Power on Influential Committees

We use three proxies to capture the power of a firm's influential committee representation. Each proxy is calculated at the firm-year level. Our primary tests aggregate a firm's Senate and House influential committee representation because we do not a priori expect different effects between the influential committees. In sensitivity tests discussed below, we find that our primary results are qualitatively similar when using separate proxies for the House and Senate committees. A key determinant of committee power is committee seniority (Levitt and Poterba, 1999; Cohen et al., 2011). Senior committee members determine a committee's actions and agenda and oversee regulatory bodies under their jurisdiction. Thus, our first firm-level proxy for influential committee power is the aggregate years of influential committee member service (*Total_Seniority*).

[9] The Big 6 are BDO Seidman, Deloitte, Ernst & Young, Grant Thornton, KPMG, and PricewaterhouseCoopers.

[10] An important issue for our study is the link between firm headquarters location and influential committee representation. A limitation of using Compustat to identify firm location is that we can only obtain the current (i.e., non-historical) firm location data, which may result in biased estimates. In order to overcome this limitation, we obtain annual firm-year headquarters location details from Audit Analytics. In addition, our results are robust to the removal of firms that change headquarters during our sample period.

This firm-level measure is easily illustrated using an example: Books-A-Million Inc. (NASDAQ: BAMM) is headquartered in Alabama's 6th congressional district. In 2004, Alabama had one representative on the Senate Committee on Banking, Housing, and Urban Affairs – Richard C. Shelby (D-AL) – who had served on the committee for 17 years. Alabama also had two representatives on the House's Financial Services Committee: Spencer Bachus (R-AL), who was the 6th congressional district representative, and Artur Davis (D-AL), who was the 7th congressional district representative. Bachus and Davis had served on the House committee for six years and one year respectively as of 2004. The value of *Total_Seniority* applied to Books-A-Million for 2004 represents the aggregate years of service for Shelby and Bachus only (17 + 6 = 23). Davis is not included in the seniority count as the firm is neither in Davis' congressional district.

A possible limitation of the *Total_Seniority* measure is that it imperfectly captures differences in the strength of a firm's political representation on influential committees. For instance, firm A with two judiciary committee members of 10 years and 11 years (i.e. a total of 21) is treated the same as firm B with two committee members of 20 years and 1 year. It may be the case that firm B's senior member is more likely to be able to influence antitrust outcomes than either of firm A's members. In order to address this issue, our second proxy to measure influential committee representation is an indicator variable set to one when a firm is located in a state and/or district for which a Senator and/or Representative is in the top quartile of influential committee member seniority for that year, and zero otherwise (*Seniority_Dum*).

Our third proxy for an influential committee member's political power is a continuous yearly variable for the total number of influential committee members (*Committee_Num*) that represent a firm. This variable captures the possibility that committee influence may stem from

"power in numbers" – a greater volume of representation on influential committees can result in more cohesive influence over SEC actions.

2.3 Methodology

We begin by investigating whether the power of a firm's representation on influential committees affects the likelihood that the firm receives an AAER for accounting misconduct. We estimate the following logit model:

$$Enforcement_{i,t} = \alpha + \beta_1 * Seniority_{i,t} + \beta_X * Controls_{i,t} + \xi_{i,t} \quad (1)$$

where $Enforcement_{i,t}$ is an indicator variable set to one for detected fraudulent financial reporting cases against firm *i* in year *t* based on the SEC's issuance of an AAER and set to zero otherwise. $Seniority_{i,t}$ represents one of three measures of influential committee representation: *Total_Seniority*, *Committee_Num*, or *Seniority_Dum*.

$Controls_{i,t}$ is a vector of control variables which have been shown to be associated with accounting misconduct, including a litigation risk indicator variable (*Litigation Risk*), log of total assets (*Size*), long-term debt divided by total assets (*Leverage*), market-to-book ratio (*MtB*), scaled earnings (*Profit*), an indicator variable to capture recent debt or equity issuances (*Issuance*), the standard deviation of operating cash flows over the past five years (*Stdev_Cashflow*), the standard deviation of total sales over the past five years (*Stdev_Sales*), the operating cycle (*Oper_Cycle*), and financial reporting quality (*FRQ1*). *FRQ1* is defined in Appendix B. We also control for the total stock ownership by institutional investors (*Inst_Own)*, the log of the number of analysts that cover the firm (*Analyst_Following*), and the log distance in miles between the firm's headquarters and the nearest SEC regional office (*Distance_to_SEC*). In addition, we control for multiple auditor quality variables that have been shown to affect the likelihood of financial misconduct: the auditor's city-level industry expertise (*Auditor_Share*),

the number of years that the auditor has been retained (*Auditor_Tenure*), the log number of clients of the firm's auditor office (*Office_Size*), and whether the firm received a going concern opinion in the prior year (*GC_Dummy*).

Finally, we also include controls for the possibility that committee member behavior is influenced by other connections to constituent firms. First, we follow Faccio et al. (2006) and control for political connections based on a committee members' previous employment experience at the firm in an executive or director capacity (*Political_Connection*). We find that 402 unique sample firms are professionally connected with 376 unique politicians during the sample period. Second, we control for the firm's logged monetary political contribution (*Politicial_Contribution*) via PAC contributions and logged SEC lobbying expenditures (*Lobby_SEC*). All variables are defined in Appendix A.

All specifications include state, year, Fama-French industry, and auditor fixed effects. Standard errors are adjusted for heteroscedasticity using a Huber-White Sandwich estimator and clustered by firm.

Although we include multiple fixed effects to mitigate omitted variable biases, the specification above does not permit causal inferences. In order to provide evidence about causality, we use a changes specification that regresses exogenous changes in a firm's influential committee representation on changes in financial misconduct enforcement actions. We exploit exogenous drops in a firm's influential committee representation that occurs via the cessation of influential committee membership. In order to rule out the possibility that committee member turnover and financial misconduct are both driven by a time-variant omitted variable such as a state-level economic downturn, we conduct a series of falsification tests (described below) to examine whether financial misconduct enforcement is affected by committee member turnover

on other *unrelated* congressional committees.

Our central argument is that SEC financial misconduct-related enforcement action against a firm is a function of the power of the firm's representation on influential committees. Under this argument, the exogenous turnover of a state's powerful representation on influential committees should result in an increase in the likelihood of enforcement actions against financial misconduct, ceteris paribus. However not all committee turnover cases are likely to be exogenous. For instance, influential committee politicians may lose voter support, or choose to retire or not seek reelection if local economic conditions are poor or following adverse events, or if they anticipate negative repercussions from the revelation of SEC investigations against constituent firms.[11] Thus, we only treat politician turnover cases as exogenous if the politician departs the committee for a more prestigious opportunity or because of death. We define prestigious opportunities as a transfer to a more powerful congressional committee based on the committee rankings by Edwards and Stewart (2006).[12] Committee transfers typically occur following a successful reelection campaign or a presidential cabinet or ambassadorial appointment.

We identify 112 influential committee turnover events during our sample window (29 Senators and 83 Representatives). We use LexisNexis and Google.com to identify the reason for

[11] An example of a turnover case that is unlikely to be exogenous is Senator Phil Gramm (R-TX), who announced his retirement from the Senate in 2002. Gramm was the chairman of the Senate Committee on Banking, Housing, and Urban Affairs between 1999 and 2001. In December 2000, Gramm cosponsored a bill favorable to Enron Corp that exempted energy commodity trading from government regulation and public disclosure. Furthermore, Gramm's wife, Wendy Gramm was an Enron board director between 1993 and Enron's collapse in 2001.

[12] Committee rankings are based on a method developed by Groseclose and Stewart (1998) that involves tracking committee transfers. For instance, a politician switching from committee A to committee B implies that the politician value the latter more highly than the former. The demand for a given committee is the proxy for committee power. The ten most powerful committees are as follows. Senate: Finance, Veterans Affairs, Appropriations, Rules, Armed Services, Foreign Relations, Intelligence, Judiciary, Budget, and Commerce. House: Ways and Means, Appropriations, Energy and Commerce, Rules, International Relations, Armed Services, Intelligence, Judiciary, Homeland Security, and Transportation and Infrastructure.

each turnover case. Of these cases, 69 cases (62%) represent prestigious departures or death. These are the cases we use as exogenous turnover events. The remaining 43 departures (38%) represent turnover for some other reason as described above. We do not treat these as exogenous turnover event cases.

In order to minimize the sample differences between firms that do and do not experience influential committee member exits, we use propensity score matching to identify treatment and control group firms, with matching occurring in the year prior to committee member turnover. Treatment firms experience the loss of a powerful influential committee member during our sample window, while control firms are in other states that do not experience a shock to their influential committee representation in the same year, or in the two preceding or subsequent years.[13] All treatment cases are coded such that year 0 represents the year of the loss of a powerful influential committee member. We match firms based on size (log total assets), Fama-French industries, state GDP growth, and state unemployment rate, with no replacement, and with a caliper of 0.1%. The matching process results in 538 firms (i.e., 269 treatment and 269 control firms). We estimate the following difference-in-differences specification using a logit model:

$$\Delta Enforcement_{i,t} = \alpha + \beta_1 * Senior\_Drop_{i,t} + \beta_X * \Delta Controls_{i,t} + \xi_{i,t} \quad (2)$$

where $\Delta Enforcement_{i,t}$ is an indicator variable set to one if firm i does not receive an AAER in year t-1 or t-2, and does receive an AAER in year t+1 or t+2, where t is the year of influential committee member turnover.[14] $Senior\_Drop_{i,t}$ is an indicator variable set to one if a firm

[13] Our results are unaffected if we use the following conditions to identify possible control firms: firms in states 1) with no change to their influential committee membership; 2) with no change to their senior influential committee membership; or 3) with no influential committee membership in the year of turnover.

