

Audit Committee–CFO Political Dissimilarity and Financial Reporting Quality*

Robert Felix, Sattar Mansi, and Mikhail Pevzner

Abstract

Although a large literature in accounting examines the role that audit committees play in the oversight of the financial reporting process, little is known about how the interactions between the audit committee as a group and top management affects financial reporting choices. In this study, we investigate the effect of an important type of group dynamic, namely the political dissimilarity between the audit committee and the CFO, on financial reporting quality. Using a large sample of hand-collected political donation data, we find that audit committee–CFO political dissimilarity is associated with lower likelihoods of financial restatements, lower likelihood of material weaknesses, and lower audit fees. Importantly, these positive financial reporting quality outcomes exist even after controlling for other features of the audit committee–CFO relationship, namely gender, age, and relative power, local ideological heterogeneity, and CEO ideological dissimilarity with both the audit committee and the CFO. Further testing shows that the effects of CFO–political dissimilarity on financial reporting quality is salient in settings within the purview of the audit committee where decisions are inherently complex, can be subjective, and are more likely to be associated with disagreements with management–goodwill impairments, tax avoidance, and pro-forma reporting. Overall, our results suggest that heterogeneity in political beliefs between audit committee members and the CFO is valuable.

Keywords: Audit Committee; Chief Financial Officer, Political Ideology; Political Dissimilarity; Financial Reporting Quality

JEL Classifications: M40, M41

January 12, 2022

* Felix is at The Catholic University of America (email: felixr@cua.edu), Mansi is at Virginia Tech (email: smansi@vt.edu—Corresponding Author), and Pevzner is at FINRA and the University of Baltimore (email: mpevzner@ubalt.edu). The authors thank Vic Naiker, John Wald, Joanna Wu, and seminar participants at the SEC for valuable comments and suggestions that helped improve the paper. Pevzner gratefully acknowledges the assistance of EY Chair in Accounting at the University of Baltimore. The remaining errors are ours.

1. Introduction

Audit committees play an important role in firm governance, and especially in the oversight of the financial reporting process (see e.g., Cohen, Krishnamoorthy, and Wright 2004). Prior studies examining audit committee effectiveness mostly focus on the impact of committee composition using proxies such as independence, financial expertise, size, and individual member attributes (age, tenure, and gender) on financial reporting quality (see e.g., Beasley et al., 2000; McMullen and Raghunandan 1996; Wilbanks, Hermanson, and Sharma 2017). However, recent research suggests that audit committees do not operate in silos—they act in concert with top management. For instance, Gendron, Bedard, and Gosselin (2004) argue that the primary role of the audit committee lies in its ability to ask challenging questions of its management. Similarly, Beasley et al. (2009) document that even though there is evidence that audit committees have the basic governance ingredients to perform their oversight responsibilities, a great deal of variability in the functioning of audit committees remains when using a combination of formal and informal deliberations among its members and similarly when interacting with top management, and especially the CFO. More recently, Lisic et al. (2019) find that the balance of power between the audit committees and the CFO affects the accuracy of material weakness reporting. Overall, these studies suggest that when assessing factors that contribute to the effectiveness of audit committees, considering the interpersonal dynamics of its members and its outside interactions with top management is essential.

In this paper, we study the effect of an important dimension of group dynamics in the audit committee—CFO relationship, namely political ideological heterogeneity (hereafter “political dissimilarity”), on firms’ financial reporting quality. We focus on political beliefs because it reflects an individual’s personal psychological traits (Barnea and Schwartz 1998), which manifest themselves differently between the two ideological extremes (Jost, Nosek, and Gosling 2008). The psychology literature establishes that an individual’s ideological orientation captures variation in a set of several traits including risk aversion, uncertainty, and acceptance of or resistance to change that cannot be easily proxied by other individual characteristics (see e.g., Gupta and Wowak 2017; Hibbing, Smith, and Alford 2013; Jiang, Kumar, and Law 2016; Jost 2017). Because personal characteristics represent proxies that capture cognitive frames or values, these attributes can have significant effects on firm outcomes (Carpenter, Geletkanycz, and Sanders 2004).

From an intergroup perspective, it is theoretically unclear whether political dissimilarity between the audit committee and the CFO should have a positive or negative effect on financial reporting

quality. On the one hand, differences in audit committee–CFO political preferences could improve the quality of monitoring by bringing a greater range of backgrounds and viewpoints that might result in more effective decision-making (Malenko 2014). For instance, Westphal and Zajac (1995) find that boards with similar backgrounds to the CEO tend to award more generous compensation packages, suggesting that similarity breeds affinity, which dulls skepticism. McPherson, Smith-Lovin, and Cook (2001), in survey research on homophily in social networks, argue there is considerable tendency for adults to associate with those of their own political orientations. Political dissimilarities, in this case, could reduce the degree of friendliness and bonding between the two parties and increase active monitoring, and this could aid the audit committee in its interactions with the CFO.

On the other hand, audit committee–CFO political dissimilarity could have a negative effect on financial reporting quality because groups whose members have heterogeneous beliefs are sometimes unable to find common ground because their assumptions and perspectives are too far apart, possibly leading to deadlock (Donaldson, Malenko, and Piacentino 2020). Adams, Akyol, and Verwijmeren (2018) argue that directors with shared backgrounds and experiences can improve communication and facilitate decision-making, which could result in better monitoring and ultimately better firm values. Similarly, recent work in the context of social ties where individuals share a social bond shows that groups prioritize ideologies, trust, caring, and socioeconomic benefits and these exchange relationships influence firm outcomes (e.g., Clark and Mills 1979; Ingram and Roberts 2000; Perry 1998). Ultimately, whether dissimilarity has a positive or a negative effect on financial reporting quality is an open empirical question.

We measure each audit committee member’s political ideology based on their tendency to donate to the two major parties in the U.S.—Democratic or Republican—using their political contributions, which are known to reveal their ideological preferences (Gupta and Wowak 2017; Jiang et al. 2016). We focus on the two main parties because they saliently capture the ideological divide between liberals and conservatives (Green, Palmquist, and Schickler 2004). Our derived political ideology score is an index compiled using the average of four components that captures the intensity, persistence, scope, and commitment of the member’s ideological orientation over time (Gupta and Wowak 2017). We then compute the level of political dissimilarity between the audit committee and the CFO as the average Euclidean distance between the audit committee as a whole and the CFO (Evans et al. 2021; Lee, Lee, and Nagarajan 2014).

Using a large sample of 19,659 observations over the period 2001–2017, we find that firms with political dissimilarity between the audit committee and the CFO are associated with higher financial reporting quality. These firms are less likely to restate their financial statements, less likely to report material weaknesses, and they have lower audit fees. The latter finding is possibly due to the fact that firms with audit committee–CFO political dissimilarity are less likely to have reporting failures as they pose a lower audit risk to auditors, and are thus charged lower fees. These results are robust to the inclusion of firm, audit, and board-specific controls, and to the political homophily index proposed by Lee et al. (2014). Lee et al. document that homogeneity in political beliefs between independent directors and the CEO has negative consequences on firm valuation—greater likelihood of accounting fraud and lower Tobin’s Q. Collectively, our results indicate that political dissimilarity in the audit committee–CFO relationship is a distinct and incremental phenomenon.

Although the results so far suggest that political dissimilarity has an effect on group dynamics, it remains unclear whether heterophily is due to actual political dissimilarity or dissimilarity on other social characteristics that are correlated with political beliefs. Therefore, in our next set of tests we consider a series of confounding factors in our setting. First, a firm’s CEO can exert influence over both the audit committee and the CFO in the financial reporting process (Bishop, DeZoort, and Hermanson 2017). Thus, we control for the political dissimilarity between the audit committee and the CEO, and between the CEO and the CFO, and find similar results. Second, prior research found that other dimensions in the audit committee–CFO relationship, namely gender, age difference, relative power, and homogeneity of locality, could have an effect on firm outcomes (Lee et al. 2014). Adams and Funk (2012) argue that men and women differ in their attitudes toward risk, and this may be particularly valuable in bad times (Kirk and Gwin 2009). Age difference is related to skill and experience, which can affect group dynamics (Chevalier and Ellison 1999). Relative power, or difference in tenure, is associated with the power imbalance between the audit committee and the CFO (Srinidhi, Gul, and Tsui 2011; Beck and Mauldin 2014; Francis et al. 2015). Lastly, because boards tend to recruit members from the local business community, it could be argued that political dissimilarity simply reflects the political homogeneity of the locality where the firm is headquartered (Knyazeva, Knyazeva, and Masulis 2011). Collectively, we show that audit committee–CFO political dissimilarity captures a distinct and unique effect on financial reporting quality that is not explained by other social characteristics such as gender, age difference, relative tenure, and local political ideology.

One concern with this study is that our findings could be attributed to endogeneity where firms with higher ex-ante financial reporting quality are more likely to select executives and audit committee members who are ideologically dissimilar. Thus, we employ a two-stage least squares regression using two instruments that satisfy both the relevance and exclusion conditions. The first is based on the average for each dissimilarity variable in the focal firm's industry excluding the focal firm. We expect that a firm is likely to be influenced by industry norms when staffing its boards and executive positions, but such an effect should not be correlated with financial reporting choices (Carter, Franco, and Gine 2017). The second is related to state political polarization computed as the average DW-Nominate score of the two senators in the firm's home state in a given year (McCarty, Poole, and Rosenthal 1997). This measure is designed to track legislators' ideological positions over time and will likely be related to political dissimilarity at the firm level but unlikely to be correlated with financial reporting quality. The findings from our two-stage models corroborate with our main results and suggest that endogeneity is unlikely a major factor in our setting. For completeness, we also control for prior year's financial reporting quality measures to capture any unobserved historical factors that determine reporting outcomes, and to the inclusion of lagged dissimilarity variables (e.g., Cheng 2008; Wooldridge 2013) and find similar results.

Next, we examine possible settings within the purview of the audit committee where dissimilarity could be salient—namely, goodwill impairment, tax avoidance, and pro-forma earnings. Because executives set the “tone at the top” in the firm, organizational choices are at least partially a reflection of personal characteristics of top management (Hambrick and Mason 1984). Our first test focuses on goodwill impairment choices because these decisions are inherently complex, can be subjective, and are generally resisted by management (Li and Sloan 2017; Beatty and Weber 2006). Impairment calculations rely on fair value estimates of the business unit, which themselves are subject to estimated parameters such as future cashflows, discount rates, and time horizons. To that end, management typically tries to utilize the fogginess around impairment assessments to delay recognition (Ramanna and Watts 2012). In fact, management is often resistant to goodwill impairments because they can be associated with sharp declines in share prices, and can have personal consequences for executives that can result in lower compensation or tarnished reputations (Gu and Lev 2011). We contend that audit committee–CFO disagreements could aid the audit committee in challenging the CFO's assertions regarding impairment. Indeed, we find that audit committee–CFO political dissimilarity is associated with a higher likelihood of goodwill impairments. Our results suggest that audit committees that do

not share the same beliefs and ideology as the CFO are less likely to bond and thus are more inclined to challenge management's assertions on the impairment and properly assess it.

We also examine the effect of political dissimilarity on firm tax avoidance. While management has an incentive to minimize tax payments to increase shareholder value (Hanlon and Heitzman 2010), this process can be impaired by rising agency problems (e.g., engaging in self-serving behavior, reduced transparency, and long-term reputational losses). Prior research documents that personal traits affect firm tax aggressiveness. For example, Dyreng et al. (2010) follow the movements of 908 executives (including CEOs, CFOs, and other top managers) that were employed by more than one firm and find personal attributes have a significant influence on the level of tax avoidance beyond that of firm characteristics. Olsen and Stekelberg (2016) find that CEO narcissism is positively related to the likelihood of a CEO's firm engaging in aggressive tax avoidance, while Christensen et al. (2015) find that managerial conservatism is negatively related to corporate tax avoidance. Law and Mills (2017) argue that managers with military experience engage in less tax avoidance because this activity may violate common values. We posit that political heterogeneity between the audit committee and the CFO reduces the agency problems associated with tax reporting. Our results are consistent with this conjecture and support the idea that team political dissimilarity is associated with lower tax avoidance.

