

The Role of Political Ideology in Corporate Governance

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**Abstract**

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This dissertation examines how beliefs and values held by members of a board of directors can influence the decisions and actions they take in the board. I have adopted theories found in political ideology literature in order to suggest that the political ideology of the board may influence important governance decisions. In particular, I look at five corporate governance contexts: governance structure, the adoption of certain governance policy, monitoring financial misconduct and misdemeanors, and the actions boards take following financial misconduct. In each context, I find support for the idea that the political ideology of the board has affected their governance decisions and actions, i.e., separation of CEO and board chair roles, designing compensation packages for CEOs, and adoption of the clawback provision, a governance policy designed to increase managerial accountability. The results also suggest that firms with more conservative boards are less likely to experience financial misconduct such as

misrepresentation and earnings manipulation. Following financial misconduct, boards tend to take different actions toward CEO depending on their ideology: conservative boards tend to replace CEOs and negative reactions from the stock market and financial analysts further encourage conservative boards to do so. Taken together, I find that the political ideology is an important factor that influences the decision-making processes in the board. The findings demonstrate the important influence that political beliefs can play in corporate governance decisions, corroborating previous studies that find beliefs and preferences influence organizational decisions and outcomes. This study also highlights and reinforces the growing notion that the effects of corporate governance are actually quite nuanced and critically contingent on the political ideology of the individuals in governance positions. In addition, this paper builds on the emerging literature regarding the role of political ideology in organizations.

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## CHAPTER 1. INTRODUCTION

At the heart of corporate governance research lie governance structures and mechanisms. Numerous studies have suggested various structures and mechanisms that would protect shareholders from the self-interest of managers (Daily, Dalton, & Cannella, 2003). However, when we look at major corporate scandals such as Enron and HealthSouth that destroyed shareholder value, most had the “right” structures and mechanisms for good corporate governance, which the majority of studies highlight. That is, the scandal-ridden companies had compensation schemes to align the interests of shareholders and management/directors. They had outside directors and non-CEO chair to allow for board independence, and experts on audit committees to oversee the integrity of financial reporting. Regardless of these measures, such governance structures did not prevent massive scandals from occurring. This dissertation attempts to examine corporate governance beyond these structures in order to delve into the minds of decision makers within the corporate governance realm.

**Figure 1-1. Perspectives on Corporate Governance**

<b>Formal structure</b>	<b>Informal structure</b>	<b>Behavioral process</b>
Optimal incentive and monitoring structures	Power dynamics and politics within organizations	Biases in decision-making process

Adapted from Hambrick, v. Werder, and Zajac (2008) and Zajac and Westphal (1998).

Corporate governance reflects ways in which corporations are controlled and directed at the organizational level. In general, scholars tend to examine three areas of corporate governance: formal structures or governance structures that incentivize and monitor management; informal structures of power and politics within organizations; and behavioral processes that include decision-making by directors (see Figure 1) (Hambrick, v. Werder, & Zajac, 2008; Zajac & Westphal, 1998).

Research that focuses on governance structures is often called an economic perspective (Fama, 1980; Fama & Jensen, 1983). Relying mostly on agency theory, the economic perspective suggests that formal governance structures achieved through formal contracts and governance arrangements within the organization may reduce agency costs and increase firm performance. In simple but strong terms, the economic perspective of corporate governance has contributed significantly to our understanding of the role and mechanisms of corporate governance. However, the empirical evidence does not strongly support such a perspective. Rather, studies have found only a weak or insignificant relationship between suggested formal structures and contracts, and firm performance.

Research that examines power and politics within organizations generally examines a more informal structures (Westphal & Zajac, 2013). While acknowledging the role of contracts or formal structures, this perspective highlights how positions, power, and politics within organizations (hence, informal structures) may influence how corporations are controlled and directed. This perspective has expanded our understanding of the role and evolution of informal governance structures, complementing the economic perspective. In fact, some major corporate scandals (e.g.,

Tyco International, and Wells Fargo) have involved powerful CEOs.

While most scholars have focused on these areas, some have noted another important aspect: the decision-making processes of individuals within corporate governance, what is labeled behavioral process in the literature (see highlighted box in Figure 1) (Hambrick et al., 2008). In the end, this comes down to the decisions made by individuals within the governing bodies, which can differ significantly, depending on individuals' underlying beliefs and preferences. Unfortunately, we have limited knowledge about such decision-making mechanisms of directors, and how they may influence corporate governance (Hambrick et al., 2008). This dissertation seeks to contribute knowledge to this under-explored area.

Directors are responsible for making important organizational decisions in several areas, including strategic guidance for corporations (e.g., mergers and acquisitions), managers' accountability to the company and shareholders, and governance structure. Organizational decisions have been shown to be driven not only by rational, utility-maximizing logic but the personal beliefs and preferences of organizational elites (Finkelstein, Hambrick, & Cannella, 2009; Westphal & Zajac, 2013). These individuals' beliefs and preferences may shape how problems and challenges are perceived, articulated, and acted upon, and can have a critical influence on organizational outcomes (Chin, Hambrick, & Treviño, 2013; Hambrick & Mason, 1984).

My particular focus is on the political ideologies of directors (Jost, 2006). While corporate managers and directors are generally considered to be pragmatic and rational, research has shown that they may possess a wide range of ideological tendencies (e.g., Francia et al., 2005; Seider, 1974; Tetlock, 2000). Political ideologies, generally defined

as “a set of beliefs about the proper order of society and how it can be achieved” (Erikson & Tedin, 2003: 64), encompass beliefs and preferences that upper echelon literature highlights as important factors influencing the decision-making process in organizations (Finkelstein et al., 2009). In addition, political ideologies are shown to play a significant role in the judgment and behavior of individuals (Jost, Federico, & Napier, 2009), which affect not only the personal choices of individuals but those of organizations (e.g., Chin, Hambrick, & Treviño, 2013; Eastwick, Richeson, Son, & Finkel, 2009).

I begin by discussing how the political ideologies of directors may affect corporate governance, in an attempt to address the research question:

*How do the political ideologies of directors influence governance decisions and their monitoring activities?*

I believe examining the role of political ideologies in corporate governance can independently contribute and at the same time complement the existing literature to better our understanding of corporate governance. I have adopted theories found in political ideology literature in order to suggest that the political ideology of the board may influence important governance decisions. In particular, I look at multiple corporate governance contexts: governance structure, the adoption of certain governance policy, monitoring financial misconduct and misdemeanors, and the actions boards take following financial misconduct. In each context I find support for the idea that the political ideology of the board has affected their governance decisions and actions, i.e., separation of CEO and board chair roles, designing compensation packages for CEOs,

and adoption of the clawback provision, a governance policy designed to increase managerial accountability. The results also suggest that firms with more conservative boards are less likely to experience financial misconduct such as misrepresentation and earnings manipulation. Following financial misconduct, boards tend to take different actions toward CEO depending on their ideology: conservative boards tend to replace CEOs and negative reactions from the stock market and financial analysts further encourage conservative boards to do so. Taken together, I find that the political ideology is an important factor that influences the decision-making processes in the board.

The main contributions of this study include highlighting and reinforcing the growing notion that the effects of corporate governance are actually quite nuanced and critically contingent on the political ideology of the individuals in governance positions (Aguilera & Jackson, 2010; Dalton, Hitt, Certo, & Dalton, 2007; Desender, Aguilera, Crespi, & García-cestona, 2013;). They corroborate previous studies that find beliefs and preferences influence organizational decisions and outcomes (Hambrick & Mason, 1984; Zajac & Westphal, 1998) and shed light on a growing interest in behavioral process within corporate governance (Westphal & Shani, 2016; Westphal & Zajac, 2013). In addition, this paper builds on the emerging literature regarding the role of political ideology in organizations (Chin et al., 2013; Christensen, Dhaliwal, Boivie, & Graffin, 2015; Gupta, Briscoe, & Hambrick, 2017)

This dissertation is organized as follows. Chapter 2 is a review of the literature on corporate governance and political ideology. Based on this review, I theorize the role played by political ideologies by boards of directors, and proceed to suggest propositions and hypotheses regarding governance and monitoring decisions in Chapter 3.

Methodology and the results of empirical tests are explained in Chapter 4, discussion and conclusions are presented in the final chapter.

## **CHAPTER 2. LITERATURE REVIEW OF CORPORATE GOVERNANCE AND POLITICAL IDEOLOGY**

In this chapter I review three main areas of corporate governance literature: formal structures, informal structures, and behavioral processes. I summarize and highlight key studies in each area and then delve into political ideologies in general and the research on political ideologies in different fields, including political science, social psychology, and management.

### **CORPORATE GOVERNANCE**

#### **Formal Structure**

The Industrial Revolution of the nineteenth century gradually formed the modern corporation and complex businesses that function with a large number of workers and have created demand for professional managers. At the same time the development of the stock market increased dispersion of ownership. As the proportion of individual holdings decreased and the interests of owners became dispersed, managers, who usually had little ownership, came to control the modern corporation (Berle & Means, 1932). This separation of ownership and control produced an agency relationship between owners and managers of corporations, and created a condition where the interests of owners and of managers could and often did diverge (Monks & Minow, 2008). As an agency problem, this may incur such costs as monitoring expenditures by owners, bonding expenditures by the agent, and residual loss.

Using the separation of ownership and control as a reference point, economists

have suggested that the formal structure of organizations might solve the agency problem and reduce agency costs, increasing the chances of survival and contributing to the prosperity of the corporation. They argue that owners can maximize their welfare by reducing agency costs by structuring contracts which align managers' compensation incentives with owners' interests (Jensen & Meckling, 1976), and by formal monitoring structures that increase the independence of the board of directors in monitoring management (Fama, 1980; Fama & Jensen, 1983).

While this argument is convincing, and has dominated the discourse in corporate governance literature, empirical evidence supporting the argument is somewhat inconclusive. In terms of board structure, meta-analyses suggest no evidence of a relationship between board independence and financial performance (Dalton, Daily, Johnson, & Ellstrand, 1999; Rhoades, Rechner, & Sundaramurthy, 2000; Wagner, Stimpert, & Fubara, 1998). Recent studies that control for endogeneity of board independence also failed to find a causal relation between board independence and firm performance (Wintoki, Linck, & Netter, 2012). In terms of contracts aligning the interests of agents and owners, a meta-analysis of 229 empirical studies suggests no substantive relationship between incentive alignment and firm performance (Dalton, Daily, Certo, & Roengpitya, 2003). (See Table 2-1 for key studies of formal structure.) In a 1992 American Finance Association presidential address, Jensen acknowledged this, saying that “substantial data support the proposition that the internal control systems of publicly held corporations have generally failed to cause managers to maximize efficiency and value.”

While formal structures may be a good starting point for corporate governance,

the mere presence of such structures are not sufficient in order to fully understand the governance issue (Eisenhardt, 1989). As a result, informal structures of corporate governance have begun to predominate as scholars explored boardroom dynamics.

**Table 2-1. Key Studies of Formal Structure**

<b>Study</b>	<b>Key findings</b>
Jensen and Meckling (1976)	Divorce of owner and manager created a tension between principal and manager. Institutional mechanism to align the interests of principal and manager as a measure of managerial performance. Related costs of this alignment include monitoring, enforcement, alignment, and bonding.
Fama (1980)	The market for professional managers disciplines managers to align performance with an efficient contract. Divorcing owner and manager interests is in fact efficient.
Demsetz (1983)	Corporate executives, while often not the largest shareholders, receive incomes that are highly correlated with stock performance, and forms a strong link between management and owner interests.
Fama and Jensen (1983)	Organizations characterized by separation of ownership, and control are so common and survive well despite the agency problems. Such organizations control the agency problems by separating management (initiation and implementation) and control (reification and monitoring) of decisions. The common features of the decision control system include mutual monitoring system, board of directors consisting of outsiders, and decision hierarchies.
Eisenhardt (1989)	Review of seven empirical studies on corporate governance that use agency theory suggests that outcome-based contracts (e.g., golden parachutes), incentive alignment, boards and efficient markets. However, the author suggests agency theory can be more useful when coupled with complementary perspectives in organization theories.
Zahra and Pearce (1989)	Empirical support for agency theory is moderate. An integrated model for board attributes and roles is suggested.
Wagner, Stimpert, and Fubara (1998)	Meta-analysis of 63 empirical studies shows curvilinear effect on board composition and performance. Increased inside and outside director presence have positive effects on financial performance.
Dalton, Daily, Johnson, and Ellstrand (1999)	Meta-analysis of 131 studies suggests that there is no relationship between board composition and firm performance.
Rhoades, Rechner, and Sundaramurthy (2000)	Meta-analysis of 59 empirical studies indicates small positive relationship between board composition and firm performance. Both insider- and outsider-dominated boards have positive influence on financial performance.
Dalton, Daily, Certo, and Roengpitya (2003)	Meta-analysis of 229 empirical studies suggests that the size of the board is positively correlated with performance. However, the results show no substantive relationship between the incentive alignment structure and firm performance.
Dalton and Dalton (2011)	Board composition and CEO duality are not related to firm performance. They propose a multi-level approach in corporate governance study.
Wintoki, Linck, and Netter (2012)	Board structure is endogenous. It is partly determined by past performance and controlling for endogeneity, there is no causal relation between board size or independence and firm performance.

## **Informal Structure**

With a greater behavioral science orientation, scholars have begun to focus on informal rather than contractual or formal structures (Hambrick et al., 2008). As they noticed the under-socialized nature of governance theories based on the economic perspective, they suggest a more socialized view (Westphal & Zajac, 2013), emphasizing the politics within organizations between the CEO and board and among board members are significant factors in governance mechanisms (Hambrick et al., 2008). Growing bodies of research indicate the significance of sociopolitical dynamics in corporate governance.

Numerous studies investigating this area may broaden our understanding (see Table 2-2 for a listing of key studies). First of all, power matters. CEOs gain and lose informal power over the board through tenure, experience, and expertise; as a consequence, the relative power of the CEO may affect the level of monitoring effectiveness and board composition (e.g., Lynall, Golden, & Hillman, 2003; Ocasio, 1994). Finkelstein and D'Aveni (1994) found that when CEOs are powerful and firm performance is good, CEOs tend to eschew the position of chair of the board. This implies that the structure of the board, which is meant to increase board independence (i.e., CEO-chair non-duality), may be meaningless. CEO power also influences CEO compensation contracts (Abernethy, Kuang, & Qin, 2015). A meta-analysis of 219 U.S.-based empirical studies shows that CEO power may increase CEO compensation, but decrease a pay-to-performance ratio (van Essen, Oosterhout, & Heugens, 2012).

Boards of directors can also be powerful. For example, if board consists of directors with relatively longer tenure than the CEO, they may become an effective

political force to replace an incompetent CEO (Boeker, 1992; Ocasio, 1994). There is also a power structure among directors, where some directors have more influence than others when it comes to decisions such as director appointments, which in turn can affect CEO compensation contracts (Wade, O'Reilly, & Chandratat, 1990; Westphal & Zajac, 1995).

Political dynamics may also occur on the board. Research suggests that directors and CEOs engage in social influence such as ingratiating behaviors in order to gain personal benefits. Westphal (1998) found that CEOs who flatter their independent directors may neutralize control mechanisms in order to create incentive alignment schemes. Such CEOs may achieve more board appointments in other organizations (Westphal, 1998). Directors of such CEOs may lower the level of monitoring vigor and been shown to receive more directorship appointments in other boards (Westphal & Stern, 2007). Ultimately, this type of internal politics is known to affect corporate strategic decisions, such as the level of corporate diversification and initiation of strategic changes that affect firm performance (Park, Westphal, & Stern, 2011; Westphal & Stern, 2006; 2007).

This stream of research has explored the nuances of governance mechanisms and helped us to better understand what is happening inside the boardroom. Some scholars have acknowledged further opportunities for understanding corporate governance by examining the individuals responsible for governing the organization (Dalton & Dalton, 2011; Hambrick et al., 2008).