[14] To illustrate, consider a state that has an influential committee senior political representative who retires in year t. $\Delta AAER$ is only set to one for firms that did not receive an AAER in year t-1 and did receive an AAER in year t+1 or

experiences the exogenous loss of a powerful influential committee member in year *t,* and zero otherwise. We define "powerful" as committee member in the top quartile of committee seniority at the time of departure. We also estimate a specification in which we examine the effects of committee member turnover by non-senior influential committee members. In this specification, we replace *Senior_Drop* with a variable *Non-Senior_Drop*, a variable that represents all turnover cases of influential committee members who are not in the top quartile of committee seniority. $\Delta Controls_{i,t}$ represents the change form of a vector of control variables similar to those in equation (1), all measured by the difference between *t-1* and *t+1*, where *t* represent the shock year.[15] We drop variables that do not vary in the pre and post periods during our sample window: *Political_Connection, Litigation Risk,* and *Distance_to_SEC.* All specifications include state, industry, auditor, and year fixed effects. In untabulated sensitivity tests, we find that our results are robust to using matched-firm-pair fixed effects instead of state fixed effects. Standard errors are adjusted for heteroscedasticity using a Huber-White Sandwich estimator and clustered by firm.

2.4 Summary Statistics

Table 1 displays descriptive information about influential committees. The House (Senate) committees we examine have an average of 69 (21) members during our sample period, representing 29 (21) states. Thus, conditional on a state having representation on a committee, each state has an average representation on the House (Senate) committee of about 2 (1) members. Politicians serving on the House (Senate) influential committee have an average tenure of approximately 3.6 (6.9) years, with a maximum tenure of 19 (29) years. Next, we tabulate

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year *t*+2. For all other possible outcomes between *t*-1 and *t*+1 or *t*+2, *ΔAAER* is set to zero. Our results are robust to the use of a multinomial regression specification in which *ΔEnforcement* takes values of 1, 0, and -1.

[15] In sensitivity tests, we use the average value of pre and post-shock, or the differenced measure of control variables. Under each scenario, we find similar inferences to those presented.

states with representation in the top (bottom) quartile of influential committee power over the sample period based on the number of consecutive years of service on a committee. Influential committee power does not appear to be exclusively driven by the largest or most populated states, such as New York, California, or Texas. Rather, committee power appears to be spread across a large cross-section of states. The states with the longest representation on the Senate committee are Connecticut (10 years), Alabama (10 years), Utah (8 years), and Maryland (8 years). Only two states (Alaska and Maine) have no representation on influential committees during our sample period (representing 22 firm-year observations).

Table 2 presents descriptive statistics for the variables used in the multivariate tests. We begin with the three-abovementioned proxies of committee power based on state-level values (500 state-year observations based on 50 states multiplied by the 10-year sample period). The average aggregate seniority of a state's influential committee representation is approximately 8.8 years, with a median of 6 years. Each state has an average of about 0.4 representative across the influential committees. In addition, approximately 26% of states have a committee member in the top seniority quartile across both influential committees. We also present seniority measures for the firm-level full sample of 17,017 observations. While quite similar, the differences in the state-level and firm-level seniority measure values are mechanically driven by an uneven distribution of sample firm headquarters across U.S. states and districts.

In Table 2, we find that *Enforcement* has a mean value of 0.02, indicating that 2% of sample firm-year observations are subject to SEC enforcement action. We find that roughly 17% of firm-year observations have political connections, while on average each firm makes political contributions of about $466,000 annually and spends $140,000 to lobby the SEC. Approximately 32.8% of sample observations are in industries classified as having a high risk of litigation. The

average (median) total assets is $3,303 ($407) million, while the median leverage is 11.3% and the median market-to-book ratio is 2.041. The median profitability (using ROA) is 3.3% and the average occurrence of firms issuing security is 44%. Sample firms have median institutional ownership of 62.3%, are followed by about 15 analysts, and the average auditor tenure is about 9.8 years.

3. Multivariate Results

In Section 3.1 we discuss results from our primary tests examining the effects of influential committee membership on SEC enforcement actions. Section 3.2 presents results from falsification tests. We document the effects of influential committee membership on regulatory penalties in Section 3.3.

3.1 Influential Committees and Financial Misconduct Enforcement Actions

In Table 3 we present results from multivariate tests examining whether political representation on influential committees is associated with financial misconduct-related regulatory enforcement actions. Columns 1-3 present coefficient estimates from tests of equation (1). Column 1 shows that firms with more powerful influential committee representation are significantly *less* likely to receive financial misconduct-related AAERs. More specifically, the coefficient on *Total_Seniority* is negative and statistically significant at the 1% level (|z-statistic| = 2.66). Economically, a one standard deviation increase in *Total_Seniority* is associated with a 14% decrease in the odds that a firm will receive an AAER, relative to out-of-state firms. The evidence in columns 2 and 3 provides similar inferences when we use alternative measures of influential committee power (i.e., *Committee_Num* and *Seniority_Dum* respectively). The effects are statistically significant at the 5% level. For instance, a one-politician increase in influential

committee membership is associated with an 8.7% decrease in the odds that constituent firms will receive an AAER. Finally, coefficients for control variables are largely consistent with prior studies that examine the determinants of enforcement actions. Our results are robust to the inclusion of controls for political connections, contributions, and lobbying.

Next, we undertake tests to provide evidence about causality. We use influential committee member turnover and exploit the fact that only some turnover cases are likely to be plausibly exogenous because they reflect departures for more prestigious opportunities, as discussed in Section 2. Our tests examine whether the likelihood of the SEC issuing an AAER changes around turnover shocks to influential committee members. The minimum loss in a firm's influential committee seniority representation is 1 year and the maximum loss is 34 years. The median loss is 10.5 years and the top quartile is 20 years. Of the sample cases, 14 (6 Senators and 8 Representatives) depart while their seniority is in the top quartile of committee seniority.

Table 4 presents coefficients from estimations of equation (2). The evidence indicates that firms that experience exogenous decreases in senior influential committee representation are significantly more likely to subsequently receive AAERs relative to firms in other states. The loss of a senior influential committee member results in a 50% increase in the odds that constituent firms will subsequently be subject to financial misconduct-related enforcement action, relative to a matched sample of firms with no changes to their influential committee representation. Column 2 presents results from tests of the effect of *non-senior* committee member turnover on the likelihood that the SEC issues an AAER against financial misconduct. The coefficient on *Non-Senior_Drop* is positive but statistically insignificant. Thus, the loss of a non-powerful influential committee member does not appear to have a statistical significant

effect on financial misconduct-related enforcement actions against constituent firms. This is consistent with prior work that suggests that congressional committee influence is concentrated amongst senior committee members (e.g., Levitt and Poterba, 1999). The evidence in column 2 also serves as a falsification test: if some omitted variable drives both influential committee politician turnover and AAERs, then the omitted variable must affect turnover for all committee members, but simultaneously only affect AAER likelihood for firms that experience the loss of a powerful influential committee member.

Figure 1 presents a graphical depiction of the impact of senior influential committee member turnover on subsequent AAERs. The evidence indicates that firms with (without) shocks to their influential committee representation subsequently experience an increase (no effect) in the propensity that they will receive a financial-misconduct related AAER.

In untabulated robustness tests, we find that the *addition* of a committee member to an influential committee has no statistical effect on the likelihood of AAER issuances. This is consistent with new committee members having relatively less political influence due to their junior status. We also examine the possibility that our results are affected by unobserved, time-invariant, firm-specific factors by replicating our tests after including firm-level fixed-effects (and removing industry and state fixed-effects). The untabulated results are economically and statistically similar to those presented in Tables 3 and 4 across both levels and change specifications. In addition, we find that our results are qualitatively similar when we control for governance characteristics over the 2001 to 2007 period using firm-specific governance characteristics based on the G-Index (Gompers et al., 2003).[16]

In sum, the results in Table 4 provide evidence consistent with a causal and economically

[16] For years that are missing G-Index values, we apply the previous year's G-Index value.

significant relation between influential committee member representation and SEC financial misconduct-related regulatory enforcement actions. In Section 4 below, we examine the mechanisms that can explain this finding.

3.2 Falsification Test: Senior Politicians on Other Powerful Congressional Committees

It is conceivable that our sample of politician turnover cases and SEC enforcement action likelihood are still driven by some other unobserved factor such as changes in state level economic (i.e., an omitted variable problem). To alleviate this possibility we undertake a series of falsification tests using changes in representation on the most powerful congressional committees that have no jurisdiction over the SEC (i.e., powerful committees other than influential committees). We again identify the ten most powerful unrelated Senate and House committees from Edwards and Stewart (2006). We create measures of committee power that are similar to the previously defined measures, but based on the power of a firm's political representation on these alternative powerful committees.[17] We re-estimate equation (2) after replacing the *Senior_Drop* and *Non-Senior_Drop* variables with these new variables: *Senior_Drop_OtherComm* and *Non-Senior_Drop_OtherComm*. We match each firm that experiences the turnover of a senior/non-senior non-relevant committee politician with a firm in another state that also has representation on one of the ten alternative committees but does not experience a shock to the committee representation. We use the same matching variables as previously discussed. For tests using senior and non-senior committee member turnover on other non-SEC-related powerful committees, the matched sample yields 7,000 and 9,972 firm-year observations respectively.

Table 5 presents regression results. Coefficients on both *Senior_Drop_OtherComm* and

[17] In untabulated robustness tests, we find similar results to those presented if we focus on the top 3 or top 5 (instead of top 10) most powerful other committees.

Non-Senior_Drop_OtherComm in columns 1 and 2 respectively are negative and statistically insignificant. In other words, the loss of a powerful politician (or a relatively less powerful politician) from a non-influential congressional committee does not appear to change the likelihood of financial reporting enforcement actions for the politician's constituent firms. These findings indicate that it is unlikely that our results are driven by omitted variables that also drive senior committee member turnover.