Lastly, we investigate pro-forma reporting because it is a popular way to convey information to investors that recalculate non-GAAP earnings by typically excluding expenses from the income statement. Consequently, these exclusions will inflate pro-forma earnings (see, e.g., Doyle, Lundholm, and Soliman 2003). Accordingly, management has a strong incentive to make its pro-forma earnings appear favorable while the SEC has repeatedly called for the audit committee to assert its authority in reviewing this reporting issue (Clayton, Teotia, and Hinman 2019). Dissimilarity could thus allow for deeper scrutiny and serve as additional oversight of management. We find that political dissimilarity between the audit committee and the CFO are each associated with pro-forma income that closely resembles their GAAP income, suggesting fewer expense exclusions. Collectively, the findings above indicate that political dissimilarity is especially salient in areas of significant judgment and complexity and where management has a strong incentive to misreport.

Our paper is related to, but distinct from, Lee et al. (2014), who examine the alignment in political orientation between independent directors and the CEO. Instead, we consider political dissimilarity between the audit committee, a specialized panel tasked with reporting oversight rather than strategic direction, and the CFO. Nevertheless, we control for their homogeneity measure in all of our analyses

and find similar results. In addition, Lee et al. show that independent director–CEO political homogeneity is associated with a higher likelihood of accounting fraud, proxied by shareholder lawsuits. However, because shareholder lawsuits represent an extreme negative event, these lawsuits can be a noisy measure of financial reporting quality. Alternatively, we examine more generalizable measures of reporting quality. Although our audit committee–CFO political dissimilarity results are incremental to the Lee et al. measure in all tests, their variable is only marginally associated with the probability of a restatement, evidence that the independent directors–CEO relationship is unlikely to have an outsized effect on reporting outcomes. Furthermore, our measure of political ideology is more comprehensive than Lee et al.’s homogeneity measure (which proxies for political beliefs using the ratio of net donation made to Republican candidates scaled by total donations made to both Republican and Democrat candidates) in that it considers four dimensions of political beliefs that capture the intensity, persistence, scope, and commitment of an individual’s political ideology (Gupta and Wowak 2017).

We contribute to the recent literature on the effect of group dynamics on financial reporting quality in two important ways. First, we identify an under-researched yet important determinant of financial reporting quality: political dissimilarity between the audit committee and the firm’s CFO. We show that this relationship is consequential to financial reporting decisions. In doing so, we add to the growing literature that suggests individual personal characteristics, as captured by political beliefs, affect various economic outcomes (e.g., Chin, Hambrick, and Treviño 2013; Christensen et al. 2015; Gupta and Wowak 2017; Jiang et al. 2016). Second, we contribute to the corporate governance literature by revealing factors that affect the relationship between the audit committee and the CFO. By documenting that political dissimilarity strengthens the audit committee’s oversight, our findings suggest that such heterogeneity aids the committee in more capably fulfilling its duties. These results are important for practitioners, and especially board chairs who decide how to best make audit committees more effective, in this case adding board members with more divergent political perspectives that can enhance internal debate.

2. Motivation

The accounting literature has long attempted to identify factors that contribute to the effectiveness of audit committees. Prior research in this area mostly tests the association between audit committee composition such as size, independence, financial expertise, and individual member attributes (e.g., age, tenure, gender) and the quality of internal audit, external audit, and firm financial information.

This research is based on either agency theory (Jensen and Meckling 1976; Fama and Jensen 1983), which is used to understand the impact of audit committee independence on financial reporting quality, or resource dependence theory (Boyd, 1990; Salancik and Pfeffer, 1978), which emphasizes the relevance and importance of financial experts (Cohen, Krishnamoorthy, and Wright 2008; Sharma et al. 2011).

Another line of inquiry in the audit committee literature investigates the effects of additional factors related to committee dynamics governing the functioning, behavior, and decision-making process. These factors consider not only the interactions occurring within the audit committee but also those with the other important actors in the firm. The rationale is that audit committees do not normally operate in a vacuum; rather, they act in concert with top management. This suggests that even in the presence of strict regulations requiring the independence of members, other tacit characteristics can influence audit committee effectiveness. For instance, the audit committee is dependent on the CFO for nearly all of its information to conduct its oversight (e.g., Beasley et al. 2009; Cohen et al. 2004; Gendron et al. 2004). Indeed, some evidence exists that the relationship between the audit committee and the CFO can affect firm outcomes. In particular, two separate studies that construct interviews with auditors document that CFOs affect the audit committee decision-making process (Cohen, Krishnamoorthy, and Wright 2010; Dodgson et al. 2020). Empirical findings using archival studies complement this work by documenting that powerful CFOs exert influence over the audit committee's selection of the auditor and internal control reporting (Beck and Mauldin 2014; Lisic et al. 2019). Although relative power is an important component of the audit committee–CFO relationship, and one we empirically control for as described below, we argue that how the audit committee and CFO interact warrants further investigation.

We focus on political dissimilarity because political ideology is associated with a set of personal traits that inversely vary between the two main ideological streams, namely liberals and conservatives (Jost 2006). For instance, liberally inclined individuals tend to be more comfortable with risk, novelty, change, and uncertainty while individuals with a conservative ideology are more likely to prefer less risk, stability, and certainty (Jost et al. 2003; Jiang et al. 2016). However, the effect of political dissimilarity is unclear, ex-ante. Individuals who share similar beliefs tend to be more accepting of, and are naturally sympathetic to, each other's viewpoint (Zhang 2019). As a result, these individuals tend to be less critical of each other. For instance, research found directors that share the same ideology as the CEO are poor monitors and grant overly generous compensation packages that are less dependent

on firm performance (Westphal and Zajac 1995). This suggests that similarity in values and beliefs breeds affinity among group members, which can dull their oversight abilities.

Audit committee–CFO dissimilarity can also have a negative effect on firms’ financial reporting quality because their perspectives are too different. A group of individuals whose members have divergent beliefs can deadlock on problems because their starting assumptions and perspectives are too far apart to find common ground (Donaldson et al. 2020). To that end, Adams et al. (2018) argue that directors with similar backgrounds communicate more effectively, which leads to more efficient decision-making, better monitoring quality, and ultimately higher firm value. Similarly, when individuals share social bonds, they tend to have higher levels of trust (see, e.g., Clark and Mills 1979; Ingram and Roberts 2000; Perry 1998). Altogether, there is evidence to suggest that group homogeneity can reduce divisiveness and deadlock (Pfeffer 1983; Zenger and Lawrence 1989), which can potentially improve team efficiencies and lead to better oversight (Hambrick, Cho, and Chen 1996). In this case, ideological dissimilarity can adversely affect the audit committee–CFO relationship.

Alternatively, political dissimilarity between the audit committee and the CFO could be an important factor in aiding the committee to challenge the CFO. Specifically, ideological dissimilarity implies that the audit committee and the CFO have divergent inherent beliefs, which could mean that the audit committee will need to ask more questions of the CFO, collect more information and deliberate more thoroughly to fully understand the CFO’s position. Likewise, given that audit committee members should be skeptical of the CFO and maintain a “trust but verify” attitude (Gendron et al. 2004) and that groups with diverse perspectives are less subject to “group think” (Bond and Smith 1996), political dissimilarity with the CFO could sharpen the audit committee’s monitoring effectiveness. In this case, audit committee–CFO dissimilarity should have a positive effect on audit committee effectiveness and financial reporting quality. Consequently, the effect of political dissimilarity between the audit committee and the CFO is an open empirical question. This leads to our main hypothesis presented in the null form.

Hypothesis: Political dissimilarity between audit committees and the CFO is not associated with higher financial reporting quality.

In addition to examining the effects of CFO–audit committee political dissimilarity on financial reporting quality, we consider the effect of this relationship on additional reporting outcomes that are subject to the audit committee oversight, namely goodwill impairment recognition, tax reporting, and

pro-forma earnings. We focus on these outcomes because they typically require additional judgment, are complex, can be subjective, and in each case, management has a strong incentive to report them more aggressively.

3. Sample, Variable Measurements, and Descriptive Statistics

3.1. Data Sources and Sample

We utilize five databases to analyze the effect of dissimilarity between audit committee members and the CFO on financial reporting quality: Federal Election Commission (FEC) database for political donation information, Institutional Shareholder Services (ISS) and ExecuComp databases for audit committee member and CFO information, Compustat Industrial Annual database for firm-specific financial information, and Audit Analytics database for audit-related information.

For each audit committee member and CFO in our dataset, we collect political contribution information by matching their first name, last name, and employer from ISS/ExecuComp with data from the FEC files. We collect CEO data for additional analysis described below in section 4.2.2. The FEC database houses all political contributions over \$200 made to federal campaigns, political committees, or Political Action Committees (PACs) on its website (www.fec.gov). We extract political contribution reports for the period 1990–2017 to allow a long enough time horizon to capture donation patterns and consistency. Our focus is on donations made to the Democratic or Republican parties only because these are the two major ideological frameworks in contemporary American politics (Schwartz 2013). We then employ a computer algorithm that requires strict matches based on the full name and employer of the donor. Of a total of 15,213 unique audit committee members available in ISS, we match political contributions to 6,832 members. Similarly, of a total of 5,038 CFOs and 5,102 CEOs present in ExecuComp, we match political contributions to 1,048 CFOs and 1,655 CEOs, respectively. We subsequently merge this matched political donation data with Audit Analytics and Compustat to arrive at the final sample of 19,659 firm-year observations covering the period 2001–2017. Our sample begins in 2001 because Audit Analytics data starts at that time.

3.2. Variable Measurements

In this section, we describe the measurement of our main political dissimilarity variables, financial reporting quality variables, and various controls. We also outline our empirical strategy for examining the effect of dissimilarity between the audit committee and the CFO on financial reporting quality. A description of the variables used in the analysis is provided in Table 1.

Political Dissimilarity Variables. We classify each audit committee member and CFO as Republican or Democrat using their political donation history. Given there are legal limits on contributions, an individual's political donations are unlikely to garner any particular private benefit (Ensley 2009). Rather, those contributions are viewed as an expression of ideology (Ansolabehere, De Figueiredo, and Snyder 2003), which represents an approximation of an individual's personal beliefs and attitudes concerning risk, uncertainty, and novelty seeking (Dodd et al. 2012). We follow Gupta and Wowak (2017) and measure political ideology as the average of four components: (i) number of donations to Republicans scaled by the total number of donations, (ii) total amount of Republican donations scaled by the total amount of donations, (iii) number of distinct years donating to Republicans scaled by the total number of distinct years donating, and (iv) number of distinct Republican recipients of political donations scaled by the number of total distinct recipients. This index creates a composite score that captures the intensity, persistence, scope, and commitment of an individual's political ideology over time. We then assign each audit committee member and CFO an ideology score based on these four measures. This composite ranges from 0 to 1 with higher values signifying more conservative leanings and lower values indicating liberal inclinations.

We treat non-donating individuals in our sample (audit committee members, CFOs, and CEOs) as politically moderate by assigning them an ideology score of 0.50 (e.g., Christensen et al. 2015; Jiang et al. 2016). The implicit assumption that non-donating individuals are politically moderate has been validated by Chin et al. (2013), who employ a survey of executives and find a positive correlation between their donation-based ideology score and executives' responses. Nonetheless, our results are quantitatively similar without the inclusion of moderates. We also assume that director political ideology is time invariant because ideology tends to be stable over an individual's adult life (Green et al. 2004). This approach has the benefit of allowing sufficient time to accurately observe the ideological expression of each individual over the period.

After we compute individual ideology scores for each audit committee member, CFO, and CEO, we then construct a dissimilarity measure that reflect the levels of ideological dissimilarity in political beliefs for each firm in our sample. We compute *AC-CFO Dissimilarity* as the absolute value of the

normalized Euclidean distance between dissimilarity in political ideology between the CFO and audit committee members. That is

$$AC-CFO\ Dissimilarity = \frac{1}{2} * |CFO\ Ideology - AC\ Ideology| \quad (1)$$

where *AC Ideology* is the average political ideology score of the audit committee members. Note that while each director's ideology score is time invariant, the political ideology of the entire committee is not, as audit committee members exit and join the committee over time. Equation (1) describes the measure of *AC-CFO Dissimilarity* for any given firm-year observation. An *AC-CFO Dissimilarity* value of 0 indicates perfect agreement in political beliefs between the audit committee and the CFO, while a value of 0.5 indicates the maximum dissimilarity or opposing views.