**Table 2-2. Key Studies of Informal Structure**

<b>Study</b>	<b>Key findings</b>
Wade, O'Reilly, and Chandratat (1990)	Social influence of the CEO over the board (number of outside directors appointed to the board after the CEO) affects the adoption of golden parachutes.
Boeker (1992)	CEOs with power are less likely to be dismissed even though the performance of the firm is poor. This relationship is moderated by the incentive alignment and board independence.
Ocasio (1994)	Power of CEO circulates depending on CEO tenure. Board tenure and board size combined with economic adversity trigger the circulation.
Finkelstein and D'Aveni (1994)	CEO informal power influences CEO duality structure. When CEO is powerful and the firm performance is good, CEO duality is less common.
Westphal and Zajac (1995)	Power of CEO or board influences the appointment of board members. Ones with power appoint directors who are similar to them. When board and CEO are similar, CEO has higher compensation.
Westphal and Zajac (1997)	Using social exchange theory, they found that CEO-directors inhibit changes in board structure to enhance board independence. However, if CEO-directors experienced changes in board structure in their managing firms, they are going to increase board independence.
Westphal (1998)	Increase in board independence leads to higher levels of CEO ingratiation and persuasion behavior toward board members. Such behaviors mitigate the effect of board independence on corporate strategy and CEO compensation.
Lynall, Golden, and Hillman (2003)	Board composition is determined by the relative power of the CEO and external financiers. Board composition is also influenced by the stage of the organizational life cycle within which the board is formed.
Westphal and Stern (2006)	Ingratiation behaviors of top managers would increase board appointment, and such behaviors are more effective for those who lack elite credentials, and who are ethnic and gender minorities. This in turn may cause inertia to the norm change in the corporate governance.
Westphal and Stern (2007)	Directors who provide advices and information to CEOs and ingratiate toward peer directors increase their chances of board appointments in other boards. Moreover, directors increased their appointment chances when they lower their level of monitoring and control behavior.
Park, Westphal, and Stern (2011)	Flattery and opinion conformity toward CEO by top executive and directors increase CEO's overconfidence in their judgment and leadership capability, which lead to organizational inertia in response to low performance.
van Essen, Otten, and Carberry (2011)	Meta-analysis of 219 U.S.-based studies shows that CEO power is positively related to the amount of CEO compensations and negatively associated with the sensitivity of pay to performance.
Abernethy, Kuang, and Qin (2015)	Powerful CEOs influence compensation system in response to regulatory and public pressure and create less challenging targets in the initial performance-vested stock option (PVS0).

## **Behavioral Process**

Since individuals within an organization are the ultimate decision makers in corporate governance, how they actually make decisions and take actions is important. Studies of the behavioral process used in corporate governance raise questions about decisions made by directors and the rationality of such decisions on a micro level. This area has great potential for furthering our understanding of the subject and complementing other areas in the literature (Westphal & Shani, 2016).

Top management literature suggests that the values, cognitive models, and personalities of top managers are important factors that determine organizational decisions (Finkelstein et al., 2009), a hint that the values of directors may also be important in corporate governance. To date, only a handful of studies have examined this at the board level. Westphal and Zajac (1995) were among the first to investigate behavioral process on the board. Using the concept of in-group favoritism, they suggested that CEOs or boards with power will appoint directors and CEOs who come from a similar demographic background (Westphal & Zajac, 1995; Zajac & Westphal, 1996). However, they did not look at individual differences, only the general biases that people possess.

Following these studies, the authors acknowledged the need for more work to understand how bias can lead to different governance decisions, particularly in the area of director selection and CEO compensation (Zajac & Westphal, 1998). However, only a few studies have investigated individual differences, mostly due to the difficulty of gathering data on personal values, cognitive models, and personality.

Adams and her colleagues (2011) found that directors may possess different

personal values, leading to a preference for shareholder versus stakeholder views, by surveying directors from 288 Swedish firms. In turn, these values may affect directorial decisions that favor the shareholder or stakeholder, beyond their roles on the board. Masulis and Mobbs (2014) found that independent directors who value their reputation may increase board attendance rates, firm performance, and CEO replacement due to poor performance.

Forbes and Milliken (1999) suggested a theoretical model which integrates board characteristics, cognition (i.e., effort norms, cognitive conflict, use of knowledge and skills), board level outcomes, and firm level outcomes. After conducting a meta-analysis of 140 studies that examined the effect of female directors on financial performance, Post and Byron (2015) theorized that the different cognitive frame of female directors (i.e., having stricter ethical standards, more risk-averse, and more prepared) promote board monitoring activities and increase firm financial performance. Westphal and Shani (2016) found that self-regulated cognition influences the effect of ingratiation on high-status actors within the organization, and may increase the chance of board appointments. In addition, directors' identities and identification with the organization may influence resource provision and monitoring (Hillman, Nicholson, & Shropshire, 2008; Zhu & Yoshikawa, 2016).

In sum, compare to the other areas in the literature, only a few recent studies have paid theoretical or empirical attention to the difference among individuals and their behavioral processes in a corporate governance setting. While these studies help us understand how differences between decision makers may influence corporate governance (see Table 2-3 for summaries of each study), we have very limited

knowledge regarding individual values, cognitive models, personalities, and influence on boards, with scholars calling for more studies in this area (Hambrick et al., 2008).

**Table 2-3. Studies on Behavioral Process**

<b>Study</b>	<b>Key findings</b>
Westphal and Zajac (1995)	In-group bias influences powerful actors (either CEO or board) to appoint directors with similar background. When board and CEO are similar, CEO has higher compensation.
Zajac and Westphal (1996)	In-group bias influences powerful actors (either CEO or board) to appoint new CEOs with similar background.
Forbes and Milliken (1999)	They proposed a model of board processes using the literature on group dynamics and workgroup effectiveness.
Westphal and Bednar (2005)	Using the pluralistic ignorance concept from social psychology, they suggest that under conditions of low firm performance, outside directors may not speak out for strategic change because other directors are not.
Hillman, Nicholson, and Shropshire (2008)	They proposed that directors' identities and identification with the organization would influence the level of resource provision and monitoring.
Tuggle, Sirmon, Reutzel, and Bierman (2010)	Using prospect theory, they found that negative/positive deviation from prior performance increases/reduces boards' attention to monitoring.
Adams, Licht, and Sagiv (2011)	Directors possess differing personal values, which would lead to preference for shareholder view versus stakeholder view.
Masulis and Mobb (2014)	Independent directors who value the directorship for reputation would increase the board attendance rate, firm performance and CEO replacement due to the poor performance.
Post and Byron (2015)	Meta-analysis of 140 studies suggests that the presence of female directors and the financial performance. They propose that this is due to the difference in a cognitive frame in female directors.
Zhu and Yoshikawa (2015)	Director's identification with the focal firm or the government affects the level of monitoring and resource provision.
Westphal and Shani (2016)	Self-regulated cognition of directors induces genuine feelings and admiration for other directors, especially when interacting with high-status actors. This, in turn, influences board appointment.

## **POLITICAL IDEOLOGY**

This dissertation focuses on the political ideology of directors and how this may contribute to our understanding of behavioral process in corporate governance. Political ideology encompasses values, cognitive models, and personalities which the literature on top management teams emphasizes as important factors for decision makers in organizations (Finkelstein et al., 2009).

Political ideology is “a set of beliefs about the proper order of society and how it can be achieved” (Erikson & Tedin, 2003: 64), known to be an enduring, stable, and coherent system of ideas which individuals harbor (Bawn, 1999; de St. Aubin, 1996; Feldman, 2003; Jost et al., 2009; Lorence & Mortimer, 1979). Political ideology is inherently related to personal values, which serve as an anchor for core political attitudes and behaviors (Schwartz, Caprara, & Vecchione, 2010). Political ideology often shapes cognitive models in individuals, influencing how they perceive and interpret a given situation (Ball & Dagger, 1998). Tomkins (1979, 1987) has suggested that ideology is the most important class of scripts for predicting, interpreting, responding to, and controlling for a set of scenarios, because “they endow fact with value and affect. . . . a matter of faith without which human beings appear unable to live” (p. 170). Scores of studies have suggested possessing a certain political ideology is related to the Big Five personality traits (e.g., Gerber, Huber, Doherty, & Dowling, 2011). Not only is political ideology correlated with values, cognitive models, and personality, it may dictate the behaviors and actions of individuals in realizing certain social, economic, and political ideals (Ball & Dagger, 1998; Kerlinger, 1984). For most people, political ideology remains an important aspect of their day-to-day lives (Carney, Jost, Gosling, & Potter, 2008).

## **Values, Cognitive Models and Personality**

While there is a wide range of ideologies, from Marxism to fascism, and such contemporary ideologies as feminism and environmentalism, for centuries the most useful and parsimonious way to classify political ideology was the conventional spectrum of left-right or liberal-conservative (Jost, 2006). This notion of a political spectrum dates back to the late eighteenth century, where the National Assembly of the French Revolution was composed of moderates who sat in the middle, advocates of radical change and revolution seated on the left, and those who supported the status quo seated in the right wing of the chamber. While there is considerable variation among liberalism and conservatism, each stands out as a typical ideology encompassing a coherent and comprehensive set of belief and ideas (Ball & Dagger, 1998).

Liberals and conservatives are associated with distinct values formed throughout modern western history (see Appendix for a historical background of modern liberalism and conservatism). Kerlinger (1984) offers a comprehensive list of values which modern liberals and conservatives endorse. While liberalism values “freedom of the individual, constitutional participatory government and democracy, the rule of law, free negotiation, discussion and tolerance of different views, constructive social progress and change, egalitarianism and the rights of minorities, secular rationality and rational approaches to social problems, and positive government action to remedy social deficiencies and to improve human welfare” (p. 15), conservatives emphasizes “the status quo and social stability, religion and morality, liberty and freedom, the natural inequality of men, the uncertainty of progress, and the weakness of human reason” (p. 16-17) Kerlinger suggests that political conservatism values “the support of individualism and individual

initiative, the sanctity of private property, and the central importance of business and industry in the society” (1984: 17).

Besides the associated values, studies suggest that political ideology is related to differences in individual cognitive style. On a personal level, those who espouse a conservative ideology often share such cognitive styles as dogmatism, intolerance of ambiguity, rigidity, and simplicity (e.g., Rokeach, 1956; Sidanius, 1978; Taylor, 1960; Tetlock, 1983). On the other hand, individuals with a liberal ideology tend to portray a more flexible, conceptually complex, and integrative cognitive style (e.g., Russell & Sandilan, 1973; Scott, Osgood, Peterson, & Scott, 1979; Taylor, 1960; Tetlock, 1981).

Based on these findings, Jost and his colleagues (2003a) have suggested a model where relative preferences for liberal or conservative ideologies are associated with basic psychological needs, motives, and desires. The researchers argue that a conservative ideology (characterized as resistance to change and acceptance of inequality) tends to appeal to individuals who have a greater psychological need to reduce uncertainty and threat. While people generally seek to reduce uncertainty, conservatives may have a greater need for this (Budner, 1962; Kagan, 1972; Kruglanski, 2004; Webster & Kruglanski, 1994), as well as a perception that the world is a dangerous place, reflecting a greater fear of death (Weber & Federico, 2007) and a stronger motive to mitigate anxiety and threat (Cohen et al., 2005; Landau et al., 2004). A more liberal ideology, on the other hand, caters to social change through equality, and appeals to individuals with fewer fears of uncertainty and potential threats.

Another stream of research has shown that political ideology is related to personality. Numerous studies found differences between liberals and conservatives,

where liberal personalities are open, tolerant, flexible, imaginative, complex, and unpredictable (e.g., Adorno, Frenkel-Brunswik, Levinson, & Sanford, 1950; Altemeyer, 1998; Bem, 1970; Brown, 1965; Jost et al., 2003a; 2003b; Tomkins, 1963), while conservative personalities are tenacious, rigid, intolerant, consistent, careful, and orderly (e.g., Adorno et al., 1950; Bem, 1970; Block & Block, 2006; Costantini & Craik, 1980; Fromm, 1941; Milbrath, 1962). Systematically, ideological orientation is found to map two of the Big Five personality dimensions (i.e., openness to new experience and conscientiousness),<sup>1</sup> with liberals more open-minded, creative, and novelty-seeking, and conservatives trending toward aspects like orderly, conventional, and better organized (Carney et al., 2008). A recent study found that personality traits and the possession of certain political ideologies are correlated, a function of an innate genetic factors (Verhulst, Eaves, & Hatemi, 2012).

Thus, political ideology often encompasses values, cognitive models, and personality that may lead to certain beliefs and preferences (Ball & Dagger, 1998). These beliefs and preferences are in turn associated with political ideologies shown to influence individual decision-making, not only in people's day-to-day lives (Carney et al., 2008), but the daily decisions of organizational leaders.

### **Political Ideology in Organizations**

Corporations and corporate elites such as managers and directors are generally considered to be pragmatic and rational, yet they may possess a wide range of ideological preferences (e.g., Francia et al., 2005). Political ideology is shown to play an important role in organizations. One of the first studies to examine the role of political ideology in

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<sup>1</sup> Big Five personality dimensions are openness, conscientiousness, extraversion, agreeableness, and neuroticism.

<sup>2</sup> According to the Organisation for Economic Co-operation and Development (OECD), boards are mandated to perform advisory responsibilities, to consult with management concerning strategic direction

organizations can be traced back to Seider (1974). Using a Marx-Mannheim approach, he found that American managers hold a range of ideological positions regarding how business should be conducted. Some managers adopt a neo-classical model of business, while others hold social responsibility viewpoints.

Scholars have examined political ideology in organizations using two distinct approaches. One views political ideology as an important bonding mechanism, which either ties together people and organizations or is a result of bonding. By measuring political action committee (PAC) contributions to certain political candidates and parties, Mizruchi (1990) found that geographical proximity, concentration of industries, and interfirm market interdependence affected the ideological similarity of two particular firms. He then suggested that indirect interlock ties through financial institutions could predict this ideological similarity.

Similarly, Burris (2005) showed that interlocking directors may facilitate political cohesion among corporate elites, and that this cohesion can be seen several links down the chain of indirect ties. Examining Hungarian firms, Stark and Vedres (2012) observed that political affiliations positively influenced director interlock and partnership with other firms. Some directors were shown to favor CEOs with similar political leanings. Another study suggests that directors retain CEOs with similar ideologies, even when they are performing poorly, and that they will craft compensation packages for ideologically aligned CEOs which are less sensitive to performance (Lee, Lee, & Nagarajan, 2014). Similarities in political ideology between directors and CEOs have been shown to lower monitoring effectiveness, affecting firm value and performance (Kim, Pantzalis, & Park, 2013; Lee et al., 2014).

Some scholars have focused on the beliefs and preferences associated with the political ideology of decision makers in organizations. Tetlock (2000) investigated how conservative managers are different from liberal managers in their preference for accountability and organization structure. Conservative managers are shown to hold people accountable and favor a more straightforward structure and governance style (the shareholder over stakeholder view). Conservative managers also prefer outcome accountability, whereas liberal managers prefer process accountability (Tetlock, Vieider, Patil, & Grant, 2013). Chin and his colleagues (2013) looked at the ideology of CEOs in their preference for corporate social responsibility (CSR) activities. They found that liberal CEOs tend to emphasize CSR activities, an emphasis that was more pronounced when CEOs were powerful and firm performance was poor. Similarly, Gupta and colleagues (2017) found that organizational ideology manifested itself in the form of advancing corporate social responsibility by appointing more female executives and offering equal benefits for LGBTQ employees. Due to risk aversion, conservative CEOs and top management teams were shown to engage in less risky corporate policies (regarding level of debt, capital, R&D expenditure, and investment) and tax avoidance (Christensen et al., 2015; Hutton, Jiang, & Kumar, 2014).

More recently, scholars have begun to pay attention to the role of political ideology on the board. Gupta and Wowak (2017) found that the ideology of directors may influence how they evaluate and compensate managers regarding performance measures. Such studies have laid an important foundation for understanding organizations and the ideology of the people within them.

I have summarized each study in Table 2-4.