3.3 Influential Committees and Financial Misconduct Enforcement Penalties

Next, we investigate whether the influential committee representation affects penalties for constituent firms subject to SEC investigations against financial misconduct. For each of the 339 AAERs during our sample period, we use the SEC's regulatory filings, court verdicts, LexisNexis, and Google.com to identify the scope of the alleged financial misconduct and subsequent regulatory penalties by the SEC or the Department of Justice (DOJ) on the transgressor firm and/or employees.[18] We exclude 23 ongoing investigations from our tests, as well as another 65 cases because of the difficulty in accurately mapping the assessed penalty with the scale of the financial manipulation.[19] For the remaining 251 cases, the mean aggregate income or profit manipulation is approximately $19.5 million and ranges from $76,000 to $15 billion. Firms with influential committee representation in the top quartile of seniority report an average earnings manipulation of $13.7 million compared to $21.4 million for all other cases. The difference is statistically significant at the 5% level. The regulatory penalties issued against

[18] Karpoff et al. (2008) undertake a comprehensive analysis of the consequences of financial misconduct for employees. Our analysis aggregates the consequences of financial misconduct across penalties issued to both firms and employees.

[19] For example, in the SEC's case against Dynegy Inc., the SEC "found that Dynegy violated federal securities laws by improperly disguising [a] $300 million loan as cash flow from operations on its financial statements, thereby misleading investors about the level of its energy trading activity." Our results are robust to including these non-income or sales manipulation related cases and either excluding the control variable that captures the amount of the manipulation amount (which is defined as total manipulation in income) or using a crude dollar value of manipulation in all income and non-income accounts to capture the amount of manipulation.

these firms and/or their employees ranges between $0 and $2.25 billion and the average is $11.7 million.[20] Firms with influential committee representation in the top seniority quartile report an average penalty of $7.7 million compared to $13 million for all other cases. The difference is statistically significant at the 5% level. In almost all the cases, the SEC also issues a "cease and desist" notification against the firm. In four cases, the SEC simply drops the enforcement investigation into the firms. In roughly 13% (33 cases) of the 251 misconduct cases, employees receive jail sentences, ranging from several months up to 286 years (aggregated at the firm level). In the vast majority of cases that do not result in incarceration, the SEC imposes bans against convicted employees from subsequently serving as an executive or a director of a public company and/or suspends professional licenses. Bans range from one year to life. We estimate the following multivariate specification to examine the effect of influential committee representation on penalties assessed for financial misconduct:

$$Penalty\$_{i,t} = \alpha + \beta_1 * Seniority_{i,t} + \beta_X * Controls_{i,t} + \xi_{i,t} \quad (3)$$

where $Penalty\$_{i,t}$ is a continuous variable capturing the log monetary value of the aggregate penalty imposed by the SEC or Department of Justice (DOJ) on the firm and/or employees. $Seniority_{i,t}$ is one of the three measures of seniority as previously defined. $Controls_{i,t}$ is a vector of controls, including *Political_Connection*, *Political_Contribution*, *Lobby_SEC*, the log dollar value of the net profit misstatement alleged by the SEC (*IncomeInflation$*), *Litigation Risk*, *Size*, *Leverage*, *MtB*, *Profit*, *Inst_Own*, *Analyst_Following*, and *Distance_to_SEC* as previously defined. We also include state, industry, auditor, and year fixed effects.[21]

[20] We exclude amounts paid as a result of class action lawsuits by investors as such payments are separate to penalties issued as a result of SEC enforcement actions.

[21] It is possible that a state's influential committee representation changes between the issuance of an AAER and the date that a trial outcome or settlement is determined. Our results are unaffected if we use political representation at the time of the AAER or the time that the penalty is imposed.

We present multivariate test results in Table 6. Overall, the evidence indicates that the SEC imposes lower monetary penalties for financial misconduct by firms located in areas served by powerful influential committee representation, relative to financial misconduct by firms in other states. The results are robust across all three measures of committee power: *Total_Seniority*, *Committee_Num*, and *Seniority_Dum*. In economic terms, for a firm issued with an AAER, we find that a one standard deviation increase in their influential committee *Total_Seniority* is associated with a reduced penalty of approximately $1.3 million. This amount holds after controlling for a number of determinants of the magnitude of the penalty assessed, including the alleged amount of income manipulation and firm size. More importantly, our results are robust to the inclusion of two variables that capture the presence of political connections via personal relationships and monetary contributions. We find that *Political_Connection* is negative and significant in all three specifications, indicating that connections with politicians help to mitigate the monetary penalty from the regulators. We find that *Political_Contribution* is also negative but marginally significant, suggesting that monetary contribution to politicians does not help much in lowering the penalty imposed by the regulators. In the next section, we explore mechanisms that can explain our findings.

4. Mechanisms That Drive Variation in Enforcement Actions Against Financial Misconduct

In this section, we investigate mechanisms that explain the relation between influential committee membership and SEC enforcement against constituent firms. In Section 4.1 we discuss the mechanisms and how they affect the abovementioned relation. In Section 4.2 we outline the empirical methodology used to identify which mechanism explains our results and in

Section 4.3 we discuss the results.

4.1 Mechanisms that explain the negative relation between influential committee representation and likelihood of an enforcement action for financial misconduct.

We consider two mechanisms through which influential committee representation affects the likelihood that constituent firms face SEC enforcement actions for financial misconduct. First, firms that have captured their influential committee representatives can use their political capital to pressure politicians to limit the severity of SEC investigations and penalties. This is also consistent with theoretical arguments that connected firms can use political favors when needed (Baron, 1989; Grossman and Helpman, 1994). We label this the *protection hypothesis*.

Alternatively, influential committee constituent firms may supply higher quality financial reports because of investor concerns about wealth expropriation or because of concerns about political costs from financial reporting failure. This argument is consistent with studies that argue firms respond to investor concerns about wealth transfers because of political connections by improving financial reporting quality (for example, see Watts and Zimmerman, 1983; Dyck and Zingales, 2004; Guedhami et al., 2014). Higher financial reporting quality in turn mechanically reduces the likelihood of financial misconduct (and enforcement against misconduct), all else equal. We label this possibility the *prevention hypothesis*.

In order to differentiate between the two mechanisms, we undertake a changes analysis that examines firm financial reporting characteristics around exogenous drops to firms' influential committee representation. Under the protection hypothesis, firms that lose political protection against SEC investigations because of influential committee turnover have incentives to subsequently improve financial reporting quality. Under the prevention hypothesis, influential committee turnover decreases investor concerns about wealth expropriation by firm insiders and

political costs of financial reporting transgressions. In turn, constituent firms affected by politician turnover have relatively weaker incentives to supply relatively higher quality financial reports, all else equal.

4.2 Specification and Results

The sample for our empirical tests includes a treatment group which are firms in constituencies that experience plausibly exogenous senior influential committee member turnover as described in Section 2 and a control group of matched sample firms in other non-affected states.[22] We match firms based on size (log total assets), Fama-French industries, state GDP growth, and state unemployment rate, with no replacement, and with a caliper of 0.1%. We use the following ordinary least squares (OLS) specification to estimate the effect of influential committee member turnover on financial reporting quality:

$$\Delta FRQ_{i,t} = \alpha + \beta_1 * Senior\_Drop_{i,t} + \beta_X * \Delta Controls_{i,t} + \xi_{i,t} \quad (4)$$

where $\Delta FRQ_{i,t}$ represents changes in financial reporting quality using one of three commonly used accruals-based earnings quality measures (*FRQ1*, *FRQ2,* and *FRQ3*) from the accounting literature. Detailed calculations for all three measures are in Appendix B. In order to facilitate an easier interpretation of regression coefficients, we multiply each earnings quality measure by -100 such that larger values indicate higher financial reporting quality.

Next, $Senior\_Drop_{i,t}$ is as previously defined. A negative (positive) coefficient on *Senior_Drop* indicates that financial reporting quality decreases (increases) following the exit of a senior influential committee member, consistent with the prevention hypothesis (protection hypothesis). In addition, we also conduct a number of counter-factual tests by replacing

[22] Our results discussed below are qualitatively similar if we use the following conditions to identify possible control firms: firms in states 1) with no shock to their influential committee membership; 2) with no shock to their senior influential committee membership; or 3) without influential committee membership in the year of turnover.

Senior_Drop with variables to capture: 1) departures by non-senior committee member (*Non-Senior Drop)*; and 2) departures by senior politicians on other unrelated powerful congressional committees (*Senior_Drop_OtherComm).* Under our primary thesis, changes in either of these groups should not affect constituent firm financial reporting quality.

$\Delta Controls_{i,t}$ is the change form of a vector of control variables commonly used to explain earnings quality including *Political_Contribution, Lobby_SEC*, *Size*, *Leverage*, *MtB*, *Profit*, *Issuance*, *Stdev_Cashflow, Stdev_Sales, Oper_Cycle, Inst_Own, Analyst_Following, Auditor_Share*, *Auditor_Tenure*, *Office_Size*, *GC_Dummy,* as previously defined. We drop variables that do not vary in the pre and post periods during our sample window: *Political_Connection, Litigation Risk,* and *Distance_to_SEC.* In addition, all specifications include state, year, industry, and auditor fixed effects. Standard errors are adjusted using a Huber-White Sandwich estimator and clustered by firm.

Figure 2, Panels A to C present graphical depictions of FRQ for each measure across 1) firms that experience a shock via the loss of an influential committee senior politician during our sample window; and 2) the matched sample of control firms that do not experience a shock to their influential committee representation in the same year, or in the two preceding or subsequent years. Year 0 represents the year of influential committee member turnover for the treatment group. The evidence across all three panels indicates that average financial reporting quality decreases for treatment firms immediately following committee member turnover, consistent with the prevention hypothesis. In contrast, control firms do not appear to experience any noticeable change in financial reporting quality around the turnover year.

Table 7 presents coefficients from tests of equation (4) for each of the three FRQ measures: $\Delta FRQ1$, $\Delta FRQ2$, and $\Delta FRQ3$. The evidence in columns 1-3 shows that financial

reporting quality decreases following powerful influential committee member turnover, relative to firms that do not experience changes in their influential committee representation. The coefficients on *Senior_Drop* are negative and statistically significant at the 5% level in all three specifications (|t-statistic| > 2.25). In economic terms, the loss of a senior influential committee member results in constituent firms decreasing financial reporting quality by approximately 4.5% - 5.9% relative to matched control firms that do not experience changes in influential committee representation. The evidence is again consistent with the prevention hypothesis. In supplemental tests, we find that our inferences are similar when we use financial restatements as an alternative measure of financial reporting quality (untabulated). Namely, firms are more likely to issue restatements subsequent to the loss of a senior influential committee representative, relative to other firms.