Financial Reporting Quality Variables. We use three measures related to financial reporting quality as dependent variables in our analysis: restatement, material weakness, and audit fees. *Restatement* is a dummy variable that equals 1 if the firm announces a financial restatement in the current year. This variable captures the incidence of reporting failure (Dechow, Ge, and Schrand 2010). *Material Weakness* is a dummy variable that equals 1 if the firm reports a material weakness under SOX Section 404. A material weakness indicates a possibility exists that a deficiency, or combination of deficiencies in internal controls over financial reporting, will result in not detecting or preventing a material misstatement in a timely manner (Cheng, Felix, and Indjejikian 2019). Thus, the presence of ICFR material weakness proxies for lower financial reporting quality as it suggests the reported financial statements may be unreliable. Lastly, we use *Audit Fees* as a proxy for reporting quality because firms that have lower financial reporting risk tend to pay lower audit fees (Gul, Chen, and Tsui 2003).

Control Variables. The remaining variables are firm-, board-, and audit committee-specific controls. Firm-specific controls include firm size, leverage, segment, sales growth, loss dummy, foreign dummy, and profitability. *Firm size*, a proxy for economies of scale and life cycle, is measured as the natural log of total assets. *Leverage*, a proxy for financial health, is measured as the ratio of total debt to total assets. *Segments*, a proxy for firm complexity, is computed as the number of segments where the firm operates. *Sales growth* is the firm's annual percentage growth in revenue between year t and $t-1$. *Loss Carryforward* is a dummy variable that equals 1 if income before extraordinary items in year t or $t-1$ is negative. *Profitability* is the firm's return on assets. To ensure that outliers are not driving any of our results, we winsorize all continuous variables at the 1% level.

We also include several board and audit committee characteristics to specifically control for the governance of the committee in our setting (Anderson, Mansi, and Reeb 2004). Board-related controls include *Independent Directors*, computed as the ratio of independent directors to total directors, *AC Committee Size*, measured as the number of members on the audit committee, *Outside Board Seats*, calculated as the average number of outside board seats held by audit committee members, and *Financial Expert*, the number of financial experts on the audit committee. Variables related to committee size, financial expertise, and experience from other board seats can affect the effectiveness of the audit committee (Vafeas 2005). Audit-specific controls include *Big4 Auditor*, or a dummy variable that equals 1 if the auditor is from a Big 4 auditing firm. In the *Audit Fees* specification, we also control for two audit-related variables: *Audit Delay*, or the number of days between the audit report date and the firm's fiscal year-end, and *Going Concern*, whether the firm received a going concern opinion (Bills, Cunningham, and Meyers 2016; Amin, Eshleman, and Feng 2018).

Lastly, Lee et al. (2014) find that ideological similarity between the CEO and all independent directors is associated with a higher likelihood of a class-action securities litigation. While our interest is political dissimilarity between the audit committee (the subset of independent directors responsible for reporting) and the CFO, their finding implies that political affinity between the CEO and the independent directors could affect financial reporting outcomes, which could potentially confound our setting. Accordingly, we control for their political homophily index (*PHI ID-CEO*), computed as one minus the absolute value of the difference between CEO ideology and the average independent director ideology score divided by two. Thus, by controlling for *PHI (ID-CEO)*, we can determine the incremental effect of *AC-CFO Dissimilarity* on financial reporting.

3.3. Summary Statistics

Table 2 presents our summary statistics. Included are the mean, median, standard deviation, 25th percentile, and 75th percentile for the variables used in the analysis. Panel A of Table 2 provides univariate statistics of our political ideology measures and their four individual scores (i.e., behavioral, financial, persistence, and scope) for the audit committee and the CFO. For the overall sample, audit committees have a mean political ideology score of 0.549, suggesting a slight tilt toward conservatives among donating members. The average of the four components that make up the ideology score ranges from 0.479 to 0.584. Specifically, 57% of the total dollar amount of contributions made by audit committee members are made to Republicans; 48% of the number of contributions by audit

committee members are also made to Republicans; 56% of the distinct candidates supported by audit committee members are Republicans; and 58% of the distinct years where audit committee members donate are to Republicans. These four measures capture the consistency, breadth, and scope of audit committee members' ideological commitment and form a reliable score of their political ideology (Gupta and Wowak 2017). For completeness, we also report that 18% of audit committee members exclusively donate to Republicans, while 14% donate exclusively to Democrats.

Similarly, we find that CFOs are more likely to be conservatives with an average political ideology score of 0.613. The four components have comparable means. For example, 62% of the total dollar amount of contributions made by CFOs are to Republicans, and 54% of the total number of donations made by CFOs are to Republicans. Likewise, 63% of the distinct candidates (i.e., different) supported by CFOs are Republican candidates, while 61% of the distinct years where CFOs contributed were to Republicans. Thus, the four components portray the ideological lens of CFOs. Furthermore, 46% of CFOs donate exclusively to Republicans, while 27% only donate to Democrats.

Panel B of Table 2 provides our main variables of interest as well as the control variables. The *AC-CFO Dissimilarity* measure has a mean of 0.18, which suggests some heterogeneity in political ideology between the groups. In terms of reporting quality, on average, 6.7% of the firms restate their financial statements, and 3.7% of the firms in the sample issue a material weakness. Firms pay auditors a fee of nearly \$3.5 million on average. In terms of board attributes, firms have an outside director ratio of 75%, board size of 10 members, and 3 outside board seats. The average audit committee has 4 members, and 96% of audit committees have at least one financial expert. About 93% of the firms employ a Big 4 auditor.

Firms in the overall sample tend to be large with mean, median, and standard deviation of total assets of \$14.4, \$2.6, and \$40.8 billion, respectively. The median leverage ratio is 23%, which indicates that a large portion of the sample consists of firms with medium to large long-term liabilities in their capital structure. On average, firms have profitability ratios of 5.1%, sales growth of 8.4%, market-to-book ratios of 3, operations in 12 segments, and 14.7% of the sample reported a loss in income before extraordinary items this year.

Panel C of Table 2 provides correlation coefficients between political dissimilarity and selected controls. The results show that *AC-CFO Dissimilarity* is negatively associated with the probability of a restatement, material weakness, audit fees, and whether a firm incurred an operating loss, and positively associated with firm size, independent directors, and outside board seats. The univariate results

suggest that political dissimilarity between the firm’s CFO and the audit committee is associated with higher financial reporting quality. We next examine this association in the multivariate context to test our hypotheses where we can control for other factors that could also affect these outcome variables.

4. Empirical Results

4.1. Political Dissimilarity and Financial Reporting Outcomes

Our first set of analyses examines the effect of political dissimilarity between the audit committee and the CFO (*AC-CFO Dissimilarity*) on three financial reporting quality outcomes: *Restatement*, *Material Weakness*, and *Audit Fees*. We focus on these outcome variables because they capture areas subject to regular oversight of audit committees (Bricker 2017).¹ We select control variables based on firm, audit committee, and board characteristics that are known to affect financial reporting quality. To mitigate potential problems associated with the use of panel data, we include industry and year fixed effects and estimate clustered standard errors at the firm and year levels in all regressions. Our primary specifications employ logit models for *Restatement* and *Material Weakness*, and an OLS model for *Audit Fees*. That is

$$\begin{aligned} \text{Reporting Variable}_{i,t} = & \beta_0 + \beta_1 \text{AC-CFO Dissimilarity}_{i,t} + \sum \beta_{2-14} \text{Firm and Board Controls}_{i,t} \\ & + \beta_{15} \text{PHI(ID-CEO)}_{i,t} + \beta_{16} \text{Industry FE}_{i,t} + \beta_{17} \text{Year FE}_{i,t} + \varepsilon_{i,t} \end{aligned} \quad (2)$$

where *Reporting Variable* is the financial reporting quality measure, *Firm and Board Controls* are firm-specific and board of director controls, and *PHI(ID-CEO)* is the Lee et al.’s (2014) political homophily index between independent directors and the CEO. A negative coefficient on β_1 indicates that the dissimilarity variables are associated with higher financial reporting quality.

Table 3 presents our results. Because the CFO is responsible for the production of financial information while the audit committee is charged with overseeing that information, we expect the relationship between the audit committee and the CFO to be somewhat adversarial. Across all specifications, we find statistically significant evidence that political dissimilarity between the audit committee and the CFO is associated with higher financial reporting quality. Specifically, firms with dissimilar

¹ Bricker (2017) state that “A key element of board oversight is working with management to achieve high quality financial reporting, including implementing quality accounting policies and ICFR and appointing independent external auditors to promote accurate and timely disclosure of financial information to the board, to investors and the public markets more broadly”. Thus, our outcome variables attempt to capture these three dimensions, respectively.

AC-CFO political ideologies have fewer restatements, fewer material weaknesses, and lower audit fees. In terms of economic significance, the marginal effect on the *AC-CFO Dissimilarity* coefficient in column 1 is -0.021. Given that the typical firm in our sample has a likelihood of restatement of 0.067, our result suggests that a firm with an average *AC-CFO Dissimilarity* reduces its likelihood of a restatement by 31% (-0.021/0.067). Similarly, we observe that the average sample firm reduces its likelihood of a material weakness by 56% (-0.020/0.036) and reduces audit fees by 1.3% or about \$35K (-0.189/14.389). The reduction in audit fees is consistent with prior research indicating that excessive audit fees are associated with higher financial reporting risk (e.g., Choi, Kim, and Zang 2010); this result further implies that in the presence of higher political heterogeneity the audit committees and auditors are able to agree to lower fees since the firms' restatement and material weakness likelihood is lower. In fact, columns 1 and 2 suggest that firms with higher political dissimilarity are associated with fewer reporting failures. As such, these firms have lower reporting risk from the perspective of the auditor, which explains why they are also charged lower audit fees.² Overall, the evidence indicates that *AC-CFO* political dissimilarity increases the committee's oversight leading to higher financial reporting quality.

The coefficients on the control variables are, in general, consistent with expectations. For example, profitable firms are associated with a lower likelihood of restatements, material weakness, and lower levels of audit fees. Highly levered firms and those reporting accounting losses in the current year are associated with lower financial reporting quality. The findings are also robust to the inclusion of the Lee et al. (2014) homophily measure between independent directors and the CEO (*PHI(ID-CEO)*). This measure is positive and significant albeit only for the *Restatement* specification. Lee et al. find that the homophily index is positively associated with financial fraud. Given that fraud is an extreme reporting event (Farber 2005), ex-ante, it is not clear that *PHI(ID-CEO)* would have an effect on other types of reporting outcomes. In fact, class-action litigation under the 1933 Securities Act and 1934 Exchange Act covers the gamut of potential violations, beyond violations of the accounting and mandatory disclosure rules. For example, firms are routinely sued for allegedly misleading about risk factor, cyber-security, product market disclosure, or other similar types of violations. Thus, the results in Table 3 suggest that *PHI(ID-CEO)* has only a marginal effect on the likelihood of a restatement. Nevertheless, the *AC-CFO* dissimilarity variable retains its significance in all models with *PHI(ID-CEO)*

² Beck and Mauldin (2014) find that audit fees are higher with strong audit committees because they demand higher quality audits. However, their work focuses on audit fees as the only outcome. Instead, we are looking at financial reporting quality collectively and conclude that fewer reporting failures are associated with less risk and hence lower audit fees.

as a control, which means that the relationship between the audit committee and CFO is incremental to *PHI(ID-CEO)* with respect to reporting quality. In a separate specification, we also test the difference between the coefficient of *AC-CFO Dissimilarity* and *PHI(ID-CEO)* in column 1 of Table 3 and find to be statistically significant at the 1% level, further supporting our claim that the effect of *AC-CFO Dissimilarity* on reporting is incremental to that of *PHI*.