**Table 2-4. Key Studies Examining the Role of Political Ideology in Organization**

<b>Study</b>	<b>Key findings</b>
Seider (1974)	American businesses have different positions regarding neo-classical and social responsibility even after controlling for industry.
Mizruchi (1990)	Geographical proximity and the concentration of the industries affect two firms' ideological similarity. Inter-firm market interdependence and indirect interlock ties through financial institutions also predict ideological similarity.
Tetlock (2000)	Conservative managers with strong preference for cognitive closure tend to defend simple heuristic-driven error and hold people more accountable. They are more skeptical of complex strategies for accountability and prefer simple and clear rules. Conservatives favor simple governance (the shareholder over stakeholder) and hierarchical norms.
Francia, Green, Herrnson, Powel, and Wilcox (2005)	Economic elites have significant variance in their political views and attitudes. Democratic donors are liberal on social issues and Republican donors support business agenda.
Burris (2005)	Social networks among directors facilitate political cohesion within the business community even several links down the chain of indirect ties.
Stark and Vedres (2012)	Political affiliations positively affect director interlock and partnerships.
Chin, Hambrick, and Treviño (2013)	They examine CSR decision and the decision in the face of low recent financial performance and find that liberal CEOs do emphasize CSR and CEOs' power strengthens it. Moreover, those CEOs emphasize CSR even in the face of low financial performance.
Hutton, Jiang, and Kumar (2013)	Republican managers who are likely to have conservative personal ideologies adopt and maintain more conservative corporate policies (lower levels of corporate debt, lower capital and R&D expenditures, less risky investments, and higher profitability).
Kim, Pantzalis and Park (2013)	Diversity in political ideologies influences the monitoring effectiveness (better firm performance, lower agency costs and less insiders' discretionary power over the firm's Political Action Committee (PAC) spending).
Tetlock, Vieider, Patil and Grant (2013)	Conservative managers prefer outcome accountability whereas liberal managers prefer process accountability. However, there is a bipartisan consensus when managers have clear evidence about employees' trustworthiness and the responsibilities.
Lee, Lee, and Nagarajan (2014)	Alignment in political orientation between the chief executive officer (CEO) and independent directors is associated with lower firm valuations, lower operating profitability, and increased internal agency conflicts such as a reduced likelihood of dismissing poorly performing CEOs, a lower CEO pay-performance sensitivity, and a greater likelihood of accounting fraud. Individual political donations reflect the person's political beliefs rather than opportunistic attempts to seek political favor.
Christensen, Dhaliwal, Boivie and Graffin (2015)	Firms with top executives who lean toward Republican affiliation engage in less tax/risk avoidance than firms whose executives lean toward the Democratic Party. Political orientation is helpful in explaining top management team composition and CEO succession.
Gupta, Briscoe and Hambrick (2017)	Coherent political ideologies in organizations manifest in the form of advancing corporate social responsibility, appointing more female executives and offering equal benefits for homosexual employees.
Gupta and Wowak (2017)	Board-level political ideologies influence boards' decisions about CEO compensation in that conservative boards pay CEOs more than liberal boards and this is intensified when recent firm performance is greater.

In this chapter, I have reviewed the corporate governance and political ideology literature, and find that political ideology, as a set of beliefs and preferences, may be an important variable to consider in analyzing corporate governance. Furthermore, an examination of the role of political ideology among board members may be useful in understanding corporate governance mechanisms.

In the next chapter, I elaborate on how political ideology may influence governance decisions and actions, suggesting the ways in which it could work in different corporate governance contexts.

### CHAPTER 3. THEORY AND HYPOTHESES

A board of directors is expected to represent shareholders, in particular, monitoring the actions of a company's chief executive officer. In its fiduciary role, the board is expected to behave rationally, free of any personal bias. In reality, this assumption rarely holds, since board members who report to or are appointed by the CEO may act against the interests of shareholders in order to protect the CEO (Finkelstein et al., 2009). Beyond well-established concerns about how board members may shield a CEO during agency conflicts, I would argue that board members' personal beliefs and preferences may further bias decisions made by the board. An understanding of how these beliefs and preferences influence board actions is vital, especially when such belief structures are not apparent to outside stakeholders, in particular, shareholders, while significantly influencing the board's fiduciary role.

Building on corporate governance literature and adopting theories from political ideology literature, I focus on the political ideology of the board to investigate how this may reflect the board's decisions and actions. Political ideology is a unique belief and preference system that encompasses a set of values, cognitive models, and personalities. While the beliefs and preferences of corporate elites are not always observable, the political ideologies held by managers and directors are more obvious, for example by observing political donation patterns (Chin et al., 2013). Thus, examining the role of political ideologies on the board may offer an interesting theoretical lens along with more practical implications.

## THEORY

Denzau and North (1994) define ideology as “the shared framework of mental models that groups of individuals possess that provide both an interpretation of the environment and a prescription as to how that environment should be structured” (p. 24). Ideological belief systems are characterized by stability, consistency, and logic (Allport, 1962); although some ideological differences are historically and culturally specific, such core dimensions are relatively stable and endure throughout an individual’s life, providing structure to their thinking and decision-making (Duckitt, 2001; Feldman, 2003; Jost, 2006).

To understand the form and function of political ideology, theorists examine fundamental features suggesting that conservatism is associated with a desire for order and stability, gradual rather than revolutionary change, and greater deference to the current system and existing order (Carney et al., 2008; Gosling, Rentfrow, & Swann, 2003; Van Hiel, Pandelaere, & Duriez, 2004). In contrast, liberalism is often associated with tolerance for different viewpoints and an openness to change and new experiences (Gosling et al., 2003; Jost et al., 2003a; 2003b; Kerlinger, 1984; Thórisdóttir & Jost, 2011). Differences in political ideology can have an important influence on decision-making, not only in the political arena, but in the daily decisions of organizational leaders. Recent work has examined how the political ideologies of executives and top managers may influence managerial decisions and actions, and how directors evaluate and compensate managers for their performance (Chin et al., 2013; Christensen et al., 2015; Gupta & Wowak, 2017). Extending and building on these studies, I propose that political ideology may have important influence on key governance decisions and actions

taken.

The extensive review on political ideology renders a significant and interesting theme that is closely related to beliefs and preferences that can be applied in the context of corporate governance: the tendency of uncertainty avoidance and threat management. Wilson, particularly focusing conservatism, suggested that the common psychological basis for all the various components of the political ideology is “the susceptibility to experiencing threat or anxiety in the face of uncertainty” (Wilson, 1973: 259). Building on this premise, Jost and his colleagues (2003a) found that individuals with conservative ideology tend to have greater needs to avoid uncertainty and possess a greater fear of threat and loss based on a meta-analysis of 88 studies across 12 countries. They characterized conservatism as a motivated social cognition that leads individuals with a conservative ideology to engage in uncertainty-avoiding and threat-managing behaviors. Indeed, following studies found that conservatives have greater needs both to reduce uncertainty and to manage threats by reducing risks and minimizing losses in choosing consumers product and even in interpreting images such as destroyed buildings (Fernandes & Mandel, 2014; Jost et al., 2007; Vail, Arndt, Motyl, & Pyszczynski, 2012). Recent studies tracking physiological differences in the brain using magnetic resonance imaging (MRI) have further supported the idea that liberals have brain characteristics associated with a greater tolerance for uncertainty (a larger anterior cingulate cortex) and conservatives have brain characteristics associated with a greater sensitivity to threat and fear (a larger right amygdala) (Kanai, Feilden, Firth, & Rees, 2011; Schreiber et al., 2013).

I adopt the uncertainty avoidance-threat management model of political ideology

in order to see how the ideology of board members may affect their decisions and actions. Following past work, I define *uncertain situations* as those where the eventual outcome of an event is not known, and *threatening situations* as those where the occurrence of an event may have a severe or adverse effect on the organization (Knight, 1921; Luce & Raiffa, 1957). The basic model I am proposing is shown in Figure 3-1.

**Figure 3-1. Board Ideology and Governance Decisions and Actions**

Political Ideology of Board of Director



Although individuals are generally motivated to resolve and reduce uncertainty across a wide range of situations (Kagan, 1972), individuals vary in the extent to which they perceive and react to uncertainty (Kruglanski, 2004; Wilson, 1973). Scholars have suggested that those who have a greater need to reduce uncertainty and seek stability may exhibit political conservatism (e.g., Adorno et al., 1950; Chirumbolo, 2002; Frenkel-Brunswick, 1954; Kemmelmeier, 1997; Jost et al., 2007). Tomkins (1965) observed this phenomenon among mathematicians, noting that right-wing mathematicians seemed to seek security and the promise of certainty while more left-leaning mathematicians were attracted by novelty and the “divine madness of wild, unaccountable spaces” (p. 23). Similar studies have found that people who avoid uncertainty tend to vote for more conservative candidates (Chirumbolo, Areni, & Sensales, 2004; Chirumbolo & Leone, 2008). Since political ideology is closely related to personal beliefs and preferences, I

would argue that uncertainty avoidance may manifest itself in corporate boardrooms as well. Specifically, those boards with a conservative ideology will make decisions and actions to reduce the uncertainty of how corporations are controlled and monitored.

*Proposition 1: Politically conservative boards are more likely to make decisions and take actions to avoid uncertainty than more liberal boards.*

Conservatives tend to have a greater need for safety and security and minimizing danger and threats (Jost, Nosek, & Gosling, 2008), which encourages individuals with conservative ideologies to embrace solutions that seek to minimize threats, even though such solutions may be perceived as simplistic and rigid, such as good/evil and us/them (Bonanno & Jost, 2006). Research has demonstrated that those with a greater need of minimizing threats are more likely to embrace conservative ideologies (Augoustinos, Walker, & Donaghue, 2014).

Based on these findings, and the behavioral consistency theory which suggests individuals are likely to behave consistently across different situations (Allport, 1937; Funder & Colvin, 1991), one would expect to see directors with a certain political ideology behaving differently when faced with a threat. That is, conservative boards may try to prevent potential threats when it comes to oversight and monitoring, seeking to minimize any threat to governing the organization. Thus, I would also suggest that boards with a conservative ideology will attempt to manage a potential or existential threat to corporate governance more vigorously, reflecting their beliefs and preferences.

*Proposition 2: Politically conservative boards are more likely to make decisions and take actions to reduce threats than more liberal boards.*

## **HYPOTHESES**

In order to test my theory, I examined multiple governance contexts where hypotheses could be tested in each setting. In the first setting, I chose the role of political ideology by the board on governance structures, particularly CEO duality, board independence, and incentive structure. In the second setting, I investigated how political ideology might influence monitoring of financial misconduct by voluntarily adopting clawback provisions, a governance policy to increase managerial accountability.

I also consider the relationship between board ideology and financial misconduct by managers, in particular two types of misconduct: subtle manipulation of earnings, and intentional and serious misrepresentation of financial reporting which violates the rules of the U.S. Securities and Exchange Commission (SEC). Finally, I investigate how boards deal with managers who committed serious financial misconduct (i.e., financial misrepresentation), based on their ideology.

### **Board Ideology and Governance Structure**

Governance structure has been a central topic in corporate governance literature. Based on agency theory, which suggests that owners (i.e., shareholders) can maximize value by reducing agency costs, the notion of governance structure, including contracts with managers that aligns compensation incentives with owners' interests, and formal monitoring structures designed to boost the independence of the board in monitoring management, may be closely related to ownership value (Fama, 1980; Fama & Jensen,

1983; Jensen & Meckling, 1976). While many studies have focused on the relationship between governance structure and firm performance, no meta-analyses have found evidence of a relationship between board independence and financial performance (Dalton et al., 1999; Rhoades et al., 2000; Wagner et al., 1998) and alignment of incentive and firm performance (Dalton et al., 2003). Instead, recent studies have suggested that endogenous factors which affect governance structure may alter firm performance (Knyazeva, Knyazeva, & Masulis, 2013; Wintoki et al., 2012). Thus, investigating the factors that drive the adoption of certain governance structure is critical.

While most studies have focused on the consequences of governance structure, some delve into its antecedents. According to these studies, firms structure their governance to elect certain directors in order to cope with an environmental threat or with uncertainty (Thompson, 1967; Zald, 1967), reflecting firm strategies and past performance (Finkelstein et al., 2009; Pearce & Zahra, 1992), as well as strategic complexity, and governance characteristics such as CEO incentives and the characteristics of the CEO (whether the CEO is a founder or not, having the CEO as chair of the board) (Dalton & Daily, 1995; Dalton et al., 2007; Daily & Dalton, 1992; Finkelstein & D'Aveni, 1994; Zajac & Westphal, 1994). Because less attention has been paid to directors who are making decisions regarding governance structure, and their characteristics, we have less understanding about how people on the board and their individual differences affect governance structures. In response, I chose to investigate how preference and bias stemming from political ideology might influence governance structure in three main areas: CEO-chair duality, board independence, and incentive alignment.

### ***CEO duality***

CEO-chair duality (or CEO duality) occurs when the CEO also holds the chair position in the board. CEO-chair duality is a widely discussed topic in the literature (Dalton et al., 2007). Although it appears to be a simple dichotomous factor, in fact CEO duality is a very complex phenomenon and a contentious one, not only among scholars but also practitioners (Boyd, 1995; Donaldson & Davis, 1991; Jensen, 1993; Lublin, 2009). On one hand, agency theorists argue that CEO duality may increase managerial entrenchment and reduce board independence, thereby negatively affecting firm performance (Jensen, 1993; Lorsch & MacIver, 1989). On the other hand, organization theorists assert it will promote leadership unity and organizational effectiveness, leading to better firm performance (Boyd, 1995; Donaldson & Davis, 1991). As such, there is a stark contrast in the two viewpoints, and inconclusive empirical support for either theory (Dalton, Daily, Ellstrand, & Johnson, 1998).

Nonetheless, both camps agree on the idea that CEO duality offers the CEO a broader power base and locus of control (Finkelstein et al., 2009). Theoretically, CEO duality may be beneficial when strong leadership is required in order to generate positive organizational outcomes (Pfeffer, 1981). Based on the empirical evidence, however, it is uncertain that such increased power and will be beneficial to the firm. Given CEO duality, the same directors who are supposed to monitor and oversee managers must report to the CEO, potentially ceding their power and control. For this reason, CEO duality can compromise a board's monitoring effectiveness and increase managerial entrenchment (Fama & Jensen, 1983). Firms that have suffered egregious scandals such as Enron and more recently Wells Fargo had CEOs who also held the chair position.

Thus, CEO duality may create uncertainty in regards to firm performance, as well as downside risk associated with managerial misconducts for directors and governing bodies.

CEO duality also creates uncertainty around responsibility and accountability. Boards are mandated to perform oversight responsibilities that monitor management (OECD, 2004), and in many instances it is the directors, not just managers, who are legally liable for any resulting financial distress or corporate wrongdoing, according to the law governing corporations. One study suggests that CEOs who have duality may be blamed for poor performance and replaced (Harrison, Torres, & Kukalis, 1988), but it is not clear whether directors are able to conduct valid evaluations and vigilant oversight in the presence of CEO duality. When CEOs are also leaders of the board, who is responsible for oversight and monitoring of management? What will happen to the CEO-chairperson who commits financial misconduct? Can a board discipline the CEO in such a case? There are no straightforward answers to these questions, increasing the ambiguousness of who is responsible for oversight and monitoring. Even worse for directors, such ambiguity does not necessarily lower their liability. Rather, CEO duality actually heightens their risk. CEO duality may thus not appeal to boards that are sensitive to uncertainty and threat.

Such questions about CEO duality may be of concern to directors with a certain political ideology. The literature on political ideology maintains that individuals who are more conservative tend to focus on hierarchy in order to reduce uncertainty and ambiguity (Sidanius, 1985; Tetlock, 1983; Tetlock, Bernzweig, & Gallant, 1985). Christensen and colleagues (2015) found that top management teams with a conservative

political ideology tended not to engage in risky managerial activities such as tax avoidance. Expanding on these findings in a governance context, I would argue that boards with a conservative ideology prefer to establish hierarchy and authority to reduce uncertainty around governance and accountability by electing a non-CEO chair.