We also undertake a number of robustness tests. We find no statistical evidence that financial reporting quality changes following the exit of a non-senior influential committee member (columns 4-6), or departures by senior politicians on other unrelated of other committees (columns 7-9). In sum, the results in Table 7 are consistent with the argument that firms perceive senior influential committee member representation as increasing the risk of greater SEC scrutiny. The firms proactively act to improve financial reporting quality and reduce the risk of regulatory investigation. The evidence is inconsistent with the argument that political capture-related explanations drive financial reporting practices when firms have powerful influential committee representation.

5. Robustness Checks

5.1 Effects of House and Senate Subcommittee Membership

Congressional committees divide their tasks among subcommittees that handle specific areas. The two subcommittees responsible for financial reporting oversight are the Subcommittee on Securities, Insurance, and Investment (Senate) and the Subcommittee on Capital Markets and Government-Sponsored Enterprises (House). We repeat our analyses after partitioning influential committee politicians based on whether they serve on the abovenamed subcommittees or not. We treat influential committee chairpersons and ranking members as ex-officio members of all subcommittees, consistent with committee rules in both the Senate and the House.

Table 8 presents results for tests of Equation (1) after partitioning influential committee members into subcommittee and non-subcommittee groups and identifying these groups by adding *"_Sub*" or *"_NonSub*" respectively to each seniority measure. The results show that both subcommittee and non-subcommittee representation have a negative and significant effect on the likelihood that constituent firms will face SEC enforcement action. The results are similar across all three seniority measures. F-tests indicate that the subcommittee effect is statistically larger than that for non-subcommittees. A potential explanation for why non-subcommittee membership is important is that all influential committee members (regardless of their subcommittee assignments) have the ability to influence SEC actions, either directly or via relationships with other committee members.

5.2 Differential Effects of Senate and House Influential Committees

In this section, we consider whether our results vary based on whether firms have representation on either the Senate or the House influential committees. One reason to expect a difference between the committees is that the Senate committee is tasked with the responsibility to confirm or deny the president's recommendations for SEC commissioner appointments and thus may have more influence over the SEC, which in turn affects firm behavior. We calculate

three new measures of committee member power based on a state's representation on the Senate and House committees separately. We then restrict equation (1) to either the Senate or House influential committee power measures instead of the corresponding three aggregate committee power measures. We present results in Table 9. The findings across all three measures of committee power indicate that the relation between influential committee representation and enforcement actions is statistically significant across both the Senate and House committees. In addition, *F*-tests indicate that there is no statistically significant difference between the effect from the Senate and the House influential committees.

5.3 Other Robustness Checks

5.3.1 Potential Spillover Effects from Enron and WorldCom Collapses

In order to eliminate the possibility that our results are driven by increased scrutiny against financial reporting following the collapses of Enron and WorldCom, we replicate our tests after removing all observations for 2001, 2002, and 2003. The results from these untabulated tests are qualitatively similar to the reported findings.

5.3.2 House of Representatives State Apportionment

We examine whether our results are driven by states that are disproportionately represented on the House's Financial Services Committee. This possibility exists because House seats are apportioned to a state based on the state's population (i.e., each Representative serves an approximately equal number of constituents). In contrast, each state has equal representation in the Senate. Thus, the most populous U.S. states (California, Texas, Florida, New York, Pennsylvania, and Illinois) have the largest number of House seats. Firms located in these six states represent 47.6% of all firms in our sample. Tests excluding each of these five states provide qualitatively similar results to those presented above.

5.3.3 Alternative Identification Methodology to Link Firms and States

A possible issue for our study is that linking state politician representation with firm headquarters location may not capture politician incentives for geographically diverse firms. In order to overcome this issue, we use the Garcia and Norli (2012) firm-specific measure of state-level operational dispersion.[23] The measure captures the number of times states are mentioned in a firm's 10-K filing. The greater the number of states mentioned, the greater the dispersion of the firm's operations. The more frequently a given state is mentioned, the greater the expected importance of that state for the firm.[24] The correlation between sample firm headquarters and the state (two states) with the highest count in the 10-K filing is 64% (80%). Our tabulated results are robust to two alternate methods to identify the most appropriate state-level Senate and House representation for each sample firm observation: 1) we use a weighted average of influential committee member seniority based on the geographical distribution of operations using all states identified in the 10-K filing; and 2) we determine a firm's committee seniority measures based on the state that has the highest count in the 10-K filing. Note that a limitation of this robustness analysis is that House district-firm links are not identified.

5.3.4 Business-Friendly States

We also examine whether politicians who choose to serve on influential committees represent a state or a congressional district in a state that is viewed as "business friendly." Business-friendly states are likely to attract both higher quality and more successful firms relative to other states, and politicians from those states may be more eager to serve on

[23] We thank Diego Garcia and Øyvind Norli for making these data available to us.

[24] For example, in 2006 Boeing Corp. identifies six unique states in its 10-K filing. The six states represent that the firm is headquartered in Illinois and has manufacturing facilities in Washington, South Carolina, Missouri, Kansas, and Oklahoma. However, 50% of all the state mentions are Washington, where Boeing has major manufacturing facilities. Thus, it is possible that Washington's influential committee representatives have incentives to influence potential SEC enforcement action against Boeing.

influential committees. Using Forbes' annual survey of state-level business environment data between 2005 and 2010, we partition firms into high and low business-friendly state groups.[25] Untabulated tests indicate that our main results are qualitatively similar across both partitions.

6. Conclusion

We explore the corporate governance role of U.S. politicians by examining political representation on the two congressional committees that have responsibility for financial market regulation and SEC oversight - the U.S. Senate Committee on Banking, Housing, and Urban Affairs and the U.S. House of Representatives Financial Services Committee. Our evidence indicates that firms with powerful representation on these congressional committees are less likely to be subject to SEC enforcement action for financial misconduct. We exploit exogenous turnover in committee membership to draw causal inferences. Firms that lose powerful influential committee representation subsequently experience an increased likelihood of facing SEC investigations for financial misconduct. Furthermore, conditional on the SEC issuing an enforcement action, firms with powerful influential committee representation receive relatively smaller penalties than other firms.

We undertake further tests to differentiate between the possible drivers of our findings. The evidence suggests that the documented lower enforcement activity against firms with powerful influential committee representation is due to firms' ex-ante efforts to improve financial reporting rather than because of political protection against enforcement.

Our study should be of interest to regulators, politicians, and firms. The role and influence of specific congressional committees has received relatively little attention in prior

[25] See http://www.forbes.com/best-states-for-business/.

research. To the best of our knowledge, our findings are the first to provide evidence of a direct governance role of congressional committees representation for constituent firm financial reporting behavior. Future research opportunities include examinations of the effects of congressional committee representation for auditor and firm disclosure decision.

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Appendix A. Variable Definitions

Dependent Variables:
Enforcement: An indicator variable set to one if the firm is the subject of a fraud-related AAER in the current year, and set to zero otherwise.
ΔEnforcement: An indicator variable set to one if the firm is (not) subject to fraud-related AAER (before) after the exit of influential committee member, and set to zero otherwise.
Turnover: An indicator variable set to one if the influential (other powerful) committee member from the firm's state leaves Congress, and set to zero otherwise.
Penalty$: Log of the monetary penalty extracted by the SEC from a firm and its employees for financial misconduct.
FRQ1: Unsigned abnormal accruals from Hribar and Nichols (2007) and detailed in Appendix B.
FRQ2: Industry-adjusted absolute value of DD residual from Dechow et al. (2011) and detailed in Appendix B.
FRQ3: Performance-matched discretional accruals from Kothari et al. (2005) and detailed in Appendix B.

Variables of Interest:
Total_Seniority: For each firm in a given state, the aggregate tenure of that state's current political representation for both influential committees (in years).
Committee_Num: For each firm in a given state, the total number of politicians from that state serving on influential committees.
Seniority_Dum: For each firm in a given state, an indicator variable set to one if that state's political representation on influential committees is in the top quartile of seniority on at least one of the influential committees, and zero otherwise.
Senior_Drop: For each firm in a given state, an indicator variable set to one if a powerful (i.e., top seniority quartile influential committee politician from that state ends his/her congressional appointment in that year, and zero otherwise.
Non-Senior_Drop: For each firm in a given state, an indicator variable set to one if a non-top seniority quartile) influential committee politician from that state ends his/her congressional appointment in that year, and zero otherwise.
Senior_Drop_OtherComm: For each firm in a given state, an indicator variable set to one if a state's powerful (i.e., top seniority quartile) political representative serving on one of the ten most powerful non-SEC relevant congressional committee ends his/her congressional appointment in that year, and zero otherwise.
Non-Senior_Drop_OtherComm: For each firm in a given state, an indicator variable set to one if a state's powerful (i.e., non-top seniority quartile) political representative serving on one of the ten most powerful non-SEC relevant congressional committee ends his/her congressional appointment in that year, and zero otherwise.
Recent_AAER: An indicator variable set to one if the firm has received a financial misconduct related AAER in the prior three years, and set to zero otherwise.

Control Variables:
Analyst_Following: The (log) of the number of analysts that cover the firm during the year.
Auditor_Share: The auditor's national industry share, measured by the proportion of the total assets of all firms in the same Fama-French industry.
Auditor_Tenure: Number of years that the firm has retained the current auditor.