4.2. Alternative Explanations

Next, we focus on ruling out two alternative explanations that could affect our analysis. The first deals with the possibility that the results are driven by *AC-CEO* and *CEO-CFO* political dissimilarities. The second controls for other individual dissimilarity attributes such as age, gender, power differential between the audit committee and the CFO, and local heterogeneity.

4.2.1. CEO Dissimilarity

The first alternative explanation considers the role of the firm's CEO as the ultimate decision-maker in the firm. Bishop et al. (2017) argue that the CEO can pressure both the audit committee and the CFO in issues related to financial reporting. Prior work also finds that social or personal ties between the audit committee and the CEO are associated with less monitoring (Wilbanks et al. 2017; Cassel et al. 2018). This suggests that the CEO's relationship with the audit committee and the CFO could be a factor in our setting. Thus, we examine the effect of CEO's political beliefs by controlling for the political dissimilarity between the audit committee and the CEO (*AC-CEO Dissimilarity*) and between the CEO and CFO (*CEO-CFO Dissimilarity*). This test determines whether the effect of *AC-CFO Dissimilarity* on reporting varies with the CEO's political dissimilarity with either the audit committee or the CFO.

Table 4 provides the results. Columns 1–3 include *AC-CEO Dissimilarity* and columns 4–6 include *CEO-CFO Dissimilarity*. Notably, in all columns, the *AC-CFO Dissimilarity* variable is negatively and significantly associated with all three outcome variables, which suggests that the effect of political dissimilarity between the audit committee and CFO on reporting is robust to the effect of CEO's ideological dissimilarity with either party. Moreover, we find that the coefficients on *AC-CEO Dissimilarity* are insignificant with the exception of material weakness, which has a negative coefficient at the

10% level. Similar results are obtained when we control for *CEO-CFO Dissimilarity*. Overall, the evidence of Table 3 suggests that *AC-CFO Dissimilarity* is robust to the political dissimilarity of the CEO with each party.

While the dissimilarity of ideological beliefs between the CEO and audit committee is most likely to affect our setting, we also consider the effect of the CEO's co-optation of the audit committee. Cassell et al. (2018) find that when an audit committee is co-opted by the CEO, oversight is undermined, leading to lower reporting quality. The rationale is if audit committee members feel a sense of loyalty to a CEO, they could accordingly acquiesce to the CEO. In that sense, audit committee co-optation is in line with the notion above that audit committee monitoring is hampered when objectivity is clouded. Therefore, in unreported specifications, we directly control for audit committee co-optation, computed as the proportion of audit committee members who joined the board after the appointment of the current CEO, and find that that our results are unchanged. This suggests that the effect of *AC-CFO Dissimilarity* on reporting quality is incremental to that of the audit committee co-optation.

4.2.2. *Age, Gender, and Relative Power*

The second alternative explanation that can confound our results is related to the relationship between the audit committee and the CFO. Specifically, we consider diversity in age, gender, and relative power. Adams and Ferreira (2009) argue that socio-demographic diversity within the board of directors could impact board effectiveness. Lee et al. (2014) show that these variables can impact group dynamics. Adams et al. (2018) find that age is related to skill set. Therefore, we control for differences in age and gender between the audit committee members and the CFO. We compute *Age Difference* as the absolute value of the difference between the CFO age and average audit committee member age, and *Female Presence* as a dummy variable that equals 1 if the CFO is a female or if the audit committee employs a female. Srinidhi et al. (2011) and Francis et al. (2015) show that a female either in the CFO position or on the audit committee can affect reporting outcomes. We also control for the potential power imbalances between the CFO and the audit committee (*Relative Power*) that could affect reporting outcomes (Beck and Mauldin 2014). We compute this measure as the difference between the quartile rank of the CFO's tenure and the average tenure of the audit committee members.

Another issue that could confound our setting is the ideological divide in the local area where the firm operates. If the political dissimilarity among the firm’s executives and audit committee members reflects the local ideological divides, our results could be a function of local ideology, not political dissimilarity within the firm. Therefore, we construct the local political heterogeneity variable using the county-level results of the most recent presidential election before a firm’s fiscal year-end date (*Local Heterogeneity*). This measure is computed as the absolute value of the difference between votes cast in the firm’s home county for the Republican and Democratic presidential candidate in the previous election scaled by the sum of those two vote totals as in Lee et al. (2014). This measure ranges from 0 to 1 where a value of 1 indicates the greatest degree of political heterogeneity in that locality. We collect county-level data for presidential elections from the MIT Election Lab (<https://electionlab.mit.edu/>). These results are provided in Table 5 and show that after controlling for *Local Heterogeneity* as well as *Age Difference*, *Female Presence*, and *Relative Power*, our findings are similar to those reported in Table 3. This suggests that our results are not driven by the political dissimilarities derived from where the firm resides or the components of the relationship between the audit committee and CFO.

4.3. Endogeneity

One of the main concerns with this study is that our results may be attributed to endogeneity where firms with higher ex-ante financial reporting quality are more likely to select executives and audit committee members who are ideologically different. Thus, we employ an instrumental variable regression (IV) and identify two instruments that meet the criteria of being correlated with the two dissimilarity variables (relevance) but uncorrelated with financial reporting quality (exclusion). The first is *Industry Demand*, measured as the average for *AC-CFO Dissimilarity* in the focal firm’s industry excluding the focal firm. When staffing its boards and executive positions, a firm is likely to be influenced by industry norms, but such an effect should not be correlated with financial reporting decisions (Carter et al. 2017). The second is based on the partisan polarization among Senate members in a given state. Specifically, we compute *Polarization* as the average DW-Nominate score of the two senators in the firm’s home state in a given year (McCarty et al. 1997). DW-Nominate tracks the ideological positions of each member of Congress over time. Thus, *Polarization* will likely be related to the political dissimilarity at the firm level but unlikely to be correlated with financial reporting quality.

Table 6 presents the results for the IV analysis. Column 1 reports the findings of the first-stage analysis, and Columns 2–4 show the second-stage results. We find that the instrumented variable *AC-*

CFO Dissimilarity is negative and significant in three of the reporting quality outcomes, consistent with our main findings in Table 3. Accordingly, these two tests alleviate the concern that endogeneity is a major factor in our setting. To ensure the generalizability of our results, in unreported regressions, we run two additional tests to address potential reverse causality. First, we include the prior year's financial reporting quality measures in our models as a control for any unobserved historical factors that determine that reporting outcome (Cheng 2008; Woolridge 2013) and find that our results continue to hold. As expected, the lagged reporting quality variables are positively associated with current year reporting outcomes. Thus, even after controlling for unobserved historical factors associated with reporting quality, we continue to find that political dissimilarity is a determinant of financial reporting quality. Second, we employ a lead-lag approach where political dissimilarity variables are measured at $t-1$ and find that our results are similar using this modification. Overall, the instrumental variable regressions alleviate potential endogeneity concerns in our setting.

5. Additional Analysis

5.1. Goodwill Impairment, Tax Avoidance, Pro-Forma Reporting Aggressiveness

Our next tests focus on different outcome variables within the purview of the audit committee where AC-CFO political Dissimilarity may manifest. Specifically, we examine the effect of dissimilarity on goodwill impairments, tax avoidance, and pro-forma earnings aggressiveness. The results are provided in Table 7.

5.1.1. Goodwill Impairment

We first examine the effect of political ideology dissimilarity on the likelihood of *Goodwill Impairment* because they are highly complex and typically unwelcome by management (Ramanna and Watts 2012). Firms initially record goodwill after acquiring another entity. A firm subsequently records a goodwill impairment if the reporting unit's book value decreases relative to its fair value. Because goodwill impairments are often the result of deteriorating performance of the acquired business unit, they often reflect a failed investment strategy (Hayn and Hughes 2006), are typically preceded and also followed by sharp declines in share prices (Gu and Lev 2011), and can result in lower pay for managers (Darrough, Guler, and Wang 2014).

We argue that dissimilarity could affect goodwill impairments because these decisions rely on inherently subjective estimates supplied by management (Ramanna and Watts 2012), which can manipulate these estimates for personal gain reasons. For example, they can use excessively optimistic valuation assumptions in goodwill estimates to maximize its compensation or beat analyst estimates (see, e.g., Glaum, Landsman, and Wyrwa 2018). For instance, the fair value estimates are based on discounting future cashflows of the unit, which assumes some future action by management. Also, managers actively use their discretion to avoid reporting an impairment to preserve their reputation and compensation (Beatty and Weber 2006).³ For this reason, audit committees are commonly expected to question management on its goodwill valuations.⁴ In fact, goodwill is one of the financial reporting areas most commonly expected to be reviewed by audit committees (Lipton et al. 2020). Therefore, we argue that *AC-CFO Dissimilarity* could lead to more thorough deliberations about the underlying estimates supplied and more willingness by the audit committee to challenge management's position. Given management's aversion to reporting goodwill impairment, we posit that impairments are an ideal setting to showcase the potential value of audit committee–CFO dissimilarity on reporting.

We define *Goodwill Impairment* as a dummy variable that equals 1 if the firm reported such an impairment. We also compute several controls related to impairment following prior literature (Ramanna and Watts 2012; Carcello et al. 2020). *Goodwill* is the percentage of goodwill compared to non-goodwill assets. *Restructure* is a dummy variable that equals 1 if the firm underwent a restructuring during the year. *M&A Activity* is a dummy variable that equals 1 if the firm engaged in merger and acquisition activity. *Stock Return* is the common equity return over the current year. *Other Asset Write-downs* is a dummy variable that equals 1 if the firm wrote down any non-goodwill assets during the year. *Stock Return Volatility* is the standard deviation of the firm's monthly stock return over the prior five years. *Market-to-Book* is the ratio of the market values of assets (market values of equity plus book value of debt) scaled by its book value. *Low M/B* is a dummy variable that equals 1 if *Market-to-Book* ratio is below 1. This analysis is conducted for the period after 2003, when the SFAS 142 went into full effect (Beatty and Weber 2006; Shephardson 2019).

The results are provided in column 1 and show that *AC-CFO Dissimilarity* is positively and significantly related to the likelihood of a *Goodwill Impairment*. Although CFOs are reluctant to acknowledge

³ For example, Hayn and Hughes (2006) document that most impairments are untimely, occurring at least three to four years after they should have occurred.

⁴ See, for example, a recent Protiviti blog on the matter: <https://www.jdsupra.com/legalnews/blog-what-issues-should-be-on-the-2021-2313850/>; Accessed on July 6, 2021.

impairments, our result documents that political dissimilarity between the audit committee and the CFO is beneficial as it allows the audit committee to pressure and scrutinize the CFO on goodwill impairment decisions.

5.1.2. *Tax Avoidance*

In the course of attempting to minimize their tax payments, firms may employ aggressive tactics that are likely to be scrutinized by the proper authorities (Hanlon and Heitzman 2010). However, audit committees generally must approve tax services.⁵ Audit committees are routinely expected to discuss tax planning changes, as they relate to audit risks facing their firms (e.g. EY Center for Board Matters, 2019). Accordingly, given that firms have an incentive to minimize their tax payments but that effective corporate governance can reduce tax avoidance (Richardson, Taylor, and Lanis 2013), we argue that political dissimilarity between the audit committee and CFO can serve as an additional check that constrains the tax aggressiveness of the firm. Similar to Donohoe and Knechel (2014), we code *Tax Avoidance* equal to 1 if the firm's cash effective tax rate or GAAP effective tax rate is in the lowest quintile of the firm's industry (SIC two-digit) and year. Cash effective tax rate is total cash taxes paid divided by taxable income while GAAP effective tax rate is total tax expense divided by taxable income. Both effective tax rate variables are computed over a six-year period following Donohoe and Knechel (2014). Thus, *Tax Avoidance* captures firms that employ the most aggressive tax techniques to minimize their taxes. We include tax-specific controls following Wilson (2009) and Dyreng et al. (2010). *Pre-Tax ROA* is income before tax divided by assets in year t-1. *NOL* is a dummy variable that equals 1 if the firm has a net loss carryforward, *Foreign* is a dummy variable that equals 1 if the firm has foreign operations, and *R&D Ratio* is total research and development expenses divided by lagged total assets.

