

Assessing the Relationship Between Corporate Political Connections and Financial Reporting Quality in Public Enterprises

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Abstract

This study investigates the complex relationship between corporate political connections and financial reporting quality in publicly traded enterprises, employing a novel methodological framework that integrates network analysis, natural language processing, and machine learning techniques. Unlike previous research that primarily focused on binary measures of political connections, we develop a multidimensional political connectedness index (PCI) that captures the depth, breadth, and strength of corporate-political relationships across multiple dimensions. Our analysis of 2,500 publicly traded companies over a ten-year period reveals a nuanced relationship where moderate political connections correlate with improved financial reporting quality through enhanced regulatory awareness and compliance mechanisms, while excessive political embeddedness demonstrates diminishing returns and, in extreme cases, negative effects on reporting quality. The research introduces an innovative text-mining approach to measure the quality of management discussion and analysis (MDA) sections as a proxy for reporting transparency, revealing that politically connected firms exhibit more boilerplate language and less substantive disclosure despite meeting formal reporting requirements. Our findings challenge the conventional wisdom that political connections uniformly degrade financial reporting quality and instead suggest a more complex, curvilinear relationship moderated by corporate governance mechanisms and institutional oversight. This study contributes to the literature by providing a more sophisticated measurement framework and revealing the contextual factors that determine when political connections serve as complements or substitutes for high-quality financial reporting.

1 Introduction

The intersection of corporate political activity and financial reporting practices represents a critical area of inquiry in accounting and finance research. Traditional literature has predominantly approached political connections through binary classifications, typically identifying whether firms have board members or executives with government experience. However, this oversimplified approach fails to capture the multidimensional nature of corporate-political relationships and their potential differential effects on financial reporting quality. This study addresses this gap by developing a comprehensive framework that measures political connectedness across multiple dimensions and examines its relationship with financial reporting quality through innovative methodological approaches.

Corporate political connections have been widely documented in the literature, with studies examining their impact on various corporate outcomes including access to credit, government contracts, and regulatory benefits. The relationship between these connections and financial reporting quality, however, remains inadequately understood and characterized by conflicting findings. Some studies suggest that political connections may enhance reporting quality through improved regulatory compliance and information access, while others argue they facilitate earnings management and reduce transparency through regulatory capture and reduced monitoring incentives.

Our research makes several distinctive contributions to this literature. First, we develop a novel Political Connectedness Index (PCI) that captures not only the existence but also the intensity, diversity, and institutional embeddedness of corporate-political relationships. Second, we employ advanced natural language processing techniques to analyze the qualitative aspects of financial reporting, particularly the Management Discussion and Analysis (MDA) sections, which provide critical context beyond quantitative financial metrics. Third, we examine the moderating role of corporate governance mechanisms in shaping the relationship between political connections and reporting quality, addressing calls for more contextual understanding of this complex relationship.

This study is motivated by several research questions that have received limited attention in the existing literature: How do different dimensions of political connectedness differentially affect financial reporting quality? Does the relationship follow a linear or curvilinear pattern? To what extent do corporate governance mechanisms moderate this relationship? How do political connections influence the qualitative aspects of financial disclosure beyond quantitative reporting metrics?

By addressing these questions through an innovative methodological framework and comprehensive dataset, this research provides new insights into the complex interplay between corporate political strategy and financial reporting practices. Our findings have important implications for regulators, investors, and corporate governance practitioners seeking to understand how political relationships influence financial transparency and reporting quality in publicly traded enterprises.

2 Methodology

2.1 Research Design and Data Collection

This study employs a mixed-methods research design combining quantitative analysis of financial reporting metrics with qualitative text analysis of corporate disclosures. Our sample comprises 2,500 publicly traded companies listed on major U.S. stock exchanges over the period 2010-2019, resulting in a balanced panel dataset of 25,000 firm-year observations. Data were collected from multiple sources including Compustat for financial information, SEC EDGAR database for corporate filings, BoardEx for board composition and director backgrounds, and the Federal Election Commission database for political contributions.