Democratic: A dummy variable set to one if the influential committee member is a democrat, and zero otherwise.
Distance_to_SEC: The (log) miles between the firm's headquarters to the closest SEC regional office.
Female: A dummy variable set to one if the influential committee member is female, and zero otherwise.
GC_Dummy: An indicator variable set to one if the firm's auditor issues a going-concern opinion in that year, and set to zero otherwise.
IncomeInflation$: The log of the dollar amount of net profit financial misrepresentation.
Inst_Own: Year-end institutional ownership as a percentage of common stock.
Issuance: An indicator variable set to one if the firm has issued new long-term debt or stock worth more than ten percent of the prior year's long-term debt or common equity in the prior three years, and set to zero otherwise.
Leverage: Long-term debt divided by total assets.
Litigation_Risk: An indicator variable set to one if the firm is in one of the following industries: biotech (SIC codes 2833-2836 and 8731-8734), computer (3570-3577 and 7370-7374), electronics (3600-3674), retail (5200-5961), and zero otherwise.
Lobby_SEC: Log of (1 + total dollar amount of a firm's SEC-related lobbying spending during a year).
MtB: Market value of equity divided by book value of equity.
Oper_Cycle: Log (days in account receivables + days in inventory).
Office_Size: Log number of clients of auditor office.
Penalty$: Log of monetary penalty imposed by SEC/DOJ on the firm/employees.
Political_Connection: An indicator variable set to one for each year that a firm in our sample that is affiliated with an U.S. politician based on whether the politician previously served as an executive or director of the firm, and zero otherwise.
Politicial_Contribution: Log of total dollar amount of a firm's political contributions during a year.
President Same Party: A dummy variable set to one if the influential committee member is from the same party as the incumbent president.
Presidential Election Year: An indicator variable set to one if the election occurs in a presidential election year, and zero otherwise.
Profit: Earnings before extraordinary items divided by total assets.
Size: Log of total assets.
State GDP Growth: The GDP growth rate from year *t*-1 to *t*.
State Unemployment Rate: State unemployment rate for year *t.*
Stdev_Cashflow: Standard deviation of cash flow from operations between *t*-4 and *t*.
Stdev_Sales: Standard deviation of sales between *t*-4 and *t*.

Appendix B. Financial Reporting Quality Measures

***FRQ1*: Unsigned Abnormal Accruals (Hribar and Nichols, 2007)**

We first estimate the following regression for each year and Fama-French industry:

$$TACC = \alpha + \beta_1 \Delta REV + \beta_2 PPE + \xi,$$

where *TACC* is total accruals, defined as income before extraordinary items minus cash from operations divided by lagged total assets. ΔREV is the change in sales adjusted for the change in receivables, divided by lagged total assets. *PPE* is gross property, plant, and equipment, scaled by lagged total assets. We then calculate the abnormal accruals as the residual term in the regression, i.e., $TACC - (\alpha + \beta_1 \Delta REV + \beta_2 PPE)$, and *FRQ1* is the absolute value of the residual (abnormal accruals).

***FRQ2*: Industry-adjusted Absolute Value of DD Residual (Dechow et al., 2011)**

We first regress working capital accruals (*WC_ACC*) on operating cash flows in the current year (CFO_t), the preceding year (CFO_{t-1}), and the following year (CFO_{t+1}):

$$WC\_ACC_{i,t} = \alpha_{0,i} + \beta_{1,i}\, CFO_{i,t-1} + \beta_{2,i}\, CFO_{i,t} + \beta_{3,i} CFO_{i,t+1} + v_{i,t},$$

where $WC\_ACC = \Delta CA - \Delta CL - \Delta CASH + \Delta STDEBT + \Delta TAXES$; ΔCA is the change in current assets between year t-1 and t; ΔCL is the change in current liabilities between year t-1 and t; $\Delta CASH$ is the change in cash and short-term investments between year t-1 and t; $\Delta STDEBT$ is the change in short-term debt between year t-1 and t; and $\Delta TAXES$ is the change in taxes payable between year t-1 and t.

All variables are scaled by average total assets and winsorized at the 1% and 99% levels. We estimate equation (6) by year for each of the Fama-French industry groups. *FRQ2* is the absolute value of each firm's residual less the average absolute value for the corresponding industry.

***FRQ3*: Performance-Matched Discretional Accruals (Kothari et al., 2005)**

We estimate abnormal accruals for each firm-year and subtract the value from the discretionary accruals of the performance-matched firm. The modified Jones model of abnormal accruals model is estimated cross-sectionally each year using all firm-year observations in the same Fama-French industry:

$$TA_{i,t} = \beta_0 + \beta_1 (1/ASSETS_{i,t-1}) + \beta_2 (\Delta SALES_{i,t} - \Delta AR_{i,t}) + \beta_3 PPE_{i,t} + \xi_{i,t},$$

where *TA* (total accruals) is the change in non-cash current assets minus the change in current liabilities excluding the current portion of long-term debt, minus depreciation and amortization, scaled by lagged total assets; $\Delta SALES_{i,t}$ is change in sales; $\Delta AR_{i,t}$ is change in account receivable; and $PPE_{i,t}$ is gross property, plant, and equipment, all scaled using lagged total assets, $ASSETS_{i,t-1}$. We use total assets as the deflator to mitigate heteroscedasticity in the residuals.

Residuals from the annual cross-sectional industry regression model in the modified Jones model are used to measure estimated abnormal accruals. We then match each firm-year observation with another firm from the same Fama-French industry and year with the closest return on assets in the current year, $ROA_{i,t}$ (net income divided by total assets). We define *FRQ3* for firm i in year t as the abnormal accrual in year t minus the performance-matched abnormal accrual for year t.

Figure 1: SEC Enforcement Against Financial Misconduct Around Powerful Influential Committee Politician Turnover Shocks

We present annual time series values of the percent of firms subject to enforcement across groups based on the turnover of powerful influential committee senior representatives. All observations are centered on the turnover shock year (year 0).

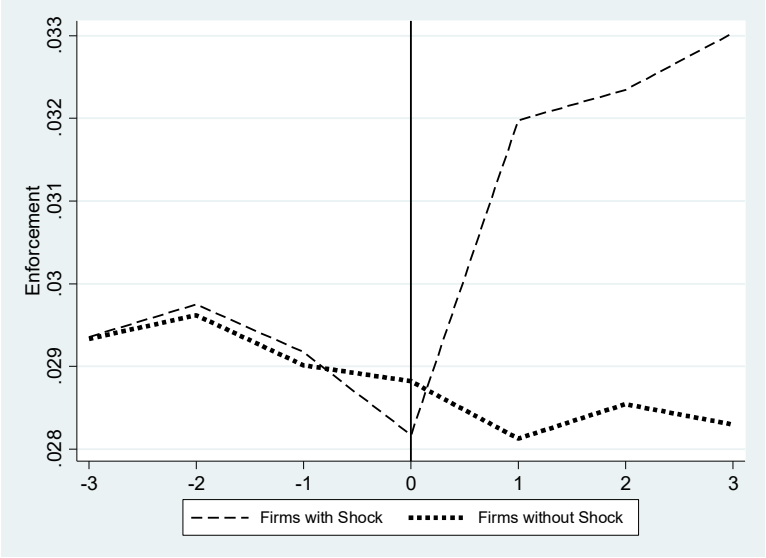
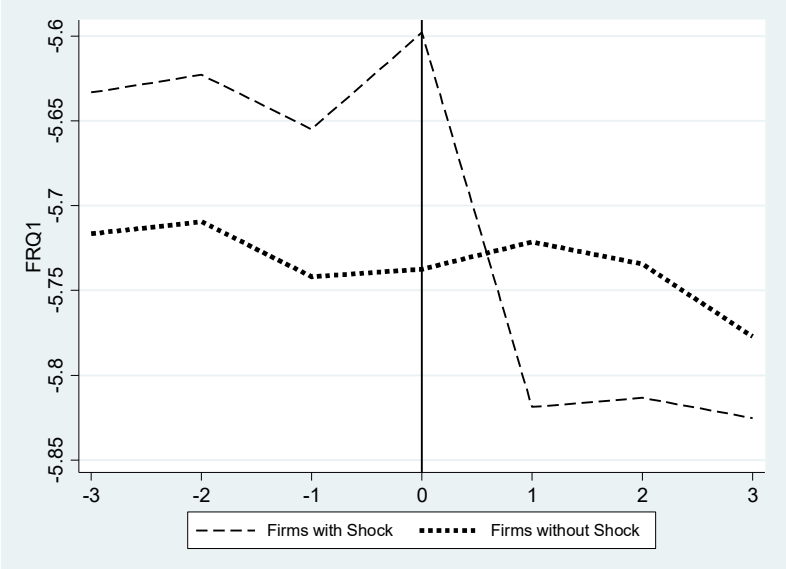


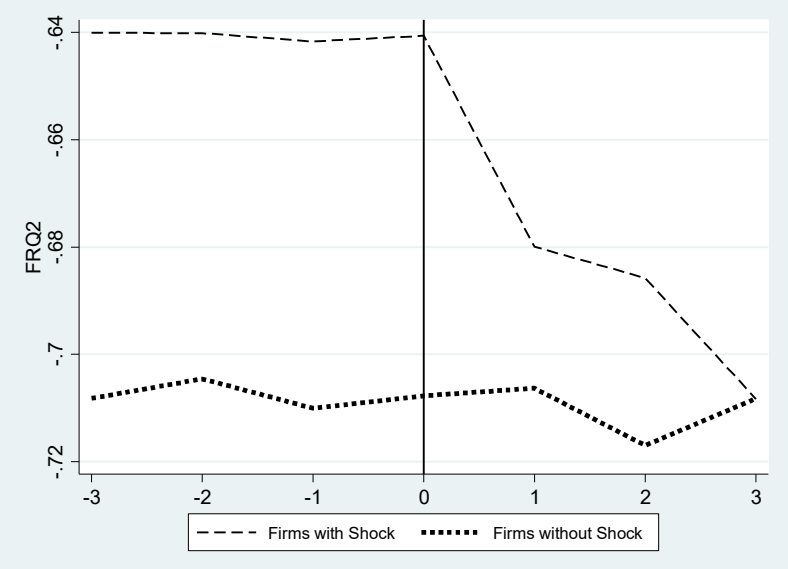
Figure 2: Financial Reporting Quality Around Influential Committee Powerful Politician Exit Shock

Panels A, B, and C present annual time series values of financial reporting quality for firms across groups based on the turnover of powerful influential committee senior representatives. All observations are centered on the turnover shock year (year 0). Financial reporting quality is measured using one of the following measures: *FRQ1*, *FRQ2*, or *FRQ3*. All three measures are defined in Appendix B.