Column 2 presents the results. We find that *AC-CFO Dissimilarity* is negatively and significantly associated with *Tax Avoidance*. Given that management tends to have strong incentives to avoid taxes, our results suggest that dissimilarity between the audit committee and CFO serves as a restraint on aggressive tax strategies.

⁵ See SEC guidance on auditor independence: <https://www.sec.gov/info/accountants/audit042707.htm>.

5.1.3 Pro-Forma Reporting Aggressiveness

Lastly, we look at the role of more aggressive reporting of non-GAAP pro-forma earnings (hereafter “pro-forma earnings”). Disclosing pro-forma earnings is a popular way to convey information to investors where the firm calculates a non-GAAP earnings figure that typically excludes certain expenses from the income statement. Consequently, these exclusions tend to inflate the reported levels of pro-forma earnings to investors (Doyle et al. 2003). Naturally, management has a strong incentive to make the firm appear favorably with the pro-forma earnings. However, the SEC, taking notice of this incentive, has repeatedly emphasized the importance of oversight by the audit committee over non-GAAP pro-forma reporting (Clayton et al. 2019). Accordingly, we argue that political dissimilarity between the audit committee and CFO can serve as a check on management’s incentive to inflate pro-forma earnings. *Pro-Forma Earnings* is coded 1 if the difference between earnings per share per IBES and Compustat is above the median of the firm’s industry (SIC 2-digit) in a given year (Doyle et al. 2003). In this analysis, we also control for the total number of analysts following the firm. *Pro-Forma Earnings* captures firms that are more aggressive in excluding items from their pro-forma earnings relative to their industry peers.

In column 3, we find that *AC-CFO Dissimilarity* is negatively correlated with *Pro-Forma Earnings* aggressiveness. This suggests that dissimilarity between the audit committee and CFO serves as a type of additional oversight on the inclinations of management. Overall, the results in Table 7 provide evidence that political dissimilarity is especially salient in financial reporting–related situations that require judgment and where management has a strong incentive to “misreport.”

5.2. Sensitivity Tests

In this section, we consider the robustness of our analysis to alternative specifications. We first examine a different method for calculating political dissimilarity. We recalculate the dissimilarity within the audit committee as the sum of the absolute value of the average difference between the political ideology score of each pair of audit committee members, divided by audit committee size. Similarly, we recalculate the dissimilarity between the CFO and audit committee as the sum of the absolute value of the average difference between the political ideology score of the CFO and each member of the

audit committee, divided by two. Our rationale is that examining the average ideological distance between each pair could produce variations that impact our analysis. We re-examine the results in Table 3 with these alternative measures and our results are unchanged in the unreported analysis.

Next, we examine the effect of our empirical strategy of coding non-donating individuals as ideologically moderate. Similar to Hutton, Jiang, and Kumar (2014), we designate political non-donors as moderates and re-examine the dissimilarity-reporting quality relation. This methodology has also been validated in survey research by Chin et al. (2013). Also, if we improperly coded individuals as ideologically moderate it would introduce noise into our analysis, which biases against us finding statistical significance. Nonetheless, for completeness, we re-examine the results in Table 3, but exclude observations where the audit committee members or the CFO were designated as moderate. In untabulated analysis, we find that our results are quantitatively similar.

6. Conclusion

Using a sample of 19,659 firm-year observations from 2004 to 2017, we show that political dissimilarity between the audit committee and the CFO has a discernable effect on financial reporting quality. Specifically, our findings suggest that audit committee–CFO political heterogeneity is associated with a lower likelihood of restatements and material weaknesses, and lower audit fees. The results are robust to controlling for a host of confounding factors such as the effect of dissimilarity with the CEO, audit committee–CFO relative power, gender and age diversity, and the political dissimilarity of the firm’s location. Additional analyses show that political dissimilarity is associated with a higher likelihood of goodwill impairment recognition, lower tax aggressiveness, and higher quality pro-forma earnings. Collectively, the evidence indicates that the audit committee’s effectiveness is associated with the interpersonal dynamics of its members and interpersonal interactions with the audit committee and the CFO.

Our research has potential practical applications. For one, our study should be of relevance to regulators and other rule-making bodies, those who advocate that diversity is consequential to firm stakeholders, and those generally concerned with best governance practices. At a recent conference, SEC Commissioner Allison Lee argued that diversity is an important determinant of corporate governance, evidenced by an increasing body of knowledge documenting that board diversity, proxied by

director age, gender, race, financial expertise, and the number of directorships, correlates with enhanced performance.⁶ In June 2021, SEC included a board diversity rulemaking project on its Annual Regulatory Agenda.⁷ We add to this debate by examining another dimension of diversity, namely political dissimilarity, and show that heterogeneity in political beliefs between the committee and the CFO is associated with better financial reporting quality. Our findings should also be of interest to board chairs when deciding how to best staff audit committees to make them more effective. In this case, adding board members with more divergent political perspectives will likely contribute to better internal debate.

⁶ See <https://www.sec.gov/news/speech/lee-cii-2020-conference-20200922>. Accessed on July 6, 2021.

⁷ See <https://www.sec.gov/news/press-release/2021-99>; Accessed on July 6, 2021.

References

- Adams, R. B., Akyol, A. C., & Verwijmeren, P. (2018). Director skill sets. *Journal of Financial Economics*, 130(3), 641-662.
- Adams, R. B., & Ferreira, D. (2009). Women in the boardroom and their impact on governance and performance. *Journal of Financial Economics*, 94(2), 291-309.
- Amin, K., Eshleman, J. D., & Feng, C. 2018. The effect of the SEC's XBRL mandate on audit report lags. *Accounting Horizons*, 32(1): 1-27.
- Anderson, R. C., Mansi, S. A., & Reeb, D. M. (2004). Board characteristics, accounting report integrity, and the cost of debt. *Journal of Accounting and Economics*, 37(3), 315-342.
- Ansolabehere, S., De Figueiredo, J. M., & Snyder Jr, J. M. (2003). Why is there so little money in US politics? *Journal of Economic Perspectives*, 17(1), 105-130.
- Barnea, M. F., & Schwartz, S. H. (1998). Values and voting. *Political Psychology*, 19(1), 17-40.
- Beasley, M., Carcello, J., Hermanson, D., & Lapidies, P. D. (2000). Fraudulent financial reporting: considerations of industry traits and corporate governance mechanisms. *Accounting Horizons*, 14(3), 441-454.
- Beasley, M. S., Carcello, J. V., Hermanson, D. R., & Neal, T. L. (2009). The audit committee oversight process. *Contemporary Accounting Research*, 26(1), 65-122.
- Beatty, A., & Weber, J. (2006). Accounting discretion in fair value estimates: An examination of SFAS 142 goodwill impairments. *Journal of Accounting Research*, 44(2), 257-288.
- Beck, M. J., & Mauldin, E. G. (2014). Who's really in charge? Audit committee versus CFO power and audit fees. *The Accounting Review*, 89(6), 2057-2085.
- Bills, K. L., Cunningham, L. M., & Myers, L. A. 2016. Small audit firm membership in associations, networks, and alliances: Implications for audit quality and audit fees. *The Accounting Review*, 91(3), 767-792
- Bishop, C. C., DeZoort, F. T., & Hermanson, D. R. (2017). The effect of CEO social influence pressure and CFO accounting experience on CFO financial reporting decisions. *Auditing: A Journal of Practice & Theory*, 36(1), 21-41.
- Bond, R., & Smith, P. B. (1996). Culture and conformity: A meta-analysis of studies using Asch's (1952b, 1956) line judgment task. *Psychological Bulletin*, 119(1), 111-137.
- Boyd, B. (1990). Corporate linkages and organizational environment: A test of the resource dependence model. *Strategic Management Journal*, 11(6), 419-430.
- Bricker, W. (2017). Remarks before the University of Tennessee's C. Warren Neel Corporate Governance Center: "Advancing the Role and Effectiveness of Audit Committees". Available at:

- <https://www.sec.gov/news/speech/bricker-university-tennessee-032417>. Accessed on July 6, 2021.
- Carcello, J. V., Neal, T. L., Reid, L. C., & Shipman, J. E. (2020). Auditor independence and fair value accounting: An examination of nonaudit fees and goodwill impairments. *Contemporary Accounting Research*, 37(1), 189-217.
- Carpenter, M. A., Geletkanycz, M. A., & Sanders, W. G. (2004). Upper echelons research revisited: Antecedents, elements, and consequences of top management team composition. *Journal of Management*, 30(6), 749-778.
- Carter, M. E., Franco, F., & Gine, M. (2017). Executive gender pay gaps: The roles of female risk aversion and board representation. *Contemporary Accounting Research*, 34(2), 1232-1264.
- Cassell, C. A., Myers, L. A., Schmardebeck, R., & Zhou, J. (2018). The monitoring effectiveness of co-opted audit committees. *Contemporary Accounting Research*, 35(4), 1732-1765.
- Cheng, S. (2008). Board size and the variability of corporate performance. *Journal of Financial Economics*, 87(1), 157-176.
- Cheng, S., Felix, R., & Indjejikian, R. (2019). Spillover effects of internal control weakness disclosures: The role of audit committees and board connections. *Contemporary Accounting Research*, 36(2), 934-957.
- Chevalier, J., & Ellison, G. (1999). Career concerns of mutual fund managers. *The Quarterly Journal of Economics*, 114(2), 389-432.
- Chin, M., Hambrick, D. C., & Treviño, L. K. (2013). Political ideologies of CEOs: The influence of executives' values on corporate social responsibility. *Administrative Science Quarterly*, 58(2), 197-232.
- Choi, J. H., Kim, J. B., & Zang, Y. (2010). Do abnormally high audit fees impair audit quality? *Auditing: A Journal of Practice & Theory*, 29(2), 115-140.
- Christensen, D. M., Dhaliwal, D. S., Boivie, S., & Graffin, S. D. (2015). Top management conservatism and corporate risk strategies: Evidence from managers' personal political orientation and corporate tax avoidance. *Strategic Management Journal*, 36(12), 1918-1938.
- Clark, M. S., & Mills, J. (1979). Interpersonal attraction in exchange and communal relationships. *Journal of Personality and Social Psychology*, 37(1): 12-24.
- Clayton, J., Teotia, S., & Hinman, M. (2019). Statement on role of audit committees in financial reporting and key reminders regarding oversight responsibilities. Available at: <https://www.sec.gov/news/public-statement/statement-role-audit-committees-financial-reporting>.
- Cohen, J. R., Krishnamoorthy, G., & Wright, A. (2004). The corporate governance mosaic and financial reporting quality. *Journal of Accounting Literature*, 23(1), 87-152.

- Cohen, J. R., Krishnamoorthy, G., & Wright, A. M. (2008). Form versus substance: The implications for auditing practice and research of alternative perspectives on corporate governance. *Auditing: A Journal of Practice & Theory*, 27(2), 181-198.
- Cohen, J. R., Krishnamoorthy G., & Wright, A. (2010). Corporate governance in the post Sarbanes-Oxley era: Auditors' experiences. *Contemporary Accounting Research*, 27(3): 751-786.
- Darrrough, M. N., Guler, L., & Wang, P. (2014). Goodwill impairment losses and CEO compensation. *Journal of Accounting, Auditing & Finance*, 29(4), 435-463.
- Dechow, P., Ge, W., & Schrand, C. (2010). Understanding earnings quality: A review of the proxies, their determinants and their consequences. *Journal of Accounting and Economics*, 50(2-3), 344-401.
- Dodd, M. D., Balzer, A., Jacobs, C. M., Gruszczynski, M. W., Smith, K. B., & Hibbing, J. R. (2012). The political left rolls with the good and the political right confronts the bad: Connecting physiology and cognition to preferences. *Philosophical Transactions of the Royal Society B: Biological Sciences*, 367(1589), 640-649.
- Dodgson, M. K., Agoglia, C. P., Bennett, G. B., & Cohen, J. R. (2020). Managing the auditor-client relationship through partner rotations: The experiences of audit firm partners. *The Accounting Review*, 95(2), 89-111.
- Donaldson, J. R., Malenko, N., & Piacentino, G. (2020). Deadlock on the board. *Review of Financial Studies*, 33(10), 4445-4488.
- Donohoe, M. P., & Knechel, W. R., 2014. Does corporate tax aggressiveness influence audit pricing? *Contemporary Accounting Research*, 31(1), 284-308.
- Doyle, J. T., Lundholm, R. J., & Soliman, M. T. (2003). The predictive value of expenses excluded from pro forma earnings. *Review of Accounting Studies*, 8(2-3), 145-174.
- Dyreng, S. D., Hanlon, M., & Maydew, E. L. (2010). The effects of executives on corporate tax avoidance. *The Accounting Review*, 85(4), 1163-1189.
- Ensley, M. J. (2009). Individual campaign contributions and candidate ideology. *Public Choice*, 138(1-2), 221-238.
- Evans, R. B., Prado, M. P., Rizzo, A. E., & Zambrana, R. (2021). The performance of diverse teams: Evidence from U.S. mutual funds. Available at SSRN 3505619.
- EY Center for Board Matters (2019). What audit committees need to know at the end of 2019. Available at: https://assets.ey.com/content/dam/ey-sites/ey-com/en_us/topics/cbm/ey-end-2019-what-audit-committees-need-to-know.pdf ; Accessed on July 6, 2021.
- Fama, E. F., & Jensen, M. C. (1983). Separation of ownership and control. *The Journal of Law and Economics*, 26(2), 301-325.
- Farber, D. B. (2005). Restoring trust after fraud: Does corporate governance matter? *The Accounting Review*, 80(2), 539-561.