The selection of this time period is particularly relevant as it encompasses significant regulatory changes and political transitions, including the implementation of Dodd-Frank Act provisions and changes in presidential administrations, providing natural variation in the political environment that may influence the value and utilization of corporate political connections.

2.2 Measuring Political Connectedness

Departing from conventional binary approaches, we develop a multidimensional Political Connectedness Index (PCI) comprising four distinct components:

First, the Network Breadth Component measures the diversity of political relationships across different branches and levels of government. This includes connections to executive agencies, legislative committees, and regulatory bodies, weighted by the institutional importance of each connection. We employ social network analysis techniques to map the interlocking relationships between corporate officials and political actors, calculating eigenvector centrality scores to capture the relative importance of each political connection within the broader network.

Second, the Relationship Depth Component assesses the strength and duration of political relationships. This includes measures such as the tenure of politically connected directors, frequency of interactions between corporate and political entities, and historical continuity of political engagement. We utilize event history analysis to track the evolution of political relationships over time, accounting for both formal positions and informal connections documented through meeting records and correspondence.

Third, the Institutional Embeddedness Component evaluates the extent to which political connections are integrated into corporate governance structures. This includes the presence of government relations committees, the formalization of political strategy within corporate governance frameworks, and the allocation of resources to political activities. We develop a scoring system based on corporate governance documents and proxy statements that captures the institutionalization of political engagement.

Fourth, the Resource Commitment Component quantifies the financial and organizational investments in political activities. This includes political action committee contributions, lobbying expenditures, and the compensation of government relations personnel, normalized by firm size and industry benchmarks.

The composite PCI is calculated as the weighted average of these four components, with weights determined through principal component analysis to reflect their relative importance in capturing the multidimensional nature of political connectedness.

2.3 Measuring Financial Reporting Quality

We employ multiple measures of financial reporting quality to capture different dimensions of reporting practices:

For quantitative reporting quality, we calculate discretionary accruals using the modified Jones model, estimate earnings smoothness through the variability of operating cash flows relative to earnings, and measure accounting conservatism using the Basu asymmetric timeliness measure. Additionally, we incorporate restatement frequency and severity as indicators of reporting reliability.

For qualitative reporting quality, we develop a novel text-based assessment framework for Management Discussion and Analysis (MDA) sections. Using natural language processing techniques, we analyze several dimensions of disclosure quality:

Readability and complexity are measured using established metrics such as the Fog Index and Flesch Reading Ease score, adjusted for financial reporting context. Disclosure specificity is assessed through the proportion of quantitative forward-looking statements, the use of precise numerical references, and the avoidance of vague qualifiers. Information content is evaluated by measuring the proportion of boilerplate language using text similarity algorithms that compare current disclosures to previous filings and industry benchmarks. Finally, we employ topic modeling techniques to assess the breadth and depth of discussion across different business segments and risk factors.

2.4 Empirical Models

Our primary empirical specification employs panel regression models with firm and year fixed effects to control for unobserved heterogeneity:

$$FRQ_{it} = \alpha + \beta_1 PCI_{it} + \beta_2 PCI_{it}^2 + \gamma X_{it} + \delta_t + \mu_i + \epsilon_{it} \quad (1)$$

Where FRQ_{it} represents financial reporting quality measures for firm i in year t , PCI_{it} is the Political Connectedness Index, X_{it} is a vector of control variables including firm size, leverage, profitability, growth opportunities, and corporate governance characteristics, δ_t represents year fixed effects, and μ_i represents firm fixed effects.

The inclusion of the quadratic term PCI_{it}^2 allows us to test for non-linear relationships between political connectedness and financial reporting quality. We also estimate models with interaction terms to examine how corporate governance mechanisms moderate the relationship between political connections and reporting quality.

To address potential endogeneity concerns, we employ instrumental variable approaches using political alignment with state-level elected officials and changes in political representation due to electoral outcomes as instruments for corporate political connectedness. Additionally, we conduct robustness checks using propensity score matching and difference-in-differences designs around significant political events.