Panel A: FRQ1



Panel B: FRQ2



Panel C: FRQ3

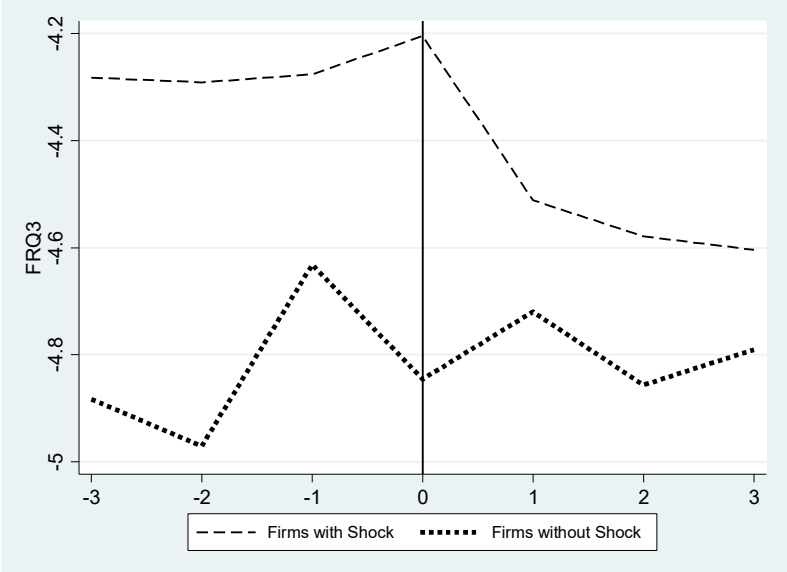

FRQ3
-4.2
-4.4
-4.6
-4.8
-5
-3
-2
-1
0
1
2
3
Firms with Shock
Firms without Shock

Table 1: Influential Committee Descriptive Statistics

This table presents statistics about the House Financial Services Committee (House Committee), and the Senate Committee on Banking, Housing, and Urban Affairs (Senate Committee) characteristics.

Panel A: Influential Committee Descriptive Statistics

	House Committee	Senate Committee
Average size (in number of members)	69.25	21.25
Average # of states represented on committee	29.05	20.67
Average # of state representatives	2.28	1.02
Max # of state representatives	11	2
Average politician tenure on committee (in years)	3.62	6.94
Maximum politician seniority on committee (in years)	19.00	29.00

States with the greatest number of years of representation (and corresponding duration) in the top quartile of influential committee between 2001 and 2010:

House Committee: CA, PA, NY, MA, AL, NC, IL, LA, DE (10 years); VT, IA, OK, (8 years); OK, KS, TX, NE (6 years); IN, OH, NJ (4 years); OR, MN, MO, FL (2 years);

Senate Committee: CT, AL (10 years); UT, MD (8 years); SD, TX, RI, (4 years); ID, ID, NE, MA, FL, WY, IN, CO, NY, KY (2 years)

States with the number of years of representation (and corresponding duration) in the bottom quartile of influential committee between 2001 and 2010:

House Committee: ME, AK (10 years); KY, WI (8 years); MN, MS (6 years); AR, AZ, CO, CT, MI, MO, NH, NJ, NM, SC, TN, UT, WV (4 years); GA, ID, NV, VA, WA (2 years)
Senate Committee: ME, AK (10 years); HI, NH, NJ (6 years); DE, FL, GA, MI, MT, NC, OH, PA, TN (4 years); CO, ID, IN, KY, LA, NE, NV, NY, OR, SC, TX, VA, WI (2 years)

States with no representation on influential committees during sample period: AK, ME.
Total # of sample firm-year observations from these states: 22.

Table 2: Descriptive Statistics

We present mean, median and standard deviation values for variables used in the primary multivariate tests. All variables are defined in Appendix A.

	(1)	(2)	(3)
	Mean	**Median**	**Std. Dev.**
State-year Seniority Measures (n = 500)			
Total_Seniority	8.763	6.000	9.981
Committee_Num	0.420	0.000	0.525
Seniority_Dum	0.262	0.000	0.443
Firm-year Seniority Measures (n = 17,017)			
Total_Seniority	10.576	2.000	14.962
Committee_Num	0.906	0.000	0.988
Seniority_Dum	0.271	0.000	0.448
Other Variables (n = 17,017)			
Enforcement	0.020	0.000	0.110
Political_Connection	0.169	0.000	0.375
Political_Contribution ($)	466,029	0.000	2,481,660
Lobby_SEC ($)	140,113	0.000	1,538,735
Litigation_Risk	0.328	0.000	0.469
Total Assets ($Million)	3,303	408	12,118
Size	6.064	6.010	2.039
Leverage	0.167	0.113	0.189
MtB	2.850	2.041	4.073
Profit	-0.010	0.033	0.174
Issuance	0.440	0.000	0.496
Stdev_Cashflow	0.110	0.062	0.167
Stdev_Sales	0.259	0.195	0.224
Oper_Cycle	4.567	4.646	0.810
Inst_Own	0.565	0.623	0.313
Analyst_Following	2.327	2.708	1.452
Distance_to_SEC (miles)	1,771	1,580	1,262
Auditor_Share	0.200	0.214	0.123
Auditor_Tenure	9.845	7.000	8.657
Office_Size	2.717	2.772	1.118
GC_Dummy	0.023	0.000	0.151

Table 3: Influential Committee Seniority and Enforcement Against Financial Misconduct

This table presents coefficients from logit regressions examining the relation between the power of firms' influential committee representation and the likelihood that the firms are subject to SEC enforcement for financial misconduct. The dependent variable is *Enforcement* and the independent variable of interest is set to one of our three measures of influential committee power. All variables are defined in Appendix A. z-values are in parentheses. Standard errors are Huber-White sandwich estimator clustered at the firm level. All specifications include fixed effects for state, industry, year, and auditor. Statistical significance at the 1%, 5%, and 10% levels is denoted by ***, **, and *, respectively.

	(1)	(2)	(3)
Dependent Variable:		**Enforcement**	
Constant	-7.506***	-7.158***	-7.632***
	(-8.66)	(-8.72)	(-8.49)
Total_Seniority	**-0.015*** **	**-**	**-**
	(-2.67)		
Committee_Num	**-**	**-0.090** **	**-**
		(-2.52)	
Seniority_Dum	**-**	**-**	**-0.146** **
			(-2.34)
Political_Connection	0.702**	0.713**	0.695**
	(2.35)	(2.36)	(2.29)
Political_Contribution	0.047**	0.048**	0.048**
	(2.16)	(2.18)	(2.19)
Lobby_SEC	-0.024	-0.025	-0.024
	(-1.26)	(-1.28)	(-1.27)
Litigation Risk	0.778	0.782	0.775
	(1.33)	(1.33)	(1.31)
Size	-0.425***	-0.426***	-0.427***
	(-4.11)	(-4.10)	(-4.11)
Leverage	-0.092	-0.063	-0.080
	(-0.13)	(-0.10)	(-0.13)
MtB	0.026	0.026	0.025
	(1.10)	(1.09)	(1.10)
Profit	0.627	0.630	0.629
	(1.46)	(1.46)	(1.46)
Issuance	-0.131	-0.128	-0.133
	(-0.51)	(-0.50)	(-0.52)
FRQ1	-0.003	-0.003	-0.003
	(-1.39)	(-1.28)	(-1.30)
Stdev_Cashflow	0.355*	0.359*	0.364*
	(1.80)	(1.77)	(1.80)
Stdev_Sales	1.385***	1.357***	1.381***
	(2.90)	(2.90)	(2.90)
Oper_Cycle	0.637**	0.631**	0.640**
	(2.11)	(2.11)	(2.12)
Inst_Own	0.388	0.366	0.405
	(0.62)	(0.60)	(0.66)
Analyst_Following	-0.277	-0.266	-0.272
	(-1.49)	(-1.42)	(-1.47)
Distance_to_SEC	-0.101	-0.097	-0.070
	(-1.39)	(-1.40)	(-0.94)

Auditor_Share	-1.845	-1.791	-1.666
	(-1.18)	(-1.15)	(-1.09)
Auditor_Tenure	-0.036**	-0.035**	-0.036**
	(-2.35)	(-2.32)	(-2.33)
Office_Size	-0.451***	-0.465***	-0.457***
	(-2.95)	(-2.96)	(-2.95)
GC_Dummy	0.775	0.886	0.763
	(1.52)	(1.55)	(1.40)
State, Industry, Year, and Auditor Fixed Effects	Yes	Yes	Yes
N	17,017	17,017	17,017
Pseudo R^2	0.119	0.118	0.118

Table 4: Effects of Exogenous Shocks to Influential Committee Seniority on Financial Misconduct Enforcement

This table presents coefficients from logit regressions examining the effect of an exogenous decrease in firms' influential committee representation on the likelihood that the firms will be subject to SEC enforcement for financial misconduct. We match firms that experience an exogenous departure to their influential committee membership with similar out-of-state firms that do not experience the same shock. The dependent variable is Δ*Enforcement* and the independent variable of interest is set to one if the firm loses a senior (Column 1) or a non-senior (Column 2) committee member, respectively. All control variables are in change form. All variables are defined in Appendix A. z-values are in parentheses. Standard errors are Huber-White sandwich estimator clustered at the firm level. All specifications include fixed effects for state, industry, year, and auditor. Statistical significance at the 1%, 5%, and 10% levels is denoted by ***, **, and *, respectively.