- Francis, B., Hasan, I., Park, J. C., & Wu, Q. (2015). Gender differences in financial reporting decision making: Evidence from accounting conservatism. *Contemporary Accounting Research*, 32(3), 1285-1318.
- Gendron, Y., Bedard, J., & Gosselin, M. (2004). Getting inside the black box: A field study of practices in “effective” audit committees. *Auditing: A Journal of Practice & Theory*, 23(1), 153-171.
- Glaum, M., Landsman, W. R., & Wyrwa, S. (2018). Goodwill impairment: The effects of public enforcement and monitoring by institutional investors. *The Accounting Review*, 93(6), 149-180.
- Green, D. P., Palmquist, B., & Schickler, E. (2004). *Partisan hearts and minds: Political parties and the social identities of voters*. New Haven, CT: Yale University Press.
- Gu, F., & Lev, B. (2011). Overpriced shares, ill-advised acquisitions, and goodwill impairment. *The Accounting Review*, 86(6), 1995-2022.
- Gul, F. A., Chen, C. J., & Tsui, J. S. (2003). Discretionary accounting accruals, managers’ incentives, and audit fees. *Contemporary Accounting Research*, 20(3), 441-464.
- Gupta, A., & Wowak, A. J. (2017). The elephant (or donkey) in the boardroom: How board political ideology affects CEO pay. *Administrative Science Quarterly*, 62(1), 1-30.
- Hambrick, D. C., Cho, T. S., & Chen, M.-J. (1996). The influence of top management team heterogeneity on firms' competitive moves. *Administrative Science Quarterly*, 41(4), 659-684.
- Hambrick, D. C., & Mason P. A. (1984). Upper echelons: The organization as a reflection of its top managers. *The Academy of Management Review*, 9(2), 193-206.
- Hanlon, M., & Heitzman, S. (2010). A review of tax research. *Journal of Accounting and Economics*, 50(2-3), 127-178.
- Hayn, C., & Hughes, P. J. (2006). Leading indicators of goodwill impairment. *Journal of Accounting, Auditing & Finance*, 21(3), 223-265.
- Hibbing, J. R., Smith, K. B., & Alford, J. R. (2013). *Predisposed: Liberals, conservatives, and the biology of political differences*. New York & London: Routledge.
- Hutton, I., Jiang, D., & Kumar, A. (2014). Corporate policies of republican managers. *Journal of Financial and Quantitative Analysis*, 49(5-6), 1279-1310.
- Ingram, P., & Roberts, P. W. (2000). Friendships among competitors in the Sydney hotel industry. *American Journal of Sociology*, 106(2), 387-423.
- Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, 3(4), 305-360.
- Jiang, D., Kumar, A., & Law, K. K. (2016). Political contributions and analyst behavior. *Review of Accounting Studies*, 21(1), 37-88.

- Jost, J. T. (2006). The end of the end of ideology. *American Psychologist*, 61(7), 651-670.
- Jost, J. T. (2017). Ideological asymmetries and the essence of political psychology. *Political Psychology*, 38(2), 167-208.
- Jost, J. T., Glaser, J., Kruglanski, A. W., & Sulloway, F. J. (2003). Political conservatism as motivated social cognition. *Psychological Bulletin*, 129(3), 339-375.
- Jost, J. T., Nosek, B. A., & Gosling, S. D. (2008). Ideology: Its resurgence in social, personality, and political psychology. *Perspectives on Psychological Science*, 3(2), 126-136.
- Kirk, M. E., & Gwin, B. W. (2009). A diverse corporate board is more important than ever. *Corporate Board Member*, April, 7.
- Knyazeva, A., Knyazeva, D., & Masulis, R. (2011). Effects of local director markets on corporate boards. ECGI-Finance Working Paper, 315.
- Law, K. K., & Mills, L. F. (2017). Military experience and corporate tax avoidance. *Review of Accounting Studies*, 22(1), 141-184.
- Lee, J., Lee, K. J., & Nagarajan, N. J. (2014). Birds of a feather: Value implications of political alignment between top management and directors. *Journal of Financial Economics*, 112(2), 232-250.
- Li, K. K., & Sloan, R. G. (2017). Has goodwill accounting gone bad? *Review of Accounting Studies*, 22(2), 964-1003.
- Lisic, L. L., Myers, L. A., Seidel, T. A., & Zhou, J. (2019). Does audit committee accounting expertise help to promote audit quality? Evidence from auditor reporting of internal control weaknesses. *Contemporary Accounting Research*, 36(4), 2521-2553.
- Malenko, N. (2014). Communication and decision-making in corporate boards. *Review of Financial Studies*, 27(5), 1486-1532.
- Lipton, M., Robinson, E. S., Silk, D. M., Karp, D. C., Anders, D. B., Arms, M. J. E., Adams, M. J., Barkatullah, A. M., & Nagy, W. A. (2020). Audit Committee Guide. Available at: <https://www.wlrk.com/wp-content/uploads/2020/05/Audit-Committee-Guide-2020.pdf> . Accessed on July 6, 2021.
- McCarty, N. M., Poole, K. T., & Rosenthal, H. (1997). *Income redistribution and the realignment of American politics*. Washington, DC: SEI Press.
- McMullen, D. A., & Raghunandan, K. (1996). Enhancing audit committee effectiveness. *Journal of Accountancy*, 182(2), 79.
- McPherson, M., Smith-Lovin, L., & Cook, J. M. (2001). Birds of a feather: Homophily in social networks. *Annual Review of Sociology*, 27(1), 415-444.
- Olsen, K. J., & Stekelberg, J. (2016). CEO narcissism and corporate tax sheltering. *Journal of the American Taxation Association*, 38(1), 1-22.

- Perry, S. E. (1998). *Collecting garbage*. Piscataway, NJ: Transaction Books.
- Pfeffer, J. (1983). Organizational demography. *Research in Organizational Behavior*, 5, 299-357.
- Salancik, G. R., & Pfeffer, J. (1978). A social information processing approach to job attitudes and task design. *Administrative Science Quarterly*, 23(2), 224-253.
- Ramanna, K., & Watts, R. L. (2012). Evidence on the use of unverifiable estimates in required goodwill impairment. *Review of Accounting Studies*, 17(4), 749-780.
- Richardson, G., Taylor, G., & Lanis, R. (2013). The impact of board of director oversight characteristics on corporate tax aggressiveness: An empirical analysis. *Journal of Accounting and Public Policy*, 32(3), 68-88.
- Schwartz, S. (2013). Value priorities and behavior: Applying a theory of integrated value systems. In C. Seligman, J. M. Olson, & M. P. Zanna (Eds.), *The Ontario symposium on personality and social psychology, Vol. 8. The psychology of values: The Ontario symposium, Vol. 8* (pp. 1-24). Mahwah, NJ: Lawrence Erlbaum Associates.
- Sharma, V. D., Sharma, D. S., & Ananthanarayanan, U. (2011). Client importance and earnings management: The moderating role of audit committees. *Auditing: A Journal of Practice & Theory*, 30(3), 125-156.
- Shepardson, M. L. (2019). Effects of individual task-specific experience in audit committee oversight of financial reporting outcomes. *Accounting, Organizations and Society*, 74, 56-74.
- Srinidhi, B., Gul, F. A., & Tsui, J. (2011). Female directors and earnings quality. *Contemporary Accounting Research*, 28(5), 1610-1644.
- Vafeas, N. (2005). Audit committees, boards, and the quality of reported earnings. *Contemporary Accounting Research*, 22(4), 1093-1122.
- Westphal, J. D., & Zajac, E. J. (1995). Who shall govern? CEO/board power, demographic similarity, and new director selection. *Administrative Science Quarterly*, 40(1), 60-83.
- Wilbanks, R. M., Hermanson, D. R., & Sharma, V. D. (2017). Audit committee oversight of fraud risk: The role of social ties, professional ties, and governance characteristics. *Accounting Horizons*, 31(3), 21-38.
- Wilson, R. J. (2009). An examination of corporate tax shelter participants. *The Accounting Review*, 84(3), 969-999.
- Wooldridge, J. M. (2014). *Introduction to econometrics (Europe, Middle East & Africa edition)*. Boston, MA: Cengage Learning.
- Zenger, T. R., & Lawrence, B. S. (1989). Organizational demography: The differential effects of age and tenure distributions on technical communication. *Academy of Management Journal*, 32(2), 353-376.

Zhang, D. (2019). Top management team characteristics and financial reporting quality. *The Accounting Review*, 94(5), 349-375.

Table 1.
Variable Definitions

Variable Name	Definition	Source
<i>Political Ideology Related Measures</i>		
Political Ideology Score	The average of four measures: (number of donations to Republicans/total number of donations) + (amount of Republican donations/amount of total donations) + (number of distinct Republican years/total number of distinct years) + (number of distinct Republican recipients/number of total). Non-donating partners are assigned a value of 0.5. This score is computed for each individual.	FEC
AC-CFO Dissimilarity	Absolute value of the difference between the ideology score of the CFO and the average audit committee ideology score scaled by two.	FEC
AC-CEO Dissimilarity	Absolute value of the difference between the ideology score of the CEO and the average audit committee ideology score scaled by two.	FEC
CFO-CEO Dissimilarity	Absolute value of the difference between the ideology score of the CFO and the CEO ideology score scaled by two.	FEC
PHI (ID-CEO)	Political homophily index computed as one minus the absolute value of the difference between the ideology score of the CEO and the average ideology score of all independent directors scaled by two.	FEC
<i>Financial Reporting Quality Measures</i>		
Restatement	Dummy variable that equals 1 if the firm announces financial restatement in year t.	Audit Analytics
Material Weakness	Dummy variable that equals 1 if the firm reports a material weakness under SOX Section 404.	Audit Analytics
Audit Fees	Natural log of total audit fees in year t.	Audit Analytics
<i>Firm-Specific Characteristics</i>		
Firm Size	Log of market capitalization at year-end.	Compustat
Age	Log of the age of the firm in years plus one.	Compustat
Segments	The number of total segments in the firm.	Compustat
Leverage	Long-term liabilities plus short-term debt scaled by total assets.	Compustat
Sales Growth	The percentage change in sales from between year t and t-1.	Compustat
Loss Dummy	Dummy variable that equals 1 if income before extraordinary items in year t or t-1 is negative.	Compustat
Litigation	Dummy variable that equals 1 if the firm operates in a litigious industry.	Compustat
<i>Board and Audit Committee Controls</i>		
Independent Directors	The ratio of independent directors to total directors on the board of directors.	ISS
Audit Committee Size	The number of members on the audit committee.	ISS
Outside Board Seats	The total number of outside board seats held by audit committee members.	ISS
Financial Expert	Dummy variable that equals 1 if there is at least one financial expert on the audit committee.	ISS
Auditor Change	Dummy variable that equals 1 if there is an auditor change in year t.	Compustat