*Hypothesis 1: Politically conservative boards are more likely to separate the roles of CEO and chair of the board.*

### ***Board independence***

Practitioners, scholars, and lawmakers all emphasize the importance of a board's independence from management, and is actively sought by shareholder activists like the California Public Employees' Retirement System (CalPERS) and TIAA-CREF (Teachers Insurance and Annuity Association-College Retirement Equities Fund) as well as large U.S. corporations (Westphal & Zajac, 1997). An independent governance structure, particularly more independent directors on the board, has been prescribed by agency theorists (Fama, 1980) and suggested as one of the most important dimensions in corporate governance to insure firm performance (Zahra & Pearce, 1989). The Sarbanes-Oxley Act of 2002 reflect its importance, mandating that public companies have independent directors.

Contrary to the popularity and emphasis of firm performance, meta-analytic studies have found no evidence that suggests board independence increases financial performance (Dalton et al., 1999; Rhoades et al., 2000; Wagner et al., 1998). A recent study (Wintoki et al., 2012) revealed no causal relation between board independence and

firm performance when endogeneity was controlled. In terms of the literature, it would be beneficial to examine whether significant endogenous variables affect board independence; I would suggest that board ideology be one of them.

Much research has associated conservative ideology with a greater focus on the existence of threats, the perception of a dangerous world, and greater concern for downside risks (Altemeyer, 1998; Duckitt, 2001). Individuals with a more conservative ideology have been shown to have a greater need for safety and security, and a tendency to focus on actions to minimize threat and vulnerability (Jost et al., 2008). This perception of threat and increased focus on management of risk by those with a more conservative political bent has been demonstrated in work that focuses on managers making decisions in the context of business. Hutton, Jiang, and Kumar (2015) demonstrated that conservative CEOs are likely to pursue safer corporate strategies and policies, while Christensen and colleagues (2015) found that conservative executive management teams make more decisions to actively avoid risk.

Studies suggest there is an existential threat to directors who fail to monitor management. For example, they may be legally challenged when financial misconduct occurs, their reputations damaged when firms experience financial troubles, and face a greater threat of being replaced (Brochet & Srinivasan, 2014; Srinivasan, 2005). Conservative directors, being more risk-adverse, may be concerned about their future employability including any lapses in effective governance or monitoring that reflects poorly on them. A conservative board, being mindful and concerned about threats posed by negative events, would likely employ governance structures that increase discretion in order to prevent them. One way to do so is to increase board independence. Since boards

play a significant role in nominating directors, including determining a desired profile and identifying candidates (Westphal & Zajac, 1995), conservative boards would increase the number of independent directors in order to reduce potential risks.

*Hypothesis 2: Politically conservative boards are more likely to increase board independence.*

Such a relationship would thus be strengthened if boards have more independent directors who have more incentive to monitor management vigorously, since their reputations are at risk (Fama & Jensen, 1983). One of the ways to help independent directors perform their jobs is to have increase independence on the board, at least in crisis situations, such as responses to a hostile takeover or adoption of a poison pill (Hermalin & Weisbach, 2003). For this reason, once a board gains an independent director, the board may gradually increase the number of independent directors. This may be why, along with a shift toward shareholder value and the increased popularity of lone-insider boards (having the CEO as the only current employee on the board), that the proportion of independent directors has increased among U.S. public corporations from 20–75 percent between 1950–2005 (Gordon, 2007; Zorn, Shropshire, Martin, Combs, & Ketchen, 2017).

Boards with a conservative ideology that have more independent directors may be motivated to further increase the number of independent directors to reduce potential threats from the managerial opportunism. For conservative boards, more independent directors means more control and power over the CEO to monitor management

independently and effectively. When such boards are comprised of more independent directors as opposed to insider directors, they will exert their preference to reduce threat by electing even more independent directors since as conservative and independent directors, they have greater discretion over the nominating process (Westphal & Zajac, 1995).

On the other hand, when conservative boards have fewer independent directors, they may not want to increase the number of independent directors in the board. Potential threats considered by insider directors would be different from those considered by independent directors. Threats for inside directors may come from vigorous independent monitoring and oversight from the independent directors. In other words, boards with more insider directors who are conservative may attempt to reduce potential threat by decreasing the number of independent directors. In this case, conservative boards may or may not increase board independence depending on the proportion of independent directors. Thus, I propose following interaction effect hypothesis:

*Hypothesis 3: Politically conservative boards are likely to further increase board independence when the proportion of independent directors is greater.*

### ***Incentives in compensation***

Incentives are one of the key governance mechanisms advocated by agency theorists (Fama, 1980). By aligning the interests of managers and owners (shareholders), the organization can reduce agency costs and increase shareholder value (Eisenhardt, 1989). Many studies have looked at the consequences of compensation structures, but

work on the antecedents of compensation structure is few and far between. While some studies have examined contextual factors such as external environments (market risk), and such governance factors as board independence, human capital, and social influence (Devers, Cannella, Reilly, & Yoder, 2007), we have a limited understanding of how director preferences may determine the level of incentives that boards incorporate into executive compensation. Evidence suggests that board ideology affects how much CEOs are paid, based on a preference for meritocracy and free market systems (Gupta & Wowak, 2017; Jost, Blount, Pfeffer, & Hunyady, 2003). Building on this finding, I suggest that board ideology may affect how boards structure managerial incentives.

Since conservatives seek to reduce threats, more conservative boards may implement mechanisms, such as incentives, that are known to mitigate risk posed in governance. I would argue that boards with a conservative ideology would employ stock options, the right to purchase or sell a stock at a predetermined price during a certain period of time, more often as a form of incentive compensation. This would align a CEO's economic interests with shareholders' by motivating the CEO to increase share value. Although the efficacy of stock options has been challenged in empirical studies (Bodolica & Spraggon, 2009; Dalton et al., 2003), it would seem to reduce some risk involving managerial opportunism and shirking compared to offering no stock options at all. This has been deemed one of the most common solutions to agency problems (Agrawal & Knoeber, 1996) and is widely accepted in practice (Sanders & Hambrick, 2007). Thus, conservative boards seeking to minimize the downside and reduce threats may design a compensation package that includes more stock options.

*Hypothesis 4: Politically conservative boards are likely to offer a greater proportion of stock options compared to total compensation.*

## **Board Ideology and Monitoring for Financial Misconduct**

Directors have a responsibility for decisions in several areas, including strategic guidance for corporations (e.g., mergers and acquisitions) and board accountability to the company and its shareholders. In this section I focus on actions regarding the monitoring of management, since this is one of their most important fiduciary responsibilities.<sup>2</sup> Specifically, I investigate the monitoring of financial misconduct. Financial misconduct has important implications, as it can significantly damage the reputation of firms and directors.

I draw on the threat management aspect of political ideology (Jost et al., 2003a; 2003b) to examine how political ideology, as a motivated social cognition, influences the monitoring of financial misconduct. In order to test the argument, I address the question from three different but related contexts. The first is the adoption of a clawback provision, a new governance practice designed to prevent financial misconduct. I then explore whether the political ideology of a board is related to earnings manipulation and financial misrepresentation incidents.

### ***The Clawback Provision***

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<sup>2</sup> According to the Organisation for Economic Co-operation and Development (OECD), boards are mandated to perform advisory responsibilities, to consult with management concerning strategic direction and oversight responsibilities, to monitor company performance and reduce agency costs, and to represent the interests of owners. Per advisory responsibilities, boards review and guide corporate and business strategy such as setting objectives and overseeing major business decisions (e.g., merger and acquisitions). Per oversight responsibilities, boards monitor and manage the governance practices, management, nomination process, and conflicts of interest and compliance with the law, relevant business standards, and accounting/financial reporting systems.

I would suggest that political ideology not only influences how directors design governance structures but may influence the adoption of certain governance policies that appeal to their personal preference. In this section I focus on a relatively new governance policy called the Clawback provision. I chose this policy because it has not been investigated in much of the literature and represents an appropriate empirical context to examine the role of board ideology.

Following the failure of the financial reporting system in the late 1990s and the financial crisis of 2007, many observers criticized how managers were compensated and incentivized (Bebchuk & Fried, 2004; Devers et al., 2007). Managers were paid excessively in general and incentivized to focus on rather short-term performance. Moreover, in the aftermath of the Enron and WorldCom scandals, a provision was included in the Sarbanes-Oxley of 2002 (SOX) Section 304 states that the chief executive officer and chief financial officer must reimburse any bonuses and other incentive-based compensation if a firm has restated its earnings. This provision, later called the Clawback provision, is designed to encourage management to generate fewer financial errors, which can lead to significant negative consequences for the firm and its directors.

The Clawback provision was designed to make executives more accountable for financial reporting. According to SEC Commissioner Luis A. Aguilar, the rule “should go a long way toward prohibiting improper enrichment of executives for companies faced with a restatement.” However, until the financial crisis of 2007 such provisions were largely ignored. Then public interest in excessive executive compensation was renewed after the financial crisis (Markham, 2015), which led to the Occupy Wall Street movement in 2011. Even so, Clawback provisions were rarely implemented until the

Dodd-Frank Act of 2010 was formalized and enforced to adopt the provision.

Nevertheless, some companies voluntarily adopted Clawback provisions starting in 2007. For conservative boards, this provision may be a good device for preventing the threat of financial misconduct. Evidence suggests that voluntary adoption leads to improvement in financial reporting quality, perception of financial reporting quality, pay-for-performance sensitivity, and increased compensation levels (Dehaan, Hodge, & Shevlin, 2013).

Research has shown that conservatives have a greater need for safety and security and minimizing danger and threats (Jost et al., 2008). As the saying goes, a conservative is a liberal who has been mugged. In fact, conservatives tend to have different perceptions about the world than liberals. They perceive the world as a dangerous place (Altemeyer, 1998; Duckitt, 2001; Jost et al., 2003a) and are more sensitive to social, economic, and political threats (Doty, Peterson, & Winter, 1991; Willer, 2004), and fear threats, loss, and system instability more than liberals (Jost et al., 2003a). These perceptions and tendencies lead to a greater need to maintain safety and security, minimize danger, and ultimately manage threats (Jost et al., 2008). Thus, boards with conservative ideology are more likely to voluntarily adopt a Clawback provision to reduce financial misrepresentation, since a financial misrepresentation is a significant threat to both organizational and directorial reputation (Brochet & Srinivasan, 2014; Karpoff, 2012; Pfarrer, Decelles, Smith, & Taylor, 2008).

*Hypothesis 5: Politically conservative boards are likely to adopt Clawback provisions.*

### *Earnings manipulation*

Earnings manipulation is an important governance problem. It involves taking intentional steps within the boundaries of Generally Accepted Accounting Principles (GAAP) to produce the desired level of reported earnings by using discretion in the accounting system (Davidson, Stickney, & Weil, 1987). Earnings manipulation is different from financial misrepresentation (discussed in the next section) in that it involves GAAP accounting methods (Daley & Vigeland, 1983; Dechow & Skinner, 2000), whereas financial misrepresentation may occur within and outside such methods. There are several reasons managers manipulate earnings, but one common reason is to mislead stakeholders about the underlying financial performance of the firm in order to influence outcomes that depend on financial reporting such as CEO compensation, employment prospects, firm prospects, and external financing (Burns & Kedia, 2006; Cheng & Warfield, 2005; Dechow, Sloan, & Sweeney, 1996; Graham, Harvey, & Rajgopal, 2005; Healy & Wahlen, 1999).

While earnings manipulation may lead to higher market value (Barth, Elliott, & Finn, 1999), it can have negative consequences like legal challenges, SEC sanctions, and serious monetary penalties (DeFond, 2012; Feng, Ge, Luo, & Shevlin, 2011). The SEC sued Cardinal Health, Inc., for their earnings manipulation schemes, including inflating operating revenue by more than \$5 billion and prematurely recording cash discount income for \$133 million from 2000–2002. The company was forced to pay \$35 million in penalties. Once firms are known to manipulate their earnings, their reputation for disclosure transparency and trustworthiness of financial reporting can be damaged (Graham et al., 2005). In addition, if the issue is made public, firms can experience a

significant increase in the cost of capital (Dechow et al., 1996). Faced with manipulated earnings, boards may be unable to objectively evaluate the material condition of the firm and the performance of its management. For this reason, boards are shown to actively engage in monitoring earnings reports (Peasnell, Pope, & Young, 2005).

Due to the risk and threat involved, conservative boards will likely be more attentive to questionable managerial behaviors. Such vigilance regarding financial misconduct will even extend to subtle bending of the rules under GAAP guidelines. Hence, I would expect to find less earnings manipulation in firms that have a more conservative board.

*Hypothesis 6: Politically conservative boards are likely to have a lower degree of earnings manipulation.*

### ***Financial misrepresentation***

Compared to earnings manipulation, financial misrepresentation is a more serious form of misconduct that can have significantly damaging consequences for the firm. The most common source of firm-level reputation damage is shown to be the financial misconduct and misrepresentation (Karpoff, 2012; Pfarrer et al., 2008). Scandals like Enron and WorldCom are well-known examples of public companies that engaged in financial misrepresentation, which destroyed billions of dollars of market value and destroyed firms' reputations. As part of their fiduciary role, boards must vigorously monitor for such events, at the risk of serious personal penalties for any lack of oversight.

The political ideologies of the board may influence their level of monitoring and

in turn affect the likelihood of such events as financial misrepresentation occurring. Based on their perceived need to manage threat or risks, a conservative board is more likely to increase its vigilance for two reasons. First, financial misrepresentation poses a serious threat to an organization. Research has shown that firms announcing financial misrepresentation often experience a negative stock reaction, as high as 1.5% at the time of the announcement (Scholz, 2013). Less tangibly, misrepresentation can damage a firm's reputation because such actions violate ethical norms (Arthaud-Day, Certo, Dalton, & Dalton, 2006) and lead to a loss of credibility (Harris & Bromiley, 2007). Since conservative individuals and groups fear potential threats, I suggest that conservative boards would be more attentive in preventing financial misrepresentation which might pose an organizational threat.

Directors may also perceive occupational or personal hazards, depending on their ideology. Research on directors has found they often leave after a misrepresentation, which supports the notion that directors' reputations may be damaged, causing them to be replaced following a firm's financial misrepresentation (Arthaud-Day et al., 2006). Conservative risk-adverse directors may feel their reputations for governing and monitoring may be compromised by such a misrepresentation, harming their prospects for future employment (Fama & Jensen, 1983). Directors of such compromised firms may even be sued over any apparent ineffectiveness at monitoring managers (Brochet & Srinivasan, 2014). Similarly, Tetlock and colleagues (2013) argue that conservative managers worry about a failure to hold employees accountable for outcomes they could have avoided, which results in greater oversight of personnel. In the same way, conservative boards are more likely to be vigilant in averting personal and occupational

threats, making their firms less likely to experience financial misrepresentation.

*Hypothesis 7: Politically conservative boards are less likely to experience financial misrepresentation in their firms.*

### **Board Ideology and Reactions to Financial Misconduct**

In August of 2009 General Electric paid a \$50 million civil penalty stemming from charges that they misled investors by fraudulently misrepresenting their financial position, after spending \$200 million in litigation fees. Following this, their dividend was cut by a third, their prized AAA credit rating downgraded, and their future was questioned by the business and popular press (*The Economist*, 2009). Although GE stated that remedial actions and internal controls had been implemented as a result of this investigation, the company never admitted guilt even when it settled the SEC charges,<sup>3</sup> and no observable action was taken by the board of directors to discipline company managers, including a cut in pay. Despite public outcry that GE should have done more to hold their managers accountable, GE Chairman Jeffrey Immelt rejected calls for the CEO to resign, saying, “The board and I have complete confidence in CEO Keith Sherin. These issues have nothing to do with his leadership” (*Forbes*, 2009). In fact, Sherin’s bonus and salaries were increased during this time. GE is unlikely to be the last company where a board of directors is perceived as not having done its job in disciplining managers following a financial misrepresentation.