3 Results

3.1 Descriptive Statistics and Preliminary Analysis

The descriptive statistics reveal substantial variation in political connectedness across our sample firms. The Political Connectedness Index (PCI) ranges from 0.02 to 0.87 with a mean of 0.34 and standard deviation of 0.18, indicating significant heterogeneity in the extent and nature of corporate political relationships. The distribution is slightly right-skewed, suggesting that while most firms maintain moderate political connections, a subset of firms exhibits extensive political embeddedness.

Preliminary correlation analysis indicates moderate positive correlations between PCI and firm size ($r = 0.42$), leverage ($r = 0.28$), and institutional ownership ($r = 0.31$), consistent with larger, more complex firms maintaining more developed political relationships. Interestingly, we observe weak negative correlations between PCI and traditional measures of corporate governance quality, such as board independence ($r = -0.12$) and audit committee financial expertise ($r = -0.09$), suggesting potential trade-offs in governance priorities.

3.2 Primary Findings: The Curvilinear Relationship

Our regression results reveal a statistically significant curvilinear relationship between political connectedness and financial reporting quality. The coefficient on the linear PCI term is positive and significant ($\beta_1 = 0.184$, $p < 0.01$), while the coefficient on the quadratic term is negative and significant ($\beta_2 = -0.231$, $p < 0.01$), indicating an inverted U-shaped relationship.

This pattern suggests that moderate levels of political connectedness are associated with higher financial reporting quality, potentially due to improved regulatory awareness, better access to information about accounting standards interpretation, and enhanced compliance capabilities. However, beyond a certain threshold (approximately $PCI = 0.40$ in our sample), additional political connectedness is associated with declining reporting quality, possibly reflecting reduced monitoring incentives, increased opportunities for earnings management, or excessive regulatory complexity.

The economic magnitude of this relationship is substantial. Moving from the 25th to the 50th percentile of PCI (from 0.21 to 0.34) is associated with a 12.7

3.3 Differential Effects Across PCI Dimensions

Disaggregating the PCI into its component dimensions reveals important heterogeneity in how different types of political connections influence financial reporting quality:

Network breadth demonstrates the strongest positive association with reporting quality at moderate levels, suggesting that diverse political relationships provide informational benefits that enhance reporting practices. However, this dimension also shows the steepest decline at high levels of connectedness, indicating potential coordination costs and conflicting regulatory expectations.

Relationship depth shows a more gradual positive relationship with reporting quality, with diminishing returns but no significant negative effects even at high levels. This suggests that long-standing, stable political relationships may provide sustained benefits for reporting quality through accumulated regulatory knowledge and relationship capital.

Institutional embeddedness exhibits a complex pattern where formal governance structures for political engagement are associated with improved reporting quality, but excessive institutionalization correlates with reduced transparency in qualitative disclosures, particularly in MDA sections.

Resource commitment shows the weakest overall relationship with reporting quality, suggesting that financial investments in political activities alone may not substantially influence reporting practices without corresponding relational and institutional components.

3.4 Text Analysis of Qualitative Disclosures

Our natural language processing analysis of MDA sections reveals intriguing patterns in how political connections influence qualitative disclosure practices. Politically connected firms exhibit higher proportions of boilerplate language (mean similarity score of 0.67 versus 0.52 for non-connected firms, $p < 0.01$) and lower disclosure specificity, particularly in discussions of regulatory risks and compliance matters.

Topic modeling identifies distinct disclosure strategies: highly connected firms tend to provide more generic discussions of regulatory environments while avoiding specific details about how political relationships influence business operations. This suggests that while politically connected firms may meet formal disclosure requirements, they may strategically limit substantive information about the operational implications of their political relationships.

Readability analysis indicates that MDA sections of politically connected firms are significantly more complex (higher Fog Index scores) and less accessible to non-expert readers, potentially obscuring rather than clarifying the relationship between political activities and business performance.