	(1)	(2)
Dependent Variable:	**ΔEnforcement**	
Constant	-4.652***	-4.725***
	(-9.70)	(-9.82)
Senior_Drop	**0.407*** **	**-**
	(2.77)	
Non-Senior Drop	**-**	**0.253**
		(1.31)
ΔPolitical_Contribution	0.075*	0.072*
	(1.90)	(1.91)
ΔLobby_SEC	-0.332	-0.335
	(-1.50)	(-1.51)
ΔSize	-0.366*	-0.405*
	(-1.88)	(-1.82)
ΔLeverage	-1.377	-1.390
	(-0.60)	(-0.66)
ΔMtB	0.011	0.011
	(1.22)	(1.20)
ΔProfit	0.369	0.368
	(1.11)	(1.11)
ΔIssuance	0.380	0.385
	(1.01)	(1.06)
ΔFRQ1	-0.007	-0.008
	(-1.22)	(-1.41)
ΔStdev_Cashflow	1.549*	1.555*
	(1.88)	(1.92)
ΔStdev_Sales	0.992*	0.985*
	(1.75)	(1.85)
ΔOper_Cycle	1.971**	1.992**
	(2.28)	(2.25)
ΔInst_Own	0.355	0.362
	(0.18)	(0.20)
ΔAnalyst_Following	-0.150	-0.152
	(-1.07)	(-1.22)
ΔAuditor_Share	1.505	1.506
	(0.88)	(0.88)
ΔAuditor_Tenure	-0.017**	-0.018**
	(-2.08)	(-2.21)
ΔOffice_Size	-0.588*	-0.590*
	(-1.79)	(-1.80)
ΔGC_Dummy	0.301	0.280
	(1.25)	(1.30)
State, Industry, Year, and Auditor Fixed Effects	Yes	Yes
N	538	538
Pseudo R^2	0.216	0.134

Table 5: Counterfactual Tests: Non-Influential Committee Seniority

This table presents coefficients from logit regressions examining the relation between negative shocks to the power of a firm's representation on powerful committees that have no jurisdiction over financial misconduct regulation and changes in the likelihood that those firms are subject to SEC investigations for financial misconduct. The dependent variable is an indicator variable that captures whether a firm is subject to enforcement (Δ*Enforcement*). Column 1 (2) presents results from a specification in which the variable of interest is the change in senior (non-senior) membership on non-influential committees respectively. All independent variables are in changes. z-values are in parentheses. Standard errors are Huber-White sandwich estimator clustered at the firm level. All specifications include fixed effects for state, industry, year, and auditor. Statistical significance at the 1%, 5%, and 10% levels is denoted by ***, **, and *, respectively. All variables are defined in Appendix A.

	(1)	(2)
Dependent Variable:	**ΔEnforcement**	
Constant	-4.533***	-4.709***
	(-9.75)	(-9.88)
Senior Drop OtherComm	**0.113**	**-**
	(0.92)	
Non-Senior Drop OtherComm	**-**	**-0.085**
		(-1.03)
ΔPolitical Contribution	0.076*	0.072*
	(1.90)	(1.90)
ΔLobby SEC	-0.319	-0.322
	(-1.47)	(-1.51)
ΔSize	-0.375*	-0.386*
	(-1.91)	(-1.82)
ΔLeverage	-1.403	-1.405
	(-0.68)	(-0.66)
ΔMtB	0.013	0.013
	(1.33)	(1.35)
ΔProfit	0.370	0.366
	(1.22)	(1.20)
ΔIssuance	0.392	0.388
	(0.93)	(0.91)
ΔFRQ1	-0.007	-0.008
	(-1.25)	(-1.40)
ΔStdev Cashflow	1.541*	1.555*
	(1.85)	(1.92)
ΔStdev Sales	0.103*	0.999*
	(1.87)	(1.92)
ΔOper Cycle	1.975**	1.972**
	(2.12)	(2.30)
ΔInst Own	0.351	0.366
	(0.18)	(0.20)
ΔAnalyst Following	-0.157	-0.152
	(-1.10)	(-1.28)
ΔAuditor Share	1.515	1.510
	(0.88)	(0.99)
ΔAuditor Tenure	-0.020**	-0.018*
	(-2.15)	(-2.13)
ΔOffice Size	-0.582*	-0.580*
	(-1.81)	(-1.88)
ΔGC Dummy	0.310	0.305
	(1.28)	(1.26)
State, Industry, Year, and Auditor Fixed Effects	Yes	Yes
N	7,000	9,972
Pseudo R^2	0.053	0.086

Table 6: Influential Committee Power and Penalty on Financial Misconduct

This table presents OLS regression results of the effect of influential committee power on the penalty for financial misconduct. The dependent variable is Penalty$, which is the log of monetary penalty imposed by SEC/DOJ on the firm/employees. Columns 1-3 present results from tests using each of the three measures of influential committee member power, respectively. All variables are defined in Appendix A. Standard errors are Huber-White sandwich estimator clustered at the firm level. All specifications include fixed effects for state, industry, and year. Statistical significance at the 1%, 5%, and 10% levels is denoted by ***, **, and *, respectively.

	(1)	(2)	(3)
Dependent Variable:		**Penalty$**	
Constant	7.830**	7.040*	7.182**
	(2.26)	(1.90)	(2.12)
Total_Seniority	**-0.125****	**-**	**-**
	(-2.52)		
Committee_Num	**-**	**-0.280****	**-**
		(-2.31)	
Seniority_Dum	**-**	**-**	**-1.028*****
			(-2.75)
Political_Connection	-2.719**	-2.390*	-2.590*
	(-2.10)	(-1.88)	(-1.93)
Political_Contribution	-0.095*	-0.100*	-0.100*
	(-1.67)	(-1.67)	(-1.69)
Lobby_SEC	-0.519**	-0.420**	-0.422**
	(-2.40)	(-2.23)	(-2.08)
IncomeInflation$	0.881***	0.952***	0.988***
	(3.50)	(3.83)	(3.80)
Litigation Risk	0.959	1.055	1.041
	(0.90)	(0.96)	(0.99)
Size	0.382	0.418	0.422
	(1.10)	(1.28)	(1.10)
Leverage	-2.130	-2.132	-2.266
	(-0.99)	(-0.95)	(-1.06)
MtB	0.166	0.168	0.170
	(1.11)	(1.09)	(1.15)
Inst_Own	1.656*	1.292*	1.555*
	(1.82)	(1.72)	(1.77)
Analyst_Following	0.202	0.241	0.179
	(0.48)	(0.42)	(0.37)
Distance_to_SEC	-0.380	-0.355	-0.220
	(-1.53)	(-1.30)	(-1.07)
State, Industry, Auditor, and Year Fixed Effects	Yes	Yes	Yes
N	251	251	251
Adjusted R^2	0.276	0.275	0.265

Table 7: Congressional Committee Membership Shocks and Financial Reporting Quality

This table presents evidence from analysis examining the association between changes in financial reporting quality for firms that experience negative shocks to their influential committee representation, relative to firms in other states. *t*-values are in parentheses. The dependent variable is set to annual changes in *FRQ1*, *FRQ2*, or *FRQ3*. All independent variable are changes. Standard errors are Huber-White sandwich estimator clustered at the firm level. All specifications include fixed effects for state, industry, year, and auditor. Statistical significance at the 1%, 5%, and 10% levels is denoted by ***, **, and *, respectively. All variables are defined in Appendix A.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Dependent Variable:	**ΔFRQ1**	**ΔFRQ2**	**ΔFRQ3**	**ΔFRQ1**	**ΔFRQ2**	**ΔFRQ3**	**ΔFRQ1**	**ΔFRQ2**	**ΔFRQ3**
Constant	0.010	0.012	0.025	0.011	0.014	0.022	0.015	0.016	0.020
	(1.30)	(1.60)	(1.50)	(1.22)	(1.60)	(1.52)	(1.31)	(1.56)	(1.52)
Senior_Drop	**-0.106****	**-0.010****	**-0.055****	-	-	-	-	-	-
	(-2.50)	**(-2.25)**	**(-2.42)**						
Non-Senior Drop	-	-	-	**-0.033**	**-0.001**	**-0.009**	-	-	-
				(-0.90)	**(-0.35)**	**(-0.71)**			
Senior_Drop_OtherComm	-	-	-	-	-	-	**-0.011**	**-0.002**	**-0.005**
							(-1.01)	**(-0.66)**	**(-0.93)**
ΔPolitical_Contribution	-0.002*	-0.001*	-0.003**	-0.002*	-0.001*	-0.003**	-0.003**	-0.002**	-0.003**
	(-1.78)	(-1.88)	(-2.28)	(-1.77)	(-1.86)	(-2.29)	(-2.12)	(-2.15)	(-2.25)
ΔLobby_SEC	-0.045	-0.013	-0.025	-0.037	-0.020	-0.017	-0.047	-0.022	-0.029
	(-0.67)	(-0.40)	(-0.82)	(-0.72)	(-0.60)	(-0.62)	(-0.71)	(-0.75)	(-0.82)
ΔSize	0.012	0.009*	0.001	0.010	0.009*	0.001	0.015*	0.007*	0.002
	(1.60)	(1.79)	(1.06)	(1.50)	(1.80)	(1.13)	(1.91)	(1.82)	(1.50)
ΔLeverage	-0.006	-0.006	-0.039	-0.007	-0.007	-0.042	-0.009	-0.009	-0.056*
	(-1.20)	(-1.20)	(-1.60)	(-1.26)	(-1.20)	(-1.55)	(-1.42)	(-1.50)	(-1.73)
ΔMtB	0.001	0.001*	0.001*	0.001*	0.001*	0.001*	0.001	0.002	0.001
	(1.61)	(1.71)	(1.70)	(1.73)	(1.75)	(1.71)	(1.40)	(1.35)	(1.22)
ΔProfit	0.003*	0.008*	0.005**	0.003*	0.008*	0.005**	0.005*	0.007*	0.007**
	(1.88)	(1.90)	(2.35)	(1.88)	(1.90)	(2.37)	(1.90)	(1.80)	(2.30)
ΔIssuance	0.011*	0.010**	0.009**	0.009*	0.011**	0.010**	0.012*	0.015**	0.012**
	(1.90)	(2.32)	(2.11)	(1.80)	(2.30)	(2.18)	(1.91)	(2.25)	(2.33)
ΔStdev_Cashflow	-0.480*	-0.232**	-0.328**	-0.472*	-0.250**	-0.320*	-0.302*	-0.315**	-0.288**
	(-1.82)	(-2.33)	(-1.98)	(-1.85)	(-2.32)	(-1.91)	(-1.77)	(-2.28)	(-2.10)
ΔStdev_Sales	-0.178**	-0.011**	-0.030**	-0.171**	-0.011**	-0.033**	-0.145**	-0.015**	-0.022**
	(-2.12)	(-2.22)	(-2.30)	(-2.20)	(-2.18)	(-2.30)	(-2.13)	(-2.15)	(-2.11)
ΔOper_Cycle	-0.040*	-0.025*	-0.011**	-0.038*	-0.024*	-0.011**	-0.035*	-0.030*	-0.015**
	(-1.90)	(-1.75)	(-2.32)	(-1.88)	(-1.71)	(-2.35)	(-1.78)	(-1.79)	(-2.25)
ΔInst_Own	-0.023	-0.001	-0.031	-0.025	-0.001	-0.029	-0.022	-0.001	-0.036
	(-0.62)	(-1.05)	(-0.72)	(-0.60)	(-1.01)	(-0.63)	(-0.95)	(-1.10)	(-0.99)