Financial misrepresentation by firms may be financially costly and result in

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<sup>3</sup> <https://www.forbes.com/2009/08/04/ge-immelt-sec-earnings-business-beltway-ge.html>

lasting damage to a firm's reputation and credibility (Arthaud-Day, 2006; Devers et al., 2009; Harris & Bromiley, 2007). Stakeholders and other observers generally expect disciplinary action to be taken toward the managers in charge, especially the CEO. CEO replacement has been shown to be a positive signal to stakeholders that the board takes misconduct seriously and is earnest about reestablishing its reputation and legitimacy (Gomulya & Boeker, 2016). Research has also demonstrated that firms who engage in financial misrepresentation are more likely to replace their CEOs (Arthaud-Day et al., 2006; Desai et al., 2006), and that the appointment of a new CEO is generally received favorably by shareholders, stock analysts, and the media (Gomulya & Boeker, 2014). Although accused firms often replace their CEOs compared with other firms, most retain their CEOs following financial misrepresentation, even in cases where financial misrepresentations are quite significant (Beneish et al., 2016; Coates 2015).

This section will more closely examine the role of the board of directors, focusing on the political ideology of board members and the influence of board beliefs and preferences on the likelihood of remedial action. Organizational researchers have noted the recent dearth of theory and research regarding consequences for organizational misconduct (Greve & Teh, 2016; Palmer, Greenwood, & Smith-Crowe, 2016). Although passage of the Sarbanes-Oxley Act (SOX) in 2002 increased the liability for managers found guilty of financial misrepresentation (more specifically, misconduct if the misrepresentation was found to be intentional), few studies have examined the role and actions of the board in cases where financial misrepresentation has been exposed.

Some studies have examined the CEO's power and the likelihood of being replaced following financial misrepresentation (Pozner, 2007), while other studies have

examined the prevalence of financial misrepresentation and how media attention may influence CEO replacement (Wiersema & Zhang, 2013). These studies shed light on why some boards take serious action, but offer only limited insight into board mechanisms taken in response to financial misrepresentation (Pozner & Harris, 2016). In particular, we lack greater understanding into how the board's reaction to financial misrepresentation is influenced by personal preferences and beliefs of the directors. Thus, adopting theories of political ideology as a theoretical lens (Jost et al., 2003a; 2003b), I seek to examine how political ideology may affect board reactions to events involving financial misrepresentation.

Financial misrepresentation is generally viewed unfavorably as a violation of desirable management practice (Arthaud-Day et al., 2006; Harris & Bromiley, 2007). Firms that are forced to restate their earnings as the result of financial misrepresentation on average experience a 6.8% dip in value within a few days of an announced restatement (Scholz, 2013); there are even instances where financial misrepresentation has led to bankruptcy (e.g., Enron, NII Holdings and Global Geophysical Services). On a less tangible level, misrepresentation may lead to a firm's loss of credibility (Devers et al., 2009; Harris & Bromiley, 2007), and damage its reputation. Indeed, financial misrepresentation is the most common source of reputation loss for firms (Karpoff, 2012; Pfarrer et al., 2008).

Studies have also shown that firms that misrepresent earnings, and are forced to restate them are more likely to replace their CEOs (Arthaud-Day et al., 2006; Desai et al., 2006). They seek to repair their images by disassociating themselves from those seen responsible for taking illicit actions and removing the managers in charge (Agrawal,

Jaffe, & Karpoff, 1999; Devers et al., 2009; Gomulya & Mishina, 2017). A CEO's departure signals to stakeholders that a firm takes any misrepresentation seriously and is earnest about reestablishing its reputation and legitimacy (Gomulya & Boeker, 2016). While CEO replacement may be an effective and positive signal to stakeholders that a firm is serious about dealing with financial malfeasance (Gangloff et al., 2016), the majority of firms that are forced to restate their earnings do not take such drastic actions. When they looked at firms who had restated their earnings due to misrepresentation between 1993–2007, Beneish and colleagues (2016) found that on average 43% of the firms replaced their CEOs, a percentage that decreased to 30% after the passage of SOX.

While I suggest that it may be useful to apply the uncertainty avoidance-threat management model of political ideology in this context, such a model may point in different directions. Replacing a CEO in the aftermath of financial misrepresentation is a complicated issue. Any change in a firm's chief executive may result in great uncertainty. When a board replaces its CEO, the firm must deal with the increased uncertainty that surrounds working with a new CEO. For a firm that has announced a restatement of its earnings, the operational and strategic uncertainty of any change in leadership may be acute. Indeed, the instability of CEO replacement may lead to a greater likelihood of subsequent financial restatements (Dao, Huang, Chen, & Huang, 2014; Denis & Denis, 1995).

As mentioned, individuals who harbor more conservative ideologies generally prefer reduced uncertainty and ambiguity (Sidanius, 1985; Tetlock, 1983; Tetlock et al., 1985) and express this preference by maintaining the status quo. This is related to system justification theory, which suggests that individuals vary in the extent to which they

perceive existing social structures and arrangements are justifiable and rational, if not naturally innate and inevitable (Jost & Banaji, 1994). Scholars utilizing systems justification theory have argued that conservatism is partly characterized by system-justifying beliefs that support existing social, economic, and political status (Jost & Banaji, 1994). Although a conservative ideology does not necessarily hinge on preserving the status quo (Wilson, 1941), conservatives tend to prefer it because it can be comprehended based on an individual's prior experience and history, compared with more uncertain alternatives (Burke, 1790). Individuals with a more conservative ideology are thus resistant to change and tend to defend existing social and institutional arrangements when an existing system is threatened (Jost et al., 2003a). The status quo offers stability and predictability, which conservatives value above the uncertainty that can arise from change (Ball & Dagger, 1998). For this reason, conservative boards are more likely to maintain their CEO because of a preference for the status quo and avoiding uncertainty even in the face of financial misrepresentation. Thus, I suggest a hypothesis that is related to uncertainty avoidance.

*Hypothesis 8: Politically conservative boards are less likely to replace their CEOs following financial misrepresentation.*

On the other hand, financial misrepresentation represents an existential threat to an organization, as well as a threat to the board. Retaining a tainted CEO may be risky when financial misrepresentations are not dealt with convincingly; that is, the reputation of the firm may be significantly damaged, with both the firm and its managers facing

critical actions taken by shareholders and other stakeholders, such as boycotts and class-action lawsuits (Brochet & Srinivasan, 2014; Farber, 2005; Hennes, Leone, & Miller, 2013). Boards may also use a tainted CEO as a scapegoat. While CEO replacement may increase uncertainty within the organization, blaming the CEO for wrongdoing, and imposing strong disciplinary actions toward managers, can mitigate the organizational and personal threat represented by disclosure of financial misrepresentation. Since previous studies have found that conservatives embrace solutions that seek to minimize threats (Bonanno & Jost, 2006; Willer, 2004), conservative board members are more likely to take serious actions, such as the replacement of the CEO, in response to a financial misrepresentation.

*Hypothesis 9: Politically conservative boards are more likely to replace their CEOs following financial misrepresentation.*

Regardless of the direction of the main effect I offer with hypotheses 8 and 9, I suggest that the strength of board ideology may vary in terms of its effect on CEO replacement following financial misrepresentation, depending on the circumstances. There are some circumstances where organizations face an increased threat from financial misrepresentation while the level of uncertainty around CEO replacement remains constant. In such situations, I would argue that a conservative board would tend to replace the CEO rather than retain them.

First, the severity of an earnings restatement following a financial misrepresentation can have a major effect on how the ideology of the board influences

replacing the CEO. A severe restatement is salient to those board members who initiate actions that reflect their ideological positions following a restatement disclosure. Board members may believe that the firm along with its managers and board members may face stakeholder reactions including boycotts and class-action lawsuits when the severity of the misrepresentation increases (Brochet & Srinivasan, 2014; Farber, 2005; Hennes et al., 2013). Directors may be legally held liable and face occupational and personal hazards when the misrepresentation is severe (Brochet & Srinivasan, 2014; Srinivasan, 2005). Severe financial misrepresentation will affect board decisions because it can harm the financial performance of the firm along with its future prospects, and prompt other negative consequences, such as reducing the effect of increased earnings (Gomulya & Mishina, 2017) or raising the cost of capital to the firm (Dechow et al., 1996; Hribar & Jenkins, 2004). In turn, the public, stakeholders inside and outside the firm, and financial markets may demand a stronger response to a firm's financial misrepresentation, one which directly proportional to the level of penalties the firm faces. If a major misrepresentation is not dealt with convincingly, the reputation of the firm may be damaged significantly. Such a threat would likely moderate the board's decision to replace the CEO.

Given that conservatives are responsive to economic threats and potential loss, conservative boards may react more proactively than less conservative boards when restatements are severe. they may be strongly influenced by the severity of a financial misrepresentation and the level of fiduciary violation it represents when considering what actions they should take. Research has shown that conservatives tend to be more persistent in cracking down on perpetrators when the consequence of norm violation is

severe (Tetlock et al., 2006). Threat management theory would contend that conservatives are thus more likely to take action when an external threat is severe. Thus, I suggest following hypothesis:

*Hypothesis 10: Politically conservative boards are more likely to replace the CEO when the severity of financial misrepresentation is greater.*

Media also play important roles in this type of negative event, not only acting as a watchdog in detecting and debunking corporate behavior (Dyck et al., 2010; Miller, 2006), but increasing public awareness of the issues as information intermediaries (Ader, 1995; Behr & Iyengar, 1985) and influencing perceptions of corporate wrongdoing (Clemente & Gabbioneta, 2017). Increased media attention can ultimately "scandalize" an event (Adut, 2005; Wiesenfeld, Wurthmann, & Hambrick, 2008). Since a high level of media coverage regarding corporate misconduct may create a "conduit of negative images and grievances brought by activists against the company" (King, 2008: 400), it can also prompt firms to take serious action to address the situation. Examining stock option backdating, Wiersema and Zhang (2013) found that attention from the news media increased executive turnover, since raising public awareness of the practice led to increased pressure on the board to respond to the firm's misbehaviors.

Since media attention may affect the salience of financial misrepresentation, increased attention will likely increase perceptions of external threat to the organization, producing a stronger response from more conservative boards and a greater likelihood of CEO replacement due to their need to manage threat.

*Hypothesis 11: Politically conservative boards are likely to replace the CEO when there is more media attention about financial misrepresentation.*

Reaction of the market to the announcement of an earnings restatement will reflect not only the seriousness of the misrepresentation (Palmrose et al., 2004), but also how the market views it (Hennes et al., 2008). Scholars suggest that a negative market reaction serves as an additional indicator that a firm's actions are unacceptable, challenging its legitimacy (Arthaud-Day et al., 2006) and increasing the likelihood of CEO turnover (Hennes et al., 2008). Extending these baseline findings, I argue that political ideology plays an important role in how negative market reactions are perceived and acted upon. Based on the threat management argument (that conservative individuals are more sensitive to negative information), conservative boards may be more likely to react strongly to a negative reaction by the financial markets. Negative market reactions following financial misconduct can signify an imminent threat to the reputation of the firm and its directors, one that may be taken more seriously by a more conservative board (e.g., Block & Block, 2006).

Conservatives have also been shown to have a "fair market ideology," which considers market-based processes and outcomes as efficient, legitimate, and just (Blount, 2000; Jost, Blount, Pfeffer, & Hynyady, 2003). Individuals with a fair market ideology tend to blame managers rather than underlying market dynamics for poor corporate performance (Heath, Larrick, & Klayman, 1998). Such attributional bias toward individuals rather than organizations or market system when firm performance falls

below expectations tends to lead to harsher punishment of individuals (Jost et al., 2003). Consistent with the view that the market is fair and appropriate in judging the seriousness of financial misconduct, conservative boards will be likely more proactive in replacing the CEO when reaction of the markets is negative.

*Hypothesis 12: Politically conservative boards are likely to replace the CEO when market reaction is negative.*

Boards respond to the negative reactions of other important sources in a similar manner, with their reactions influenced by their political ideology. Research has shown that investment analysts who evaluate and forecast earnings and the valuation of specific firms may act as information intermediaries in assessing the effectiveness of a CEO (Jensen & Meckling, 1976; Wiesenfeld, Wurthmann, & Hambrick, 2008), as well as influencing corporate governance through their forecasts (Wiersema & Zhang, 2011). Building on these findings, I argue that the reactions of analysts to the disclosure of financial misrepresentation is an important factor for boards to consider when evaluating what actions they should take. With a greater focus on threat management, conservative boards will likely be more sensitive to negative reactions by investment analysts (e.g., a downward revision of earnings forecasts for the firm). Although not all downward earnings revisions necessarily lead to negative market returns (Clement & Tse, 2003; Loh & Stulz, 2011), they do represent an external and arguably objective reaction to the negative impact a misrepresentation may have on the future of the firm. Therefore, when faced with negative analyst reactions, conservative boards tend to treat such reactions as

threats to the firm and its leadership.

Thus, when external entities react strongly and negatively to the announcement of an financial misrepresentation, conservative boards are more likely to pay close attention and take such reactions into account when deciding whether to replace the CEO.

Accordingly, when faced with negative reactions by external stakeholders, including analysts, conservative boards are more likely to replace the CEO of a misrepresenting firm than less conservative boards.

*Hypothesis 13: Politically conservative boards will likely replace the CEO when analyst reaction is negative.*

## CHAPTER 4. EMPIRICAL TESTS

### METHODOLOGY

#### Board Ideology and Governance Structure

**Data.** I intend to test the theories and hypotheses regarding governance structure by examining a sample of S&P 1500 firms from 2003–2014. I chose this timeframe since no significant regulatory changes took place likely to confound governance structure. Under Section 301 of the Sarbanes-Oxley Act of 2002, boards of directors of public companies are required to demonstrate independence by populating their audit committees with independent directors.<sup>4</sup> Further changes to board independence would thus represent a conservative test of the hypotheses. All firm and governance-related data were retrieved from Compustat, RiskMetric, ISS and ExecuComp.

**Dependent variables.** I chose three dependent variables (stated in italics) to examine the relationship between board ideology and governance structure. Hypothesis 1 suggests that conservative boards are less likely to approve *CEO duality*. I used a dummy variable, coded 1 if the CEO was also chair of the board, and zero otherwise. Hypothesis 2 claims that a board of directors with a conservative ideology tends to increase board independence. I utilized the most common way of measuring board independence, i.e., the proportion of independent directors on the board and measured *Change in independence* from year<sub>t-1</sub> to year<sub>t</sub> (Dalton et al., 1998). I relied on the independent director code as stated in RiskMetric and ISS datasets. Lastly, I argue that board conservatism may lead to the adoption of more pay-for-performance compensation. I

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<sup>4</sup> SOX defines an independent director as one who does not accept advisory, consulting, or other compensation from the company and is not affiliated with the company or its subsidiaries.

measured this construct by calculating total stock option grant value using the Black-Scholes model divided by total compensation. In order to reflect the reality that options are granted periodically rather than annually, I calculated *Average option/total compensation* variable as a two-year average (Sanders & Hambrick, 2007; Wowak, Mannor, & Wowak, 2015).

***Independent variables.*** Following recent studies (Chin et al., 2013; Christensen et al., 2015; Lee et al., 2014) that seek to measure political ideology of corporate elites, I operationalized *Political ideology* based on individual political campaign donation information collected from the Federal Election Commission (FEC). Studies have shown that this operationalization may serve as an effective proxy for a person's political beliefs (Christensen et al., 2015; Lee et al., 2014).

First, I collected information from the FEC on all donations made to political campaigns between 1980–2014. From this data, I matched directors' individual donations to their employer. I measured a director's political orientation by calculating the net donations made to the Republican Party (total amount donated to the Republican Party minus donated to the Democratic Party, divided by total amounts donated to both parties and averaged by election cycles) (Christensen et al., 2015; Lee et al., 2014). The resulting values for individual political orientation ranged from –1 to +1, where –1 indicates that all donations were made to the Democratic Party and +1 indicates that all donations were made to the Republican Party. Based on these individual orientations, I created a summation measure of board ideology, *Board conservatism*, with the exception of CEO ideology if the CEO also serves as director or chair of the board, since each board member would have equal voting power over any governance decision. I included CEO

ideology separately in the model.