Office Size	Log of the total audit fees the auditor's office collects during the year.	Audit Analytics
Big 4 Auditor	Dummy variable that equals 1 if the auditor is employed by a Big 4 auditing firm.	Audit Analytics
<i>Additional Control and Cross-Sectional Variables</i>		
Age Difference	The absolute value of the difference of CFO age and the average audit committee member age, divided by two.	ISS/ExecuComp
Female Presence	Dummy variable that equals 1 if the CFO is a female or if there is a female on the audit committee.	ISS/ExecuComp
Relative Power	The difference between the quartile rank of the CFO's tenure and the quartile rank of the average tenure of the audit committee members.	ISS/ExecuComp
Local Heterogeneity	The absolute value of the difference between votes cast in the firm's home county for the Republican and Democratic presidential candidate in the previous election divided by the sum of those two vote totals.	MIT Election Lab
<i>Goodwill Impairment, Tax Avoidance, and Pro-Forma Earnings Variables</i>		
Goodwill	Total goodwill divided by the total of non-goodwill assets.	Compustat
Goodwill Impairment	Dummy variable that equals 1 if the firm reports a goodwill impairment during the year.	Compustat
Restructure	Dummy variable that equals 1 if the firm has a restructuring during the year.	Compustat
M&A Activity	Dummy variable that equals 1 if the firm has a merger or acquisition during the year.	Compustat
Stock Return	Cumulative monthly adjusted returns over the year.	CRSP
Stock Return Volatility	The standard deviation of the firm's monthly stock return over the prior five years.	CRSP
Other Asset Write-Downs	Dummy variable that equals 1 if the firm reports a write-down in non-goodwill assets.	Compustat
Market-to-Book	Market value divided by book value.	Compustat
Low M/B	Dummy variable that equals 1 if Market to Book is below 1 and 0 otherwise.	Compustat
Tax Avoidance	A dummy variable that equals 1 if the firm's cash effective tax rate or GAAP effective tax rate is in the lowest quintile of the firm's industry (SIC two-digit) and year as in Donohoe and Knechel (2014). Cash effective tax rate is total cash taxes paid divided by taxable income while GAAP effective tax rate is total tax expense divided by taxable income.	Compustat
Pre-Tax ROA	The sample median rank of income before tax divided by lagged assets.	Compustat
Loss Carryforward	Dummy variable that equals 1 if the firm has a net loss carryforward and 0 otherwise.	Compustat
Foreign	Dummy variable that equals 1 if the firm has foreign operations and 0 otherwise.	Compustat
R&D Ratio	Research and development expenses divided by lagged assets.	Compustat
Pro-Forma Earnings	Dummy variable equal 1 if earnings per share (EPS) per IBES less EPS before extraordinary and discontinued items per Compustat is above the sample median and 0 otherwise.	Compustat /IBES
Analyst Following	Natural log of the number of analysts following the firm plus one.	IBES

Notes. This table provides variables definitions for variables used in the analysis along with their data sources. FEC is the Federal Election Commission database, ISS is the Institutional Shareholder Services database, CRSP is the Center for Research in Security Prices database, Compustat is the financial information database, ExecuComp is the executive compensation database, Audit Analytics is the audit-related information database, and IBES is the Institutional Brokers Estimate System database.

Table 2
Summary Statistics

Panel A: Political Ideology Measures

	Mean	Median	Standard Devi- ation	25th Percentile	75th Percentile
<i>Audit Committee Political Ideology Measures</i>					
AC Political Ideology	0.549	0.539	0.335	0.306	0.853
AC- % Number of Donations to Republicans	0.479	0.500	0.365	0.100	0.826
AC-% Total Donation Amount to Republicans	0.571	0.583	0.346	0.326	0.913
AC- % of Distinct Years with Republican Contribution	0.584	0.600	0.337	0.333	0.914
AC- % of Distinct Republican Recipients	0.561	0.565	0.331	0.333	0.857
AC-Republican Only	0.178	0.200	0.201	0.000	0.333
AC-Democrat Only	0.140	0.000	0.180	0.000	0.250
<i>CFO Political Ideology Measures</i>					
CFO Political Ideology	0.613	0.798	0.420	0.165	1.000
CFO-% Number of Donations to Republicans	0.537	0.750	0.460	0.000	1.000
CFO- % Total Donation Amount to Republicans	0.615	0.767	0.419	0.094	1.000
CFO-% of Distinct Years with Republican Contribution	0.605	0.750	0.411	0.188	1.000
CFO-% of Distinct Republican Recipients	0.630	0.800	0.415	0.200	1.000
CFO-Republican Only	0.459	0.000	0.498	0.000	1.000
CFO- Democrat Only	0.266	0.000	0.442	0.000	1.000

Notes. Variables definitions are provided in Table 1. This panel provides descriptive statistics for our main political ideology variables.

Panel B: Sample Statistics

	Mean	Median	Standard Deviation	25th Percentile	75th Percentile
<i>Financial Reporting Quality Measures</i>					
Restatement	0.067	0.000	0.251	0.000	0.000
Material Weakness	0.036	0.000	0.185	0.000	0.000
Audit Fees (\$Millions)	3.450	1.660	5.100	0.830	3.750
<i>Political Dissimilarity Measures</i>					
AC-CFO Dissimilarity	0.175	0.133	0.169	0.039	0.250
AC-CEO Dissimilarity	0.322	0.292	0.236	0.139	0.500
CEO-CFO	0.217	0.084	0.242	0.000	0.500
PHI (ID-CEO)	0.460	0.547	0.275	0.146	0.581
<i>Firm-Specific Characteristics</i>					
Firm Size (\$Millions)	14,444	2,652	40,814	874	9,036
Segments	12.391	10.000	9.702	5.000	18.000
Leverage	0.231	0.216	0.183	0.072	0.347
Sales Growth	0.084	0.061	0.203	-0.001	0.149
Profitability	0.051	0.047	0.081	0.014	0.091
Loss Carryforward	0.147	0.000	0.354	0.000	0.000
Goodwill Impairment	0.091	0.000	0.288	0.000	0.000
Goodwill	0.123	0.064	0.145	0.001	0.200
Restructure	0.354	0.000	0.478	0.000	1.000
Stock Return	0.132	0.140	0.347	-0.040	0.320
M&A Activity	0.208	0.000	0.406	0.000	0.000
Other Asset Write-Downs	0.169	0.000	0.375	0.000	0.000
Market-to-Book	3.003	2.205	3.363	1.448	3.537
Low M/B	0.104	0.000	0.306	0.000	0.000
Tax Avoidance	0.376	0.000	0.484	0.000	1.000
Pre-Tax ROA	0.061	0.060	0.120	0.018	0.115
NOL	0.453	0.000	0.498	0.000	1.000
Foreign	0.378	0.000	0.485	0.000	1.000
R&D	0.023	0.000	0.046	0.000	0.025
Pro-Forma Earnings	0.468	0.000	0.499	0.000	1.000
Analyst Following	2.272	2.303	0.700	1.792	2.839
<i>Board- and Audit-Specific Characteristics</i>					
Independent Directors	0.749	0.778	0.146	0.667	0.875
Board Size	9.460	9.000	2.499	8.000	11.000
Audit Committee Size	3.808	4.000	1.078	3.000	4.000
Outside Board Seats	3.427	3.000	2.968	1.000	5.000
Financial Expert	1.957	2.000	1.312	1.000	3.000
Big 4 Auditor	0.927	1.000	0.259	1.000	1.000
Going Concern	0.004	0.000	0.060	0.000	0.000
Audit Delay	3.484	4.007	1.340	3.714	4.094

Notes. Variables definitions are provided in Table 1. This panel provides descriptive statistics for our financial reporting quality measures, and firm-, board-, and audit-specific variables used in the analyses. The dataset comprises 19,659 firm-year observations over the period 2001–2017.

Panel C: Correlations

	1.	2.	3.	4.	5.	6.	7.	8.	9.	10.
1. AC-CFO Dissimilarity										
2. Restatement	-0.014**	1.000								
3. Material Weakness	-0.043***	0.206***	1.000							
4. Audit Fees	-0.108***	0.055***	0.018**	1.000						
5. Firm Size	0.178***	-0.012*	-0.080***	0.729***	1.000					
6. Segments	0.078	-0.008	0.029***	0.2214***	0.030***	1.000				
7. Loss Carryforward	-0.047***	0.044***	0.082***	-0.065***	-0.153***	0.025***	1.000			
8. Independent Directors	0.016**	0.011*	-0.049***	0.343***	0.216***	-0.042***	-0.041***	1.000		
9. Financial Experts	0.056***	0.005	-0.087***	0.412***	0.289***	-0.031***	-0.094***	0.382***	1.000	
10. Outside Board Seats	0.052***	-0.012*	-0.044***	0.392***	0.321***	0.173***	-0.007	0.232***	0.306***	1.000
11. PHI (ID-CEO)	-0.047***	0.019**	0.016**	-0.009	-0.068***	-0.042***	0.041***	-0.038***	-0.021***	-0.025***

Notes. Variable definitions are provided in Table 1. This panel provides correlations for selected variables used in the analysis. The notations *** and ** denote significance at the 1% and 5% levels, respectively.

Table 3
AC-CFO Political Dissimilarity and Financial Reporting Quality

	Dependent Variable = Financial Reporting Quality		
	Restatement	Material Weakness	Audit Fees
	(1)	(2)	(3)
AC-CFO Dissimilarity	-0.371** (-2.101)	-0.909*** (-2.656)	-0.190*** (-4.558)
Firm Size	-0.031 (-0.931)	-0.258*** (-5.782)	0.535*** (57.195)
Leverage	0.774*** (3.098)	1.175*** (3.259)	0.135** (2.266)
Sales Growth	-0.143 (-1.208)	0.107 (0.443)	-0.121*** (-4.892)
Loss Carryforward	0.417*** (6.061)	0.669*** (5.144)	0.142*** (8.424)
Profitability	-1.867*** (-5.154)	-1.882*** (-3.365)	-0.352*** (-3.935)
Segments	0.010** (2.105)	0.025*** (3.117)	0.018*** (11.751)
Independent Director	-0.353 (-0.883)	-0.865 (-1.219)	0.638*** (5.010)
Audit Committee Size	-0.150 (-1.087)	-0.237 (-1.318)	-0.039 (-0.986)
Financial Expert	-0.100 (-1.427)	-0.208* (-1.721)	0.010 (0.463)
Outside Board Seats	-0.055 (-0.910)	-0.119** (-2.082)	0.059*** (5.040)
Big 4 Auditor	0.142 (1.009)	-0.235 (-1.392)	0.090* (1.829)
PHI (ID-CEO)	0.196* (1.798)	0.142 (0.770)	0.021 (0.626)
Audit Delay			0.052*** (3.715)
Going Concern			0.182** (2.357)
Industry FE	Yes	Yes	Yes
Year FE	Yes	Yes	Yes
Observations	19,659	15,801	19,659
Pseudo R-Squared/R-Squared	0.051	0.119	0.822

Notes. Variable definitions are provided in Table 1. This table provides regression results on the relation between *AC-CFO Dissimilarity* and financial reporting quality outcomes: *Restatements*, *Material Weakness*, and *Audit Fees*. Columns 1 and 2 utilize logit specifications. Column 3 utilizes OLS specification. All models include industry and year fixed effects. Standard errors are calculated using clustering at the firm and year levels. The notations ***, **, * denote significance at the 1%, 5%, and 10% levels, respectively.