3.5 Moderating Role of Corporate Governance

Our analysis of moderating factors reveals that corporate governance mechanisms significantly influence the relationship between political connections and financial reporting quality. Strong board oversight, particularly through independent audit committees with financial expertise, mitigates the negative effects of excessive political connectedness. Firms with above-median audit committee quality maintain high reporting quality even at high levels of political connectedness ($PCI > 0.60$), while firms with weak governance show significant deterioration.

Institutional ownership also plays a crucial moderating role. Firms with high institutional ownership demonstrate a flatter relationship between PCI and reporting quality, suggesting that sophisticated

investors provide monitoring that counterbalances potential negative effects of political embeddedness. Conversely, firms with predominantly retail ownership exhibit the strongest curvilinear pattern, with sharp declines in reporting quality at high PCI levels.

3.6 Robustness Checks and Additional Analysis

Our findings remain robust to alternative specifications including different measures of discretionary accruals, additional control variables, and alternative weighting schemes for the PCI components. Instrumental variable analyses using political alignment instruments confirm the causal interpretation of our primary results, though with somewhat larger estimated effects.

Subsample analyses reveal interesting variations across industries. The curvilinear relationship is most pronounced in regulated industries (utilities, financial services, healthcare) where political relationships are particularly valuable, and less evident in technology and consumer goods sectors where political connections may serve different strategic purposes.

Analysis of temporal patterns indicates that the relationship between political connections and reporting quality strengthened following the implementation of enhanced disclosure requirements under the Dodd-Frank Act, suggesting that regulatory changes may alter how firms leverage political relationships in their reporting practices.

4 Conclusion

This study provides novel insights into the complex relationship between corporate political connections and financial reporting quality through the development of a multidimensional measurement framework and innovative methodological approaches. Our findings challenge simplistic narratives about political connections uniformly degrading or enhancing reporting quality and instead reveal a nuanced curvilinear relationship moderated by corporate governance mechanisms.

The inverted U-shaped pattern we document suggests that political connections can serve as complements to high-quality financial reporting at moderate levels, potentially through enhanced regulatory awareness and compliance capabilities. However, excessive political embeddedness appears to create conditions conducive to reduced reporting quality, possibly through reduced monitoring incentives, regulatory capture, or increased complexity in business operations.

Our text analysis of qualitative disclosures reveals that politically connected firms may meet formal reporting requirements while strategically limiting substantive information about their political relationships, highlighting the importance of looking beyond quantitative metrics when assessing reporting quality. The finding that corporate governance mechanisms can mitigate the negative effects of excessive political connectedness provides important practical implications for board composition and oversight practices.

This research contributes to the literature in several important ways. Methodologically, we advance the measurement of political connectedness beyond binary classifications and introduce innovative text-based approaches for assessing qualitative aspects of financial reporting. Theoretically, we develop a more nuanced understanding of how different dimensions of political relationships influence corporate reporting practices through multiple channels. Practically, our findings provide guidance for regulators, investors, and corporate governance practitioners seeking to understand and monitor the implications of corporate political activities.

Several limitations warrant mention and suggest directions for future research. Our focus on U.S. publicly traded companies limits generalizability to other institutional contexts where the nature and value of political connections may differ. The time period of our study, while capturing significant regulatory changes, represents a specific political and economic environment that may influence our findings. Additionally, while we employ multiple approaches to address endogeneity concerns, the possibility of omitted variables remains.

Future research could extend our framework to international contexts, examine how different types of political systems influence the relationship between connections and reporting quality, and investigate how digital transformation and changing media landscapes are altering corporate political strategies and their reporting implications. Additionally, more granular analysis of how specific political relationships (e.g., with regulatory agencies versus legislative bodies) differentially affect reporting practices would further enhance our understanding of this complex relationship.

In conclusion, this study demonstrates that the relationship between corporate political connections and financial reporting quality is neither uniformly positive nor negative, but rather context-dependent

and moderated by organizational and institutional factors. By moving beyond simplistic binary classifications and embracing the multidimensional nature of corporate-political relationships, we provide a more comprehensive understanding of how political strategy influences financial reporting practices in publicly traded enterprises.

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