**Moderating variable.** Hypothesis 3 uses *the proportion of independent directors* as a moderating variable.

**Control variables.** I included a number of control variables in the models based on past studies. First, I control for *Firm size (logged total assets)* using logged total assets and *Net income*. Then I control for *Total diversification*, which is shown to influence governance structure (Dalton et al., 1998) using the Palepu (1985) diversification entropy measure. Additionally, I include *Number of directors*, the number of years as CEO (*CEO tenure*), and *CEO conservatism*. To control for any in-group favoritism caused by political ideology, I created and controlled for *Board-CEO ideological similarity*. This was measured using the Euclidian distance (1-the normalized Euclidian distance) between CEO conservatism and board conservatism ( $1 - (|\text{CEO conservatism} - \text{Board conservatism}|)/2$ ) (Lee et al., 2014).

**Estimation.** Two panel data estimation models were used. For hypothesis 1, I chose a logistic fixed-effects model since its dependent variable is binary.<sup>5</sup> For hypotheses 2 to 4, OLS fixed-effects with robust standard errors was used. I chose fixed-effects over random-effects because the Hausman tests demonstrated that it was preferred (Greene, 2008). The within-firm effects was deemed appropriate since I hypothesize changes within the board in terms of political ideology affecting firm-level outcomes (i.e., firm's governance structure).

### **Adoption of a Clawback Provision**

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<sup>5</sup> For robustness of the results, I used a Generalized Estimating Equation (GEE) with binomial family, logit link and exchangeable correlation to consider heteroskedasticity and serial correlation. The results were basically the same as the logistic fixed-effects model.

**Data.** I examined a sample of S&P 1500 firms that voluntarily adopted a clawback provision between 2007–2009. Since the practice of clawback provisions originated is more prevalent in the financial sector, where it originated, I excluded all financial firms (Dehaan et al., 2013). Before 2007, voluntary clawback provision adoption was practically nonexistent in S&P 1500 firms (i.e., found in only 13). However, from 2007 up to when the Dodd-Frank Act of 2010 formalized and enforced adoption of the provision in some industries, non-financial companies increasingly adopted use of the provision (165 firms). I used a matched-pair sampling approach which has been employed in past work to examine voluntary adoption of clawback provisions (Dehaan et al., 2013). Following previous studies, I matched each firm that adopted the provision with an S&P 1500 firm, based on three criteria (Arthaud-Day et al., 2006; Gomulya & Boeker, 2014). A matching firm must be from the same four-digit standard industry classification (SIC) code; of similar size in total assets; and listed on the same index used for the sample (S&P 1500) in the same year. I excluded firms that had headquarters outside of the U.S. since political ideology was based on participation in U.S. politics. This procedure resulted in a sample of 284 firms: 142 adoption firms and 142 non-adoption firms. Data were collected from proxy statements (DEF 14A), Compustat, RiskMetric, and ExecuComp.

**Dependent variables.** The dependent variable in hypothesis 5 is *Adoption of a clawback provision*. The dummy variable is coded 1 for adoption, zero otherwise.

**Independent variables.** I used the same approach cited above for the independent variable used in this model.

**Control variables.** I included a number of control variables in the models based

on studies of the adoption of clawback provisions. Thus, I control for *Market value of equity*, which has been shown to increase adoption of the provision (Dehaan et al., 2013). For governance structure, I control for *Number of directors*, proportion of independent directors on the board (*% of independent director*), *CEO duality*, and percentage of CEO pay from stock options (*% of stock options*). For CEO characteristics, I chose number of years as a CEO (*CEO tenure*) and CEO ideology (*CEO conservatism*), and further control for board-CEO ideological similarity in order to identify any in-group bias based on the political leanings, using the Euclidian distance mentioned earlier.

***Estimation model.*** I used two-stage models to test the hypotheses in order to control for potential endogeneity issues. In the first stage I use the instrument variable approach to estimate *Board conservatism*. The instrument variable is *State citizen ideology*, which may influence board conservatism but not the likelihood of a financial restatement. If a firm's headquarter is located in a more politically conservative region, the board may include more politically conservative directors. Past studies have shown that the local market for directors influences the composition of boards (Knyazeva et al., 2013; Kono, Palmer, Friedland, & Zafonte, 1998). State citizen ideology in and of itself, however, would not directly affect adoption of a Clawback provision. The variable comes from Berry and his colleague (1998), who performed an annual estimate of citizen ideology for each state from 1960–2013, based on state and district election results. The variable is continuous from 0 to 100, with zero meaning conservative and 100 equals liberal. In addition to the instrument variable, I include industry dummy variables since the nature of a given industry may influence the political ideology of the leadership (Seider, 1974). The ordinary least square (OLS) model was used in the first stage. From

this model, I calculated the predicted value and control in the second-stage logit model, where *Adoption of Clawback provision*, the dummy variable, is the dependent variable. Using OLS in the first stage and the logit/probit model in the second stage was an efficient way to control for endogeneity (Newey, 1987).

### **Earnings Manipulation**

**Data.** Earnings manipulation is not an one-time event. Rather, a firm can choose the degree of manipulation. Hence, I constructed panel data for S&P 1500 firms from 1996–2014. I chose this timeframe since I would not expect much impact of SOX on vigilance toward a subtle financial misdemeanor. Data were compiled from Compustat, ISS, RiskMetric, and ExecuComp.

**Dependent variable.** The dependent variable, *Earnings manipulation*, was measured using discretionary accruals following a modified Jones (1991) approach, the standard and most frequently used measurement for earning manipulation in the accounting literature (Dechow, Richardson, & Tuna, 2003; Dechow, Sloan, & Sweeney, 1995). Discretionary accrual represents the amount of non-recurring expenses that are recorded and have a material impact on reported earnings. These are measured with an error when discretion is exercised over revenues. In practice, it is measured as the predicted residual from the estimated non-discretionary accruals based on the following equation:

$$NDA_t = \alpha + \beta_1(1/A_{t-1}) + \beta_2(\Delta REV_t - \Delta REC_t) + \beta_3(PPE_t) + \epsilon,$$

where

$A_{t-1}$  is total asset in year t-1;

$\Delta REV_t$  is difference between revenues in year t and year t-1 scaled by total asset in year

t-1;

$\Delta REC_t$  is difference between net receivable in year t and year t-1 scaled by total asset in year t-1;

$PPE_t$  is gross property plant and equipment in year t; and

$\beta_1$ ,  $\beta_2$ , and  $\beta_3$  represent firm-specific parameters.

**Independent variable.** I employed the *Board conservatism* variable based on the FEC. For this context, I created a weighted measure for board ideology since the influence of each person would depend on the position that person holds, regarding financial reporting issues in particular (Christensen et al., 2015). I considered two directorial positions (the chair of the board and the chair of the audit committee) since they are mostly accountable for a firm's financial misconduct. Hence, the main independent variable, *Board conservatism*, is a weighted summation of the individual ideology value, with chair of the board assigned a weight of 1, audit committee chair 0.5, and other directors 0.3.

**Control variables.** I included a number of control variables in the models based on past studies of earnings manipulation. First, I controlled for firm-related variables such as *Firm size* and *Net income* in order to reflect firm performance. The other control variables were derived from previous contexts in the model: *Number of directors*, *% of independent director*, *CEO duality*, *CEO tenure*, *Average option/total compensation*, *CEO conservatism*, and *Board-CEO ideological similarity*.

**Estimation model.** The panel data model with fixed-effects was used, based on a Hausman test that was significant, suggesting any difference in coefficients between random-effects and fix-effects is systematic (Greene, 2008).

## **Financial Misrepresentation**

**Data.** I examined a sample S&P 1500 firms involved in financial misrepresentation and consequently earnings restatements from 2003–2012, using data compiled from the AuditAnalytics database, which lists firms who revised their earnings as a result of aggressive accounting practices and/or non-compliance or misinterpretation of accounting rules. I chose 2003–2012 over other timeframes based on the fact there were no significant external changes such as SOX Act of 2002 that were likely to confound the board’s monitoring style toward significant misconduct such as financial misrepresentation (Arthaud-Day et al., 2006). I excluded firms with simple accounting or clerical errors that would likely not be material to prior financial statements, based on multiple sources including press releases and media coverage.

Like the clawback provision context, I utilized a matched-pair sampling approach, a common sampling method used to examine phenomena with a low occurrence rate, such as earnings restatements (Dehaan et al., 2013; Desai, Hogan, & Wilkins, 2006). To perform a match, I considered four criteria following past studies: industry, firm size, S&P 1500, and year (Arthaud-Day et al., 2006; Gomulya & Boeker, 2014). I omitted non-U.S. firms since political ideology was based on participation in U.S. politics. The final sample is consisted of 276 firms that committed financial misrepresentation and 276 matching firms that did not commit financial misrepresentation (552 firms in total).

**Dependent variable.** The dependent variable for hypothesis 7 is *Financial Misrepresentation*. I created a dummy variable, coding 1 for misrepresentation, and zero otherwise.

**Independent variable.** The same method was used to calculate the independent

variable (*Board conservatism*) for predicting incidence of earnings manipulation. It is a weighted summation of the individual ideology value (measured as individual political donations), where the board chair is assigned a weight of 1, the audit committee chair 0.5, and other directors 0.3.

**Control variables.** I included a number of control variables in the models based on past studies of financial misrepresentation. Since firms that perform relatively lower than their peers are more likely to misrepresent their earnings (Harris & Bromiley, 2007), I compared relative firm performance to the industry (*Relative performance*). Following Harris and Bromiley (2007), I used firm return on assets (ROA) and industry ROA based on four-digit SIC codes to operationalize relative performance ( $ROA_{t-1}$  subtracted by industry  $ROA_{t-1}$ , excluding the focal firm in the industry ROA calculation). As with the previous context, I included as variables *Number of directors*, *% of independent director*, *CEO duality*, *CEO tenure*, *CEO conservatism*, and *Board-CEO ideological similarity*. Research has shown that proportion of CEO pay derived from stock options may increase the chances of financial misrepresentation (Burns & Kedia, 2006; Efendi, Srivastava, & Swanson, 2007; Harris & Bromiley, 2007). Thus, I also control for *Average option/total compensation*.

**Estimation model.** I used a two-stage models to test the hypotheses that control for potential endogeneity issues, taking *State citizen ideology* as a main independent variable, along with industry dummy variables in the first stage predicting *Board conservatism*. The logic of this approach is that state citizen ideology alone may not directly affect the likelihood of financial misrepresentation. While firms strategically and purposely set their headquarters in a particular region, they do not do so with financial

misrepresentation in mind. I then calculated the predicted value and controlled for this in the second-stage logit model, where *Financial misrepresentation*, a dummy variable, is the dependent variable (Newey, 1987).

### **CEO Replacement following Financial Misrepresentation**

**Data.** I tested the theory and hypotheses for CEO replacement by examining a sample of S&P 1500 firms that were involved with financial misrepresentation from 2003–2012 and thus required by the SEC to restate their earnings. I took data from the AuditAnalytic database, which lists firms that were forced to revise their earnings as a result of aggressive accounting practices and/or non-compliance or misinterpretation of accounting rules. I excluded non-U.S. firms and those firms where simple accounting errors were not material to a prior financial statement since no financial misconduct had taken place (Hennes et al., 2008). I also excluded firms that restated earnings as a result of positive changes to their earnings, tracked any misrepresentation, and omitted firms whose CEOs were not involved with any misconduct at the time of restatement announcement.

**Dependent variable.** The dependent variable was *CEO replacement*. As in past studies of financial misrepresentation, I coded outcome variables occurring within two years of an announcement of misrepresentation in order to minimize other confounding influences (Desai et al., 2006). Data were collected from the ExecuComp database. In order to accurately measure CEO replacement, I eliminated cases of retirement or death. I also excluded cases where the CEO had joined the board, or served as an advisor or consultant after stepping down as such cases are not considered replacement by the board (Hazarika, Karpoff, & Nahata, 2012; Shen & Cannella, 2002).

**Independent variables.** I utilized the measure, *Board conservatism*, for earnings manipulation and financial misrepresentation models, having weighted a measure for the chairperson and audit committee chair.

**Moderating variables.** I used a number of moderating variables. The first variable, *Misrepresentation severity*, which corresponds to hypothesis 10, measures the magnitude of restated income and is log transformed to account for any skewedness. For hypothesis 11, I captured levels of media attention based on the number of news articles, or *No. of media coverage*. I collected both national and regional news articles from the Lexis-Nexis database three months before and after announcements, and examined each article to exclude any irrelevant information.

To determine stock market reaction in hypothesis 12, I used a market-adjusted cumulative abnormal return (*CAR*) three days prior to three days after restatement announcement dates (Brown & Warner, 1985; Wright, Kroll, & Elenkov, 2002). This variable is commonly used to measure stock market reaction to restatement events (e.g., Hutton, Jiang, & Kumar, 2015). For hypothesis 13, I suggested the interaction effect of analysts' reactions to a restatement. For analyst reactions, I measured the *Analyst forecast change* by calculating the change in annual earnings-per-share (EPS) mean forecast made by analysts who followed the firm before and after the restatement announcement from I/B/E/S (Gomulya & Boeker, 2014; Palmrose, Richardson, & Scholz, 2004).

**Control variables.** Models follow previous studies to include control variables designed to capture firm characteristics, governance structures, and CEO characteristics. For firm characteristics, I used *Total assets (log)* for firm size and performances measures using return on asset (*ROA*). For governance structure, I control for the percentage of

independent directors on the board (*% of independent director*), *Director average tenure*, and *CEO duality*. For CEO characteristics I control for *CEO tenure* and *CEO conservatism* using political campaign donation patterns of the CEO. Since some studies have found a homophily effect to be associated with political ideology (Christensen et al., 2015; Lee et al., 2014), I control for board-CEO ideology using the Euclidian distance between CEO conservatism and board conservatism (Lee et al., 2014). All moderators mentioned above were included as controls. In addition, I control for industry by using two-digit SIC codes (manufacturing, transportation, wholesale and retail, finance, service, etc.).

***Estimation Model.*** Although I included a number of control variables, it may not be possible to capture unobserved omitted variables that might influence any decision to replace the CEO. Instead, I adopted a two-stage instrumental variable approach to address this issue (Hausman, 1975), using *State citizen ideology* as the main independent variable along with the industry dummy variables in the first stage predicting *Board conservatism*. From this model, I calculated predicted values and controlled for these in the second stage logit model where *CEO replacement* was the dependent variable (Newey, 1987).