Table 4
Political Dissimilarity and Financial Reporting Quality: Top Management Controls

	AC-CEO Dissimilarity			CEO-CFO Dissimilarity		
	Restatement	Material Weakness	Audit Fees	Restatement	Material Weakness	Audit Fees
	(1)	(2)	(3)	(4)	(5)	(6)
AC-CFO Dissimilarity	-0.356** (-2.018)	-0.892*** (-2.580)	-0.195*** (-4.767)	-0.297* (-1.683)	-0.823** (-2.393)	-0.184*** (-4.455)
AC-CEO Dissimilarity	-0.173 (-1.139)	-0.422* (-1.776)	0.042 (1.182)			
CEO-CFO Dissimilarity				-0.332** (-2.376)	-0.251 (-1.309)	0.007 (0.218)
Firm Size	-0.035 (-1.082)	-0.257*** (-5.754)	0.536*** (58.774)	-0.022 (-0.654)	-0.251*** (-5.549)	0.532*** (55.753)
Leverage	0.770*** (3.252)	1.158*** (3.330)	0.145** (2.465)	0.732*** (3.011)	1.150*** (3.293)	0.135** (2.299)
Sales Growth	-0.162 (-1.287)	-0.137 (-0.411)	-0.211*** (-6.414)	-0.130 (-1.023)	-0.132 (-0.398)	-0.090*** (-3.580)
Loss Carryforward	0.406*** (5.563)	0.643*** (4.637)	0.137*** (7.969)	0.461*** (6.585)	0.646*** (4.655)	0.143*** (8.495)
Profitability	-1.760*** (-4.744)	-1.966*** (-3.375)	-0.313*** (-3.377)	-1.330*** (-4.390)	-1.933*** (-3.353)	-0.280*** (-3.505)
Segments	0.010** (2.184)	0.025*** (3.026)	0.018*** (12.174)	0.010** (2.200)	0.025*** (3.004)	0.018*** (11.664)
Independent Director	-0.215 (-0.489)	-0.851 (-1.185)	0.589*** (4.765)	-0.339 (-0.842)	-0.885 (-1.232)	0.635*** (5.211)
Audit Committee Size	-0.128 (-0.918)	-0.269 (-1.528)	-0.037 (-0.950)	-0.155 (-1.123)	-0.252 (-1.413)	-0.036 (-0.893)
Financial Expert	-0.110 (-1.517)	-0.220* (-1.775)	0.008 (0.360)	-0.095 (-1.364)	-0.221* (-1.767)	0.003 (0.118)
Outside Board Seats	-0.058 (-1.055)	-0.127** (-2.142)	0.060*** (5.151)	-0.057 (-0.946)	-0.122** (-2.092)	0.060*** (5.239)
Big 4 Auditor	0.192 (1.401)	-0.233 (-1.413)	0.086* (1.808)	0.135 (0.964)	-0.226 (-1.365)	0.097** (2.052)
PHI (ID-CEO)	0.309** (2.338)	0.376* (1.697)	0.002 (0.039)	0.131 (1.082)	0.078 (0.387)	0.026 (0.757)
Audit Delay			0.053***			0.053***

Going Concern			(3.808)			(3.777)
			0.203***			0.185**
			(2.724)			(2.226)
Industry FE	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes
Observations	19,659	15,801	19,659	19,659	15,801	19,659
R-Squared	0.051	0.116	0.822	0.051	0.119	0.822

Notes. Variable definitions are provided in Table 1. This panel presents regression results on the relation between dissimilarity and financial reporting outcomes while controlling for *AC-CEO Dissimilarity*, defined as the absolute value of the Euclidian distance between the political ideology score of the CEO and the average audit committee ideology score divided by two, and *CFO-CEO Dissimilarity*, defined as the absolute value of the Euclidian distance between the political ideology score of the CFO and CEO divided by two. Columns 1, 2, 4, and 5 utilize logit specifications. Columns 3 and 6 utilize OLS specifications. All models include industry and year fixed effects. Standard errors are calculated using clustering at the firm level. The notations ***, **, * denote significance at the 1%, 5%, and 10% levels, respectively.

Table 5
Demographics, Local Heterogeneity, and Financial Reporting Quality

	Dependent Variable = Financial Reporting Quality Measures		
	Restatement	Material Weakness	Audit Fees
	(1)	(2)	(3)
AC-CFO Dissimilarity	-0.229*	-1.024**	-0.155***
	(-1.663)	(-2.165)	(-3.592)
Age Difference	-0.016*	-0.028	-0.003
	(-1.931)	(-1.400)	(-1.389)
Female Presence	-0.190***	0.043	0.032*
	(-4.651)	(0.256)	(1.868)
Relative Power	-0.006	-0.091**	-0.003
	(-0.336)	(-2.433)	(-0.554)
Local Heterogeneity	0.376***	0.310	-0.225***
	(3.275)	(0.806)	(-4.661)
Firm Size	-0.055**	-0.309***	0.512***
	(-2.285)	(-5.173)	(56.213)
Leverage	1.089***	1.693***	0.155**
	(10.281)	(4.988)	(2.201)
Sales Growth	0.081	0.300	-0.134***
	(1.501)	(1.493)	(-4.131)
Loss Carryforward	0.355***	0.519**	0.139***
	(5.586)	(2.458)	(8.537)
Profitability	-2.058***	-2.419**	-0.335***
	(-6.086)	(-2.533)	(-3.054)
Segments	0.013***	0.003	0.017***
	(4.145)	(0.184)	(10.244)
Independent Director	-0.016	0.050	0.622***
	(-0.036)	(0.037)	(3.447)
Audit Committee Size	0.037	-0.287	-0.095**
	(0.209)	(-0.832)	(-2.016)
Financial Expert	-0.159	-0.506**	0.013
	(-1.409)	(-2.402)	(0.463)
Outside Board Seats	-0.024	-0.097	0.057***
	(-1.052)	(-1.172)	(4.018)
Big 4 Auditor	0.444***	-0.131	0.163***
	(3.069)	(-0.493)	(3.105)
PHI (ID-CEO)	0.237	0.024	0.042
	(1.625)	(0.102)	(1.158)
Audit Delay			0.031***
			(2.889)
Going Concern			-0.035
			(-0.549)
Industry FE	Yes	Yes	Yes
Year FE	Yes	Yes	Yes
Observations	11,702	11,702	11,702
Pseudo R-squared/R-Squared	0.052	0.096	0.815

Notes. Variable definitions are provided in Table 1. This table provides regression results on the relation between Dissimilarity and financial reporting outcomes while controlling for age, gender, relative power, and local heterogeneity. All models include industry and year fixed effects. Standard errors are calculated using clustering at the firm level. The notations ***, **, * denote significance at the 1%, 5%, and 10% levels, respectively.

Table 6
Endogeneity: Instrumental Variable Analysis

	First Stage	Instrumental Variable Analysis (Second Stage)		
		Restatement	Material Weakness	Audit Fees
	(1)	(2)	(3)	(4)
AC-CFO Dissimilarity		-0.409** (-1.980)	-0.872*** (-2.827)	-3.680*** (-13.004)
Industry Demand	-2.579*** (-4.013)			
Polarization	0.029*** (3.261)			
Firm Size	0.016*** (7.055)	-0.003 (-0.154)	-0.120*** (-4.521)	0.589*** (55.222)
Leverage	-0.000 (-0.015)	0.198 (1.497)	0.535*** (3.017)	0.203*** (4.460)
Sales Growth	-0.012 (-1.356)	-0.038 (-0.351)	0.068 (0.446)	-0.188*** (-5.238)
Loss Carryforward	-0.007 (-1.401)	0.286*** (5.489)	0.347*** (4.425)	0.089*** (2.870)
Profitability	0.006 (0.231)	-0.508** (-2.382)	-0.951*** (-3.026)	-0.356*** (-2.643)
Segments	-0.000 (-0.033)	0.006** (2.087)	0.008* (1.858)	0.018*** (19.961)
Independent Director	-0.070** (-2.308)	-0.469* (-1.727)	-0.433 (-1.017)	0.323*** (3.137)
Audit Committee Size	-0.048*** (-3.696)	-0.161 (-1.441)	-0.266* (-1.678)	-0.259*** (-6.506)
Outside Board Seats	-0.006 (-0.855)	-0.047 (-0.880)	-0.097 (-1.218)	-0.005 (-0.258)
Financial Expert	0.003 (0.817)	-0.059* (-1.744)	-0.007 (-0.157)	0.090*** (7.216)
Big 4 Auditor	0.021* (1.717)	-0.032 (-0.378)	-0.153 (-1.624)	0.148*** (2.698)
PHI (ID-CEO)	-0.017 (-1.583)	0.172** (2.250)	-0.019 (-0.180)	-0.029 (-1.038)
Audit Delay	0.000 (0.016)			0.045*** (5.730)
Going Concern	0.039 (1.329)			0.211*** (3.045)
Industry FE	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Observations	10,874	10,874	10,874	10,874
(Pseudo)R-Squared	0.163	0.039	0.044	0.579

Notes. Variable definitions are provided in the Appendix. This panel provides the results of the endogeneity tests using two-stage least squares analysis. Column 1 displays the first-stage analysis. The instruments are *Industry Demand* and *Polarization* described in section 5.2. Columns 2–4 present the second-stage results. Industry and year fixed effects are included. Standard errors are calculated using clustering at the firm level. The notations ***, **, * denote significance at the 1%, 5%, and 10% levels, respectively.

Table 7
Goodwill Impairment, Tax Avoidance, and Pro-Forma Earnings

	Goodwill Impairment	Tax Avoidance	Pro-Forma Earnings
	(1)	(2)	(3)
AC-CFO Dissimilarity	0.431** (2.005)	-0.288** (-2.271)	-0.271** (-1.969)
Firm Size	0.097** (2.410)	-0.010 (-0.571)	0.109*** (3.300)
Leverage	0.285 (1.299)	0.528*** (2.814)	1.073*** (5.864)
Sales Growth	-1.026*** (-7.197)	0.160 (1.085)	-0.802*** (-5.635)
Loss Carryforward	1.894*** (18.130)	0.879*** (7.320)	1.070*** (11.754)
Segments	0.020*** (4.575)	-0.003 (-0.748)	-0.002 (-0.370)
Profitability (ROA)	0.260 (0.516)	-3.672*** (-8.120)	-0.609* (-1.688)
Independent Director	-0.413 (-0.627)	1.437*** (4.230)	0.871*** (3.024)
Audit Committee Size	0.098 (0.433)	-0.194* (-1.746)	-0.218 (-1.439)
Financial Expert	-0.155 (-1.348)	-0.040 (-0.675)	0.018 (0.236)
Outside Board Seats	0.052 (0.802)	0.016 (0.366)	0.036 (1.064)
Big 4 Auditor	0.166 (0.930)	-0.153 (-1.258)	0.174* (1.664)
PHI (ID-CEO)	-0.015 (-0.095)	0.083 (1.003)	0.111 (1.229)
Going Concern	-0.016 (-0.031)		
Goodwill%	1.242*** (4.438)		
Restructure	0.274*** (3.567)		
Stock Return Volatility	0.128 (0.176)		
M&A Activity	0.075 (1.203)		
Stock Return	-0.240** (-2.267)		
Other Asset Write Downs	0.759*** (9.949)		
Market-to-Book	-0.025*** (-3.381)		
Low M/B	0.317** (2.464)		
Foreign		-0.080 (-1.520)	

NOL		0.297***	
		(4.623)	
RD/Assets		4.911***	
		(5.856)	
Pre-Tax ROA		-1.323***	
		(-23.641)	
Analyst Following			0.140***
			(2.776)
Industry FE	Yes	Yes	Yes
Year FE	Yes	Yes	Yes
Observations	14,869	19,443	17,408
R-squared	0.155	0.183	0.108

Notes. Variable definitions are provided in the Appendix. This table presents a logit model documenting the effect of *AC-CFO Dissimilarity* on the likelihood of an impairment, *Tax Avoidance*, and *Pro-Forma Earnings Aggression*. *Goodwill Impairment* is a dummy variable that equals 1 if the firm reports a goodwill impairment during the year. *Tax Avoidance* is a dummy variable that equals 1 if the firm is in the bottom quartile of cash effective tax rate or GAAP effective tax rate for the firm's industry (SIC-two digit) and year. *Pro-Forma Earnings Aggression* is a dummy variable equal to 1 if earnings per share (EPS) per IBES less EPS before extraordinary and discontinued items per Compustat is above the median of the firm's industry in a given year, and 0 otherwise. All models include industry and year fixed effects. Standard errors are calculated using clustering at the firm level. The notations ***, **, * denote significance at the 1%, 5%, and 10% levels, respectively.