ΔAnalyst_Following	0.010*	0.002*	0.008*	0.011*	0.002*	0.009*	0.010*	0.006*	0.001*
	(1.76)	(1.71)	(1.73)	(1.85)	(1.76)	(1.80)	(1.91)	(1.85)	(1.72)
ΔAuditor_Share	0.125	0.046*	0.066	0.111	0.051*	0.060	0.151*	0.058*	0.068*
	(1.42)	(1.90)	(1.61)	(1.40)	(1.88)	(1.40)	(1.67)	(1.91)	(1.69)
ΔAuditor_Tenure	-0.002	-0.001	-0.001	-0.002	-0.001	-0.001	-0.001	-0.001	-0.002
	(-0.86)	(-0.46)	(-0.20)	(-0.90)	(-0.33)	(-0.30)	(-0.59)	(-0.33)	(-0.50)
ΔOffice_Size	0.003	0.003	0.007	0.003	0.003	0.006	0.004	0.005	0.005
	(0.29)	(0.41)	(0.59)	(0.30)	(0.45)	(0.56)	(0.55)	(0.71)	(0.91)
ΔGC_Dummy	-0.004	-0.004	-0.006	-0.004	-0.004	-0.007	-0.005	-0.006	-0.009
	(-1.17)	(-1.20)	(-1.16)	(-1.22)	(-1.25)	(-1.20)	(-1.55)	(-1.59)	(-1.46)
State, Industry, Year, and Auditor Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N	538	538	538	538	538	538	7,000	7,000	7,000
Adjusted R^2	0.082	0.106	0.112	0.080	0.103	0.108	0.075	0.091	0.092

Table 8: Subcommittee Seniority and Enforcement Against Financial Misconduct

This table presents coefficients from logit regressions examining the relation between the power of firms' influential subcommittee representation and the likelihood that the firms are subject to SEC enforcement for financial misconduct. The dependent variable is *Enforcement* and the independent variable of interest is set to one of our three measures of influential subcommittee power. All variables are defined in Appendix A. z-values are in parentheses. Standard errors are Huber-White sandwich estimator clustered at the firm level. All specifications include fixed effects for state, industry, year, and auditor. Statistical significance at the 1%, 5%, and 10% levels is denoted by ***, **, and *, respectively.

	(1)	(2)	(3)
Dependent Variable:		**Enforcement**	
Constant	-7.119***	-7.223***	-7.645***
	(-8.03)	(-8.59)	(-8.55)
Total_Seniority_Sub	**-0.025****	**-**	**-**
	(-2.55)		
Total_Seniority_NonSub	**-0.005***	**-**	**-**
	(-1.88)		
Committee_Num_Sub	**-**	**-0.142****	**-**
		(-2.42)	
Committee_Num_NonSub	**-**	**-0.040***	**-**
		(-1.82)	
Seniority_Dum_Sub	**-**	**-**	**-0.178****
			(-2.43)
Seniority_Dum_NonSub	**-**	**-**	**-0.050***
			(-1.85)
Political_Connection	0.623**	0.701**	0.702**
	(2.20)	(2.30)	(2.33)
Political_Contribution	0.041**	0.048**	0.046**
	(2.20)	(2.27)	(2.11)
Lobby_SEC	-0.020	-0.025	-0.021
	(-1.09)	(-1.22)	(-1.16)
Litigation Risk	0.755	0.777	0.766
	(1.50)	(1.47)	(1.37)
Size	-0.430***	-0.430***	-0.435***
	(-3.89)	(-4.01)	(-4.19)
Leverage	-0.096	-0.060	-0.078
	(-0.28)	(-0.16)	(-0.17)
MtB	0.021	0.029	0.025
	(0.87)	(1.15)	(1.11)
Profit	0.619	0.619	0.637
	(1.40)	(1.42)	(1.42)
Issuance	-0.147	-0.133	-0.126
	(-0.78)	(-0.57)	(-0.56)
FRQ1	-0.003	-0.003	-0.003
	(-1.26)	(-1.29)	(-1.28)
Stdev_Cashflow	0.360*	0.369*	0.361*
	(1.82)	(1.88)	(1.79)
Stdev_Sales	1.412***	1.321***	1.369***
	(2.88)	(2.72)	(2.86)
Oper_Cycle	0.627**	0.637**	0.637**
	(2.22)	(2.12)	(2.16)
Inst_Own	0.360	0.348	0.396
	(0.67)	(0.66)	(0.69)
Analyst_Following	-0.265	-0.259	-0.261
	(-1.32)	(-1.51)	(-1.38)
Distance_to_SEC	-0.106	-0.112	-0.073

	(-1.43)	(-1.32)	(-0.99)
Auditor_Share	-1.776	-1.756	-1.657
	(-1.01)	(-0.98)	(-1.12)
Auditor_Tenure	-0.035**	-0.032**	-0.037**
	(-2.25)	(-2.18)	(-2.30)
Office_Size	-0.456***	-0.455***	-0.442***
	(-2.77)	(-2.82)	(-2.82)
GC_Dummy	0.752	0.879	0.758
	(1.50)	(1.50)	(1.32)
F-test: Subcommittee = Non-Subcommittee	*3.88***	*2.81**	*2.75**
State, Industry, Year, and Auditor Fixed Effects	*Yes*	*Yes*	*Yes*
N	17,017	17,017	17,017
Pseudo R^2	0.119	0.118	0.118

Table 9: House and Senate Influential Committee Seniority and Enforcement Against Financial Misconduct

This table presents coefficients from logit regressions examining the relation between the power of firms' influential committee representation in the House and Senate and the likelihood that the firms are subject to SEC enforcement for financial misconduct. The dependent variable is *Enforcement* and the independent variable of interest is set to one of our three measures of influential committee power. All variables are defined in Appendix A. z-values are in parentheses. Standard errors are Huber-White sandwich estimator clustered at the firm level. All specifications include fixed effects for state, industry, year, and auditor. Statistical significance at the 1%, 5%, and 10% levels is denoted by ***, **, and *, respectively.

	(1)	(2)	(3)
Dependent Variable:	**Enforcement**		
Constant	-9.873***	-8.147***	-8.243***
	(-4.40)	(-5.37)	(-5.08)
Total_Seniority_House	**-0.020****	-	-
	(-2.54)		
Total_Seniority_Senate	**-0.013****	-	-
	(-2.29)		
Committee_Num_House	-	**-0.112****	-
		(-2.06)	
Committee_Num_Senate	-	**-0.078****	-
		(-2.13)	
Seniority_Dum_House	-	-	**-0.182****
			(-2.48)
Seniority_Dum_Senate	-	-	**-0.107****
			(-2.41)
Political_Connection	0.692**	0.702**	0.698**
	(2.31)	(2.28)	(2.30)
Political_Contribution	0.046*	0.046*	0.045*
	(1.94)	(1.93)	(1.91)
Lobby_SEC	-0.015	-0.023	-0.022
	(-1.16)	(-1.26)	(-1.24)
Litigation Risk	0.645	0.661	0.661
	(1.09)	(1.14)	(1.13)
Size	-0.429***	-0.422***	-0.430***
	(-3.78)	(-3.73)	(-3.82)
Leverage	-0.129	-0.028	-0.029
	(-0.18)	(-0.04)	(-0.04)
MtB	0.024	0.026	0.026
	(1.00)	(1.08)	(1.07)
Profit	0.017	0.010	0.020
	(0.42)	(0.27)	(0.49)
Issuance	0.143	0.137	0.111
	(0.75)	(0.72)	(0.59)
FRQ1	-0.003	-0.003	-0.003
	(-1.22)	(-1.24)	(-1.28)
Stdev_Cashflow	0.580*	0.535*	0.507*
	(1.68)	(1.69)	(1.66)
Stdev_Sales	1.369***	1.322***	1.349***
	(2.79)	(2.81)	(2.80)

Oper_Cycle	0.586**	0.589**	0.599**
	(2.05)	(2.02)	(2.10)
Inst_Own	0.472	0.397	0.397
	(0.75)	(0.63)	(0.63)
Analyst_Following	-0.265	-0.276*	-0.276*
	(-1.64)	(-1.71)	(-1.72)
Distance_to_SEC	-0.076	-0.051	-0.061
	(-1.02)	(-0.71)	(-0.86)
Auditor_Share	-1.767	-1.701	-1.783
	(-1.36)	(-1.36)	(-1.37)
Auditor_Tenure	-0.037**	-0.037**	-0.038**
	(-2.42)	(-2.38)	(-2.47)
Office_Size	-0.492***	-0.478***	-0.484***
	(-3.21)	(-3.13)	(-3.13)
GC_Dummy	0.415	0.467	0.537
	(1.15)	(1.09)	(1.19)
F-test: House Effect = Senate Effect	*1.04*	*0.54*	*1.53*
State, Industry, Year, and Auditor Fixed Effects	Yes	Yes	Yes
N	17,017	17,017	17,017
Pseudo R^2	0.113	0.110	0.112