**Table 4-1. Descriptive Statistics**

(A1) Descriptive statistics for governance structure

	Mean	S.D.	Min	Max	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
(1) CEO duality	0.61	0.49	0.00	1.00										
(2) Proportion of independent director	0.76	0.13	0.00	1.00	0.06									
(3) Average option/total compensation	0.09	0.19	0.00	1.00	0.16	-0.18								
(4) Firm size (logged total assets)	7.92	1.63	3.27	14.46	0.14	0.22	-0.05							
(5) Net income	545.32	2268.94	-99289.00	45220.00	0.06	0.08	-0.02	0.41						
(6) Total diversification	0.30	0.40	0.00	2.14	0.12	0.09	-0.01	0.27	0.13					
(7) Number of director	9.25	2.26	3.00	34.00	0.08	0.13	-0.03	0.58	0.24	0.24				
(8) CEO tenure	9.01	8.05	0.00	61.00	0.12	-0.23	-0.06	-0.10	-0.03	-0.06	-0.11			
(9) CEO conservatism	0.22	0.65	-1.00	1.00	0.03	0.02	0.00	0.01	0.01	0.04	0.02	0.00		
(10) Board-CEO ideological similarity	0.19	0.66	-4.17	1.00	0.02	0.01	0.02	-0.13	-0.04	-0.10	-0.22	0.02	0.02	
(11) Board conservatism	0.63	2.12	-8.47	10.20	0.00	0.03	-0.00	0.01	0.00	0.06	0.06	-0.01	0.24	-0.23

(A2) Descriptive statistics for governance structure (board independence)

	Mean	S.D.	Min	Max	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
(1) Change in independence	0.01	0.07	-0.88	0.67											
(2) Firm size (logged total assets)	7.92	1.63	3.27	14.46	-0.01										
(3) Net income	545.32	2268.94	-99289.00	45220.00	-0.01	0.41									
(4) Total diversification	0.30	0.40	0.00	2.14	-0.01	0.27	0.13								
(5) Number of director	9.25	2.26	3.00	34.00	-0.00	0.58	0.24	0.24							
(6) CEO duality	0.61	0.49	0.00	1.00	0.01	0.14	0.06	0.12	0.08						
(7) Proportion of independent director	0.76	0.13	0.00	1.00	0.17	0.22	0.08	0.09	0.13	0.06					
(8) Average option/total compensation	0.09	0.19	0.00	1.00	0.05	-0.05	-0.02	-0.01	-0.03	0.16	-0.18				
(9) CEO tenure	9.01	8.05	0.00	61.00	-0.01	-0.10	-0.03	-0.06	-0.11	0.12	-0.23	-0.06			
(10) CEO conservatism	0.22	0.65	-1.00	1.00	-0.01	0.01	0.01	0.04	0.02	0.03	0.02	0.00	0.00		
(11) Board-CEO ideological similarity	0.19	0.66	-4.17	1.00	0.01	-0.13	-0.04	-0.10	-0.22	0.02	0.01	0.02	0.02	0.02	
(12) Board conservatism	0.63	2.12	-8.47	10.20	-0.02	0.01	0.00	0.06	0.06	0.00	0.03	-0.00	-0.01	0.24	-0.23

(B) Descriptive statistics for Clawback provision

	Mean	S.D.	Min	Max	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
(1) Clawback provision adoption	0.50	0.50	0.00	1.00									
(2) Market value of equity	12416.18	29304.98	36.90	251169.73	0.06								
(3) Number of director	8.53	2.52	1.00	15.00	0.20	0.25							
(4) Proportion of independent director	0.93	0.09	0.60	1.00	0.01	-0.04	-0.33						
(5) CEO Duality	0.25	0.44	0.00	1.00	0.15	0.16	0.34	-0.45					
(6) CEO tenure	8.11	8.21	0.00	47.00	-0.08	0.02	-0.16	-0.08	-0.04				
(7) Average option/total compensation	0.07	0.14	0.00	0.91	0.04	0.02	0.05	0.02	0.06	0.09			
(8) CEO conservatism	0.19	0.62	-1.00	1.00	-0.03	0.01	0.00	0.01	0.00	-0.07	-0.10		
(9) Board-CEO ideological similarity	0.12	0.64	-1.96	1.00	-0.14	0.10	-0.24	0.02	-0.09	-0.04	-0.07	-0.06	
(10) Board conservatism	0.90	2.16	-5.29	6.91	0.15	-0.02	0.23	-0.09	0.13	-0.10	-0.01	0.29	-0.44

(C) Descriptive statistics for earnings manipulation

	Mean	S.D.	Min	Max	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
(1) Earnings manipulation	0.00	0.36	-2.22	1.05										
(2) Firm size (logged total assets)	5.13	2.90	-6.91	15.14	0.12									
(3) Net income	117.89	1146.16	-99289.00	104821.00	0.04	0.21								
(4) Number of director	9.46	2.74	1.00	39.00	0.02	0.58	0.19							
(5) Proportion of independent director	0.70	0.17	0.00	1.00	0.06	0.23	0.09	0.09						
(6) CEO duality	0.67	0.47	0.00	1.00	-0.01	0.12	0.04	0.10	-0.01					
(7) CEO tenure	8.04	7.89	0.00	61.00	0.03	-0.03	-0.00	-0.08	-0.18	0.09				
(8) Average option/compensation	0.19	0.24	0.00	1.00	-0.04	-0.04	-0.02	-0.00	-0.22	0.20	-0.10			
(9) CEO conservatism	0.21	0.62	-1.05	1.00	0.00	0.04	0.01	0.04	0.02	0.04	-0.00	0.01		
(10) Board-CEO ideological similarity	0.56	0.39	-2.76	1.00	0.01	-0.18	-0.04	-0.29	0.02	-0.12	0.04	-0.11	0.01	
(11) Board conservatism	0.60	1.26	-5.81	7.91	0.00	0.10	0.03	0.17	0.03	0.13	-0.02	0.09	0.46	-0.44

(D) Descriptive statistics for financial misrepresentation

	Mean	S.D.	Min	Max	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
(1) Financial misrepresentation	0.50	0.50	0.00	1.00									
(2) Relative performance	3.65	10.57	-104.75	37.24	-0.08								
(3) Number of director	8.95	2.22	4.00	18.00	-0.06	-0.01							
(4) Proportion of independent director	0.74	0.14	0.00	1.00	0.08	-0.08	0.08						
(5) CEO Duality	0.63	0.48	0.00	1.00	0.14	0.05	0.08	0.04					
(6) CEO tenure	9.55	8.24	0.00	54.00	0.13	0.04	-0.09	-0.17	0.15				
(7) Average option/total compensation	0.19	0.25	0.00	0.95	-0.01	0.10	-0.08	-0.11	0.13	-0.05			
(8) CEO conservatism	0.17	0.66	-1.00	1.00	-0.02	0.04	0.06	0.01	0.02	-0.01	0.03		
(9) Board-CEO ideological similarity	0.59	0.34	-2.40	1.00	0.12	0.02	-0.18	0.04	-0.06	0.08	-0.06	-0.01	
(10) Board conservatism	0.39	1.14	-3.25	6.79	-0.11	0.04	0.16	-0.00	0.05	-0.03	0.07	0.42	-0.30

(E) Descriptive statistics for CEO replacement after financial misrepresentation

	Mean	S.D.	Min	Max	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
(1) CEO replacement	0.21	0.41	0.00	1.00													
(2) Firm size (logged total assets)	7.45	1.57	3.96	14.67	0.05												
(3) ROA	1.88	9.97	-80.47	24.59	-0.02	0.03											
(4) Proportion of independent director	0.75	0.13	0.22	1.00	0.04	0.10	-0.06										
(5) Average director tenure	8.53	3.63	1.57	20.29	-0.04	-0.00	0.08	-0.22									
(6) CEO tenure	10.67	7.56	1.00	39.00	-0.04	-0.06	0.11	-0.20	0.50								
(7) CEO duality	0.70	0.46	0.00	1.00	0.06	0.12	0.08	-0.17	0.03	0.19							
(8) Amount of restating income (log)	15.90	1.74	10.86	22.57	0.18	0.54	0.03	0.05	-0.02	0.04	0.08						
(9) No. of media coverage	0.83	4.93	0.00	77.00	0.17	0.35	0.02	-0.03	-0.04	-0.01	0.06	0.35					
(10) CAR	-0.02	0.11	-1.18	0.32	-0.14	0.04	0.07	-0.01	0.10	0.05	-0.04	-0.14	-0.03				
(11) Analyst reaction	-0.06	0.97	-10.00	4.22	0.01	0.06	0.22	-0.07	0.08	0.03	-0.02	0.03	0.01	0.04			
(12) CEO conservatism	0.16	0.66	-1.00	1.00	-0.02	0.03	0.11	-0.02	0.03	0.07	0.05	-0.01	-0.09	0.08	0.05		
(13) Board-CEO ideology similarity	0.63	0.29	-0.51	1.00	-0.06	-0.14	0.02	0.00	-0.04	0.13	-0.07	-0.17	-0.00	0.11	-0.05	-0.02	
(14) Board conservatism	0.28	1.05	-3.25	4.01	0.09	0.04	0.10	0.00	0.01	-0.04	0.01	-0.03	-0.09	0.07	0.03	0.48	-0.07

**Table 4-2. Logistic Fixed-effects Model on CEO Duality**

DV: CEO Duality	Control	Main
Firm size (logged total assets)	-0.454*** (0.094)	-0.448*** (0.094)
Net income	-0.000* (0.000)	-0.000* (0.000)
Total diversification	0.313* (0.185)	0.327* (0.186)
Number of directors	-0.069** (0.027)	-0.063** (0.027)
Proportion of independent director	-0.556 (0.344)	-0.493 (0.345)
Average option/total compensation (2 year)	3.361*** (0.213)	3.404*** (0.213)
CEO tenure	0.072*** (0.006)	0.071*** (0.006)
CEO conservatism	0.017 (0.082)	0.037 (0.083)
Board-CEO ideological similarity	0.417*** (0.067)	0.333*** (0.069)
Board conservatism		-0.156*** (0.029)
N	8,341	8,341
$\chi^2$	725.66	755.80

\*  $p < 0.1$ ; \*\*  $p < 0.05$ ; \*\*\*  $p < 0.01$

## RESULTS

### Board Ideology and Governance Structure

Descriptive statistics for all observations are given in Table 4-1(A1) for hypotheses 1 and 4 and in Table 4-1(A2) for hypotheses 2 and 3. Although the dataset is comprised of panel data, the statistics demonstrate general data characteristics. No correlation was sufficiently high to raise multicollinearity concerns.

Hypothesis 1 posits that more conservative boards are unlikely to have CEO duality. I find support for the hypothesis that board conservatism is significantly and negatively associated with CEO duality ( $\beta = -0.156, p < 0.01$ , main model in Table 4-2). Please note that 1164 firms were dropped from this panel analysis when there was no change to their dependent variable. From 892 firms and 8341 firm-year observations, the analysis suggests a strong causal relationship between board ideology and the presence of CEO duality.

Results for most control variables aligned with previous studies, but I wanted to highlight one result in particular, where Lee and colleagues (2014) found that the political alignment of top management and independent directors was often associated with poor firm performance, i.e., lower valuations and profitability and the reduced likelihood of replacing a poorly performing CEO. One interesting finding related to the control variable in this model was the issue of board-CEO ideological similarity. The idea that board-CEO ideological similarity may have a positive effect on CEO duality is closely related to such findings. Perhaps one may interpret that similar political ideology directly or indirectly (i.e., CEO duality) may have a negative effect on firm performance and monitoring effectiveness.

**Table 4-3. Fixed-effects Model for Change in Independent Directors**

DV: Change in independence	Control	Main 1	Main 2
Firm size (logged total assets)	-0.026*** (0.002)	-0.026*** (0.002)	-0.027*** (0.002)
Net income	-0.000 (0.000)	-0.000 (0.000)	-0.000 (0.000)
Total diversification	0.005 (0.004)	0.005 (0.004)	0.005 (0.004)
Number of directors	0.002** (0.001)	0.002** (0.001)	0.002** (0.001)
Proportion of independent director	0.388*** (0.008)	0.388*** (0.008)	0.386*** (0.008)
Average option/total compensation	0.060*** (0.004)	0.060*** (0.004)	0.060*** (0.004)
CEO duality	0.007*** (0.002)	0.006*** (0.002)	0.006*** (0.002)
CEO tenure	-0.000 (0.000)	-0.000 (0.000)	-0.000 (0.000)
CEO conservatism	0.001 (0.002)	0.001 (0.002)	0.001 (0.002)
Board-CEO ideological similarity	0.000 (0.002)	-0.001 (0.002)	-0.001 (0.002)
Board conservatism		-0.002** (0.001)	-0.006** (0.003)
Board conservatism × % of independent director			0.006* (0.003)
Constant	-0.097*** (0.018)	-0.097*** (0.018)	-0.094*** (0.018)
N	13,445	13,445	13,445
F	222.13	202.56	185.99
R <sup>2</sup>	0.16	0.16	0.16

\*  $p < 0.1$ ; \*\*  $p < 0.05$ ; \*\*\*  $p < 0.01$

Table 4-3 above shows the results for hypotheses 2 and 3, which predict the role of board ideology on a change in board independence. The main model shows support for hypothesis 2; pointing in the opposite direction of the proposed formula ( $\beta = -0.002$ ,  $p < 0.05$ , main model 1 in Table 4-3). I discuss this surprising result in the next chapter. In main model 2, I find that hypothesis 3 is supported ( $\beta = 0.006$ ,  $p < 0.1$ ). Conservative boards (+1 S.D.) with a greater proportion of independent directors (+1 S.D.) are 4.6 times more likely to show increased board independence than conservative boards with a mean proportion of independent directors.

Compared to Table 2, on the surface, number of directors seems to have opposite effect, reducing the likelihood of CEO duality, but also reducing board independence by lowering the number of independent directors. I discuss these findings in the discussion section. Interestingly, in this model board-CEO ideological alignment does not seem to affect changes in board independence.

The last hypothesis for governance structure involves pay-for-performance incentives. The result indicates strong support for hypothesis 4, i.e., that politically conservative boards tend to offer more performance incentives in total compensation ( $\beta = 0.006$ ,  $p < 0.05$ , main model in Table 4-4). The results for the control variables in this model also seem to yield contradictory effects, especially the percentage of independent directors and the effect of CEO duality on compensation incentives. Such results clearly suggest a greater complexity in board dynamics.

**Table 4-4. Fixed-effects Model for CEO Option/Compensation Ratio**

DV: Option/compensation	Control	Main
Firm size (logged total assets)	-0.143*** (0.004)	-0.143*** (0.004)
Net income	0.000 (0.000)	0.000 (0.000)
Total diversification	0.053*** (0.009)	0.053*** (0.009)
Number of directors	-0.002* (0.001)	-0.003** (0.001)
Proportion of independent director	-0.509*** (0.016)	-0.509*** (0.016)
CEO duality	0.069*** (0.004)	0.070*** (0.004)
CEO tenure	-0.002*** (0.000)	-0.002*** (0.000)
CEO conservatism	0.005 (0.004)	0.005 (0.004)
Board-CEO ideological similarity	-0.006* (0.003)	-0.004 (0.003)
Board conservatism		0.006*** (0.001)
Constant	1.590*** (0.033)	1.587*** (0.033)
N	14,616	14,616
F	418.34	378.58
R <sup>2</sup>	0.23	0.23

\*  $p < 0.1$ ; \*\*  $p < 0.05$ ; \*\*\*  $p < 0.01$

**Table 4-5. Logistic Model for the Adoption of Clawback Provisions**

DV: Clawback provision adoption	Control	Main
Market value of equity	0.000 (0.000)	0.000 (0.000)
Number of directors	0.142** (0.060)	0.131** (0.060)
% of independent director	3.160* (1.749)	3.300* (1.766)
CEO Duality	0.680** (0.340)	0.670* (0.342)
CEO tenure	-0.012 (0.016)	-0.010 (0.016)
Average option/total compensation (2 year)	0.022 (0.902)	-0.089 (0.915)
Predicted value (Board conservatism)	-0.143 (0.191)	-0.244 (0.201)
CEO conservatism	-0.125 (0.202)	-0.229 (0.212)
Board-CEO ideological similarity	-0.340 (0.207)	-0.194 (0.225)
Board conservatism		0.125* (0.071)
Constant	-4.041** (1.910)	-4.103** (1.923)
N	284	284
$\chi^2$	22.13	25.21

\*  $p < 0.1$ ; \*\*  $p < 0.05$ ; \*\*\*  $p < 0.01$

## **Adoption of a Clawback Provision**

Table 4-1(B) gives descriptive statistics for the Clawback provision adoption model. Correlations among the variables revealed little multicollinearity. As expected, state citizen ideology had a significant effect ( $\beta = -0.04$ ,  $p < 0.01$ ) on board conservatism in the first-stage model. Indeed, local political environment seems to have an impact on ideology of the board. The predicted values were controlled in the second-stage model.

Table 4-5 shows the results for hypothesis 5, which predicts that firms with more conservative boards are more likely to voluntarily adopt the Clawback provision. Note that sample size differs from the previous context, as I focused on only a small number of firms that adopted the clawback provision (142 firms and 142 matching firms) from 2007 until the Dodd-Frank Act of 2010 which formalized and enforced adoption of the provision. Based on this sample, I find that board conservatism increases the likelihood of clawback provision adoption ( $\beta = 0.125$ ,  $p < 0.1$ ). Thus, hypothesis 4 is supported.

Again, there were seemingly contradictory results for the control variables. CEO duality, which is known to represent CEO power, tended to increase Clawback provision adoption ( $\beta = 0.670$ ,  $p < 0.1$ ). Perhaps those boards with powerful CEOs have instituted checks and balances similar to the findings of Finkelstein and D'Aveni (1994), who documented that board vigilance was positively related to CEO duality. However, in this sample CEO duality was exceptionally low compared with other samples. Perhaps this is driving the results in this sample. I found no significant board-CEO ideological similarity in this model. Looking at the mean value of the variable, I noticed that it is lower than those in other samples. Perhaps firms that adopt the provision and the matched-pairs have less ideological similarity between their board and CEO.

**Table 4-6. Fixed-effects Model of Earnings Manipulation**

DV: Earnings manipulation	Control	Main
Post-SOX	-0.001 (0.003)	-0.002 (0.003)
Firm size (logged total assets)	0.014*** (0.002)	0.014*** (0.002)
Net Income	0.000*** (0.000)	0.000*** (0.000)
Number of directors	0.000 (0.001)	0.000 (0.001)
Proportion of independent director	0.004 (0.008)	0.004 (0.008)
CEO duality	-0.004* (0.002)	-0.004* (0.002)
CEO tenure	0.000 (0.000)	0.000 (0.000)
Average option/total compensation	-0.004 (0.005)	-0.004 (0.005)
CEO conservatism	-0.004* (0.002)	-0.002 (0.002)
Board-CEO ideological similarity	-0.002 (0.003)	-0.005 (0.003)
Board conservatism		-0.003* (0.001)
Board conservatism × Post-SOX		
Constant	-0.068*** (0.016)	-0.064*** (0.016)
N	19,829	19,829
F	20.66	19.08
R <sup>2</sup>	0.01	0.01

\*  $p < 0.1$ ; \*\*  $p < 0.05$ ; \*\*\*  $p < 0.01$

## Earnings Manipulation

In the context of earnings manipulation, I used a panel dataset for the descriptive statistics shown in Table 4-1(C) as a reference, since the table contains all observations. The main model in Table 4-6 gives the result for hypothesis 6 which suggests that firms with more conservative boards are associated to a lesser degree of earnings manipulation. Again, I find support for hypothesis 6 ( $\beta = -0.003, p < 0.1$ ). There was no way to observe whether conservative boards actively monitor earnings manipulation in board meetings; however, the results suggest a negative relationship between board conservatism and earnings manipulation. Since the manipulation may be subtle and represent less significant managerial misconduct, this result seems to imply that conservative boards are more vigilant in monitoring financial misdemeanors by managers.

One interesting result for the control variables in this model is CEO duality, which is negatively associated with financial manipulation. In addition, some evidence suggests that CEOs with a conservative ideology represent less financial manipulation. This corroborates the argument that managers with a conservative ideology avoid risky management practices (Christensen et al., 2015). As predicted, SOX had no impact on the level of financial manipulation. I assume that since financial manipulation lies within the boundary of GAAP and legality, SOX may not affect how managers represent their earnings or the level of vigilance directed toward subtle managerial misconduct.

**Table 4-7. Logistic Model for Financial Misrepresentation**

DV: Financial misrepresentation	Control	Main
Relative performance	-0.020** (0.010)	-0.020** (0.010)
Number of directors	-0.047 (0.041)	-0.042 (0.041)
% of independent director	1.398** (0.694)	1.415** (0.695)
CEO Duality	0.612*** (0.190)	0.614*** (0.190)
CEO tenure	0.030*** (0.011)	0.030*** (0.011)
Average option/total compensation (2 year)	0.003 (0.368)	0.050 (0.370)
Predicted value (Board conservatism)	-0.113 (0.305)	0.003 (0.314)
CEO conservatism	-0.052 (0.135)	0.054 (0.150)
Board-CEO ideological similarity	0.717** (0.282)	0.604** (0.293)
Board conservatism		-0.156* (0.095)
Constant	-1.575** (0.706)	-1.579** (0.706)
N	552	552
$\chi^2$	37.96	40.68

\*  $p < 0.1$ ; \*\*  $p < 0.05$ ; \*\*\*  $p < 0.01$

## **Financial Misrepresentation**

Descriptive statistics for financial misrepresentation are shown in Table 4-1(D). No major concerns regarding multicollinearity were seen in the model. Table 4-7 lays out the results of the suggested model. Hypothesis 7 claims that those boards with a more conservative ideological leaning will experience less financial misrepresentation. The results validate that argument and provide support for hypothesis 7 ( $\beta = -0.156, p < 0.1$ ).

Better relative performance is shown to be associated with less financial misrepresentation ( $\beta = -0.020, p < 0.05$ ), substantiating previous findings that aspiration level is associated with firm misconduct (Harris & Bromiley, 2007). In this context, results for the control variables of CEO duality and CEO tenure are aligned with agency theory. However, contradicting agency theory the proportion of independent director seems to increase rather than decrease financial misrepresentation. This may be because more independent directors may lead to a greater information asymmetry between board and management, making it difficult for the board to sufficiently understand the business and monitor managers effectively. This may be why I found an opposite result for hypothesis 2, suggesting a positive impact of board conservatism on increased board independence in general.

**Table 4-8. Logistic Model for CEO Replacement after Financial Misrepresentation**

DV: CEO replacement	Control	Model 1	Model 2	Model 3	Model 4	Model 5
Firm size (logged total assets)	-0.002 (0.155)	0.022 (0.156)	0.025 (0.157)	0.032 (0.156)	0.024 (0.158)	0.003 (0.159)
ROA	-0.007 (0.014)	-0.011 (0.014)	-0.010 (0.014)	-0.011 (0.014)	-0.017 (0.015)	-0.012 (0.015)
Independent director proportion	0.741 (1.314)	0.890 (1.343)	0.937 (1.352)	0.869 (1.337)	0.628 (1.344)	0.938 (1.348)
Average director tenure	0.019 (0.054)	0.015 (0.055)	0.018 (0.055)	0.014 (0.055)	0.026 (0.055)	0.017 (0.055)
CEO tenure	-0.020 (0.026)	-0.014 (0.026)	-0.014 (0.027)	-0.014 (0.027)	-0.016 (0.027)	-0.014 (0.027)
CEO duality	0.290 (0.379)	0.268 (0.378)	0.262 (0.379)	0.274 (0.379)	0.237 (0.380)	0.307 (0.384)
Amount of restating income (log)	0.176 (0.121)	0.164 (0.120)	0.147 (0.126)	0.155 (0.121)	0.189 (0.122)	0.189 (0.124)
CAR	-2.672** (1.313)	-2.942** (1.377)	-2.992** (1.391)	-3.037** (1.373)	-0.933 (1.934)	-3.027** (1.379)
Analyst reaction	0.090 (0.197)	0.114 (0.210)	0.111 (0.208)	0.117 (0.211)	0.121 (0.209)	0.293 (0.336)
No. of media coverage	0.178** (0.083)	0.175** (0.083)	0.172** (0.084)	0.169** (0.076)	0.189** (0.085)	0.184** (0.084)
Predicted value (Board conservatism)	0.403 (0.841)	-0.027 (0.870)	-0.057 (0.871)	-0.074 (0.872)	0.005 (0.881)	0.043 (0.881)
CEO conservatism	-0.248 (0.690)	-0.210 (0.705)	-0.188 (0.705)	-0.195 (0.705)	-0.215 (0.708)	-0.239 (0.712)
Board-CEO ideology similarity	-0.326 (0.538)	-0.178 (0.576)	-0.154 (0.582)	-0.173 (0.575)	-0.303 (0.591)	-0.007 (0.583)
Board conservatism		0.404** (0.181)	-0.351 (1.685)	0.376** (0.183)	0.295 (0.190)	0.405** (0.182)
Board conservatism × restating income			0.046 (0.102)			
Board conservatism × media coverage				0.055 (0.049)		
Board conservatism × CAR					-2.982* (1.733)	
Board conservatism × analyst reaction						-0.956** (0.448)
Industry controlled	Yes	Yes	Yes	Yes	Yes	Yes
Constant	-4.970** (2.355)	-5.257** (2.371)	-5.072** (2.411)	-5.161** (2.357)	-5.486** (2.396)	-5.872** (2.446)
N	286	286	286	286	286	286
$\chi^2$	30.63	36.03	36.23	37.08	39.86	40.81

\*  $p < 0.1$ ; \*\*  $p < 0.05$ ; \*\*\*  $p < 0.01$

## CEO Replacement following Financial Misrepresentation

Descriptive statistics are summarized in Table 4-1(E). There are no correlations sufficiently high to raise multicollinearity concerns, and the Variance Inflation Factor (VIF) was less than 10, with a mean VIF of 2.89.

Table 4-8 gives the results of the main analyses. Hypotheses 8 and 9 proposed competing hypotheses. Hypothesis 8 predicted that board conservatism was likely to lower the possibility of CEO replacement, whereas hypothesis 9 states the opposite premise. The results of model 1 indicate that board conservatism is significantly and positively associated with CEO replacement ( $\beta=0.404, p<0.05$ , see Model 1), supporting hypothesis 9.

For hypotheses 10 through 13, I examined the interactions between board conservatism and other contextual variables. First I investigated the moderating effects of significant misrepresentation in hypothesis 10, finding no interaction effect between seriousness of misrepresentation and board ideology (Model 2). Thus, I find no support for hypothesis 10 nor hypothesis 11 (Model 3).

However, I find support for hypothesis 12 ( $\beta=-2.982, p<0.1$ ) in Model 4 and hypothesis 13 ( $\beta=-0.956, p<0.05$ ) in Model 5. When the stock market reacts negatively, more conservative boards are likely to replace their CEOs. The probability of CEO replacement for conservative boards (1 S.D. from the mean of *Board conservatism*) with an average market reaction is 0.24; if the market reacts negatively by one standard deviation, the probability goes up to 0.35, increasing the likelihood of a CEO replacement by 43% in Model 4. Similarly, given more negative analyst reactions to financial misrepresentation (i.e., a downward change in annual earnings-per-share forecasts),

conservative boards are more likely to replace a CEO. Model 5 shows that when analysts decrease their forecasts by one standard deviation, the probability of CEO replacement by more conservative boards increases from 0.25 to 0.46 (an 84% increase).

Interesting results were also found regarding control variables. The only control variables that were consistently significant across models were stock market reaction, measured as *CAR* and *No. of media coverage*. Results show that stock market reaction has a negative effect where firms with a higher *CAR* (positive market reactions) are less likely to replace their CEOs. Media attention was also related to CEO replacement, with the level of media coverage increasing the likelihood of CEO replacement. These results are consistent with previous findings. However, other variables in my models, including level of misrepresentation as measured by the amount of restated income, were not significant. In the next chapter, I discuss results further, suggesting theoretical and practical implications, and offering conclusions.

## CHAPTER 5. DISCUSSION AND CONCLUSIONS

How does the political ideology of the board of directors influence corporate governance? How might it affect governance structure and board vigilance? How will it have an impact on the way boards handle crises? Although recent scholars have paid more attention to the behavioral process of boards, they have not examined how the ideology of board members may influence the design of governance structure and board vigilance, the core topics of corporate governance. I draw on the uncertainty-threat model of political ideology (Jost et al., 2003a; 2003b) to examine how the political ideology of board members reflect underlying biases (Jost et al., 2008) and thus may influence their decisions and actions in designing governance structures, adopting certain governance policies, and monitoring and reacting to managerial misconduct.

By examining multiple governance contexts, I find that political ideology plays an important role in board decisions and actions in general. In subscribing to personal beliefs and preferences, conservative boards make decisions and actions that reduce uncertainty and minimize potential and imminent threats to the organization and board. In particular, conservative boards are more likely to choose a governance structure that separates the role of CEO and chair of the board, and has a greater pay-for-performance incentive compared to total compensation. With board independence, I find that given more independent directors, conservative boards are likely to demonstrate increased board independence. Boards with a conservative ideology also tend to adopt the clawback provision, designed to deter managerial financial misconduct. In monitoring for financial wrongdoing or misdemeanors, a board that holds a conservative ideology has been shown

to suffer less from financial misrepresentation and a lower degree of earnings management.

Although financial misrepresentation poses a significant threat to the organization by destroying millions, if not billions, of dollars of market value, managers who commit such acts are seldom held responsible. Why do some firms refuse to take serious action toward managers who commit financial misrepresentation? In answer, I find that political ideology plays an important role in board actions, with more conservative boards likely to replace the CEO following a case of financial misrepresentation in order to manage any organizational and occupational threat posed by such a misrepresentation. Contextual factors such as negative market and analyst reactions will increase the likelihood of conservative boards replacing tainted CEOs. These findings reinforce the growing notion that the effects of corporate governance are actually quite nuanced and not necessarily rational, and may be critically contingent on the political ideology of individuals in governance positions (Aguilera & Jackson, 2010; Dalton et al., 2007; Desender, Aguilera, Crespi, & Garcia-cestona, 2013).

Contrary to my predictions, I found no support for the main effect of increased board independence, as measured in hypothesis 2 by the percentage of independent directors on the board. I can only speculate that this may stem from the enactment of SOX, overall business trends and societal pressure (e.g., shareholder activism) and that over the years independent directors may influence boards differently. Liberal and conservative views on regulation, trends, and social pressure may conflict in different ways. Liberals tend to welcome regulation and respond to societal needs whereas conservatives do not. At the same time, conservatives are better at playing by the rules,

i.e., playing safe. It may be interesting to further explore these complex issues in future studies.

Another null finding was found in the interaction between board ideology and level of financial misrepresentation and the resulting media reaction to CEO replacement. I hypothesize that significant financial misrepresentation and media attention would pose an increased threat and encourage conservative boards to immediately address the problem. One reason I failed to find a moderating effect for the severity of misrepresentation could be the limited variance in the variable (Mean: 15.90 and S.D.: 1.74), given that I examined only major SEC-mandated examples of financial misrepresentation. I would further speculate that since financial misrepresentation is already a serious and reputation-damaging form of misconduct, its magnitude may not be of great concern to the board.

On the other hand, media attention is a powerful factor that influences board actions regardless of political ideology, quickly turning episodes of misconduct into major scandals (Graffin et al., 2013). Perhaps this is why we see the main effect for media attention but not a moderating effect. Taken together, directors may react differently to market and analyst reactions according to their ideology, but not to misrepresentation or media attention. These results offer practical implications for what to expect from a board with different political ideologies and why firms should consider political ideology a crucial variable when it comes to electing directors.

Overall, these findings demonstrate how board governance may be influenced by differences in ideology and beliefs of board members who have the formal authority to structure governance mechanisms, and monitor and react to managerial misconduct and

misbehavior. For boards making key governance decisions, they may be influenced to a large degree by beliefs that emerge from their political preferences. This reinforces the notion that a study of corporate governance needs to move toward a more nuanced understanding of the key factors and characteristics of individual board members, i.e., those that drive their actions. Such findings can help us better understand how the board, as an interrelated set of actors bringing their own attitudes and beliefs, goes beyond the simple dichotomies seen in past research, such as outsider/insider.

### **Theoretical Contributions**

These results highlight certain limitations of past theories of corporate governance while introducing a more behaviorally oriented perspective on corporate governance, especially the role played by belief and ideology. By introducing a more behaviorally oriented perspective, this study informs the broader corporate governance literature, which argues (at least prescriptively) that directors should exercise their fiduciary duty in an objective manner. While members of a board of directors are not expected to apply their personal beliefs and ideologies to such critical decisions as CEO replacement, these findings show how personal disposition can strongly influence board decisions, including how to deal with financial misrepresentation. Thus, individual ideologies may have an especially important influence on firm decisions and actions, both *ex-ante* and *ex-post*, when a crisis threatens the legitimacy of the firm, calling into question the efficacy of board oversight and monitoring. In complementing the agency approach to corporate governance, my results suggest that a board's ideological beliefs can influence the governance of the firm.

Political ideology of a board is a critical endogenous variable that has not been

considered in the literature, which mainly discusses the role of governance structure on firm performance. Understanding the effects of board ideology on corporate governance can help us learn why firms choose different governance structures and why some firms are better at monitoring managerial misconduct than others. Board ideology may also have implications for more informal structures, such as CEO-chair duality, known to be closely related to CEO power. The results suggest that more liberal boards tend to confer power to their CEOs by giving them chair positions. For this reason, this dissertation contributes to the literature by investigating the role of behavioral process on power dynamics in the board (Westphal & Shani, 2016); by complementing both formal and informal structures studied in corporate governance literature, it may help us start to disentangle previously puzzling findings.

Evidence has shown that negative information is more salient and has a stronger effect than positive information (Rozin & Royzman, 2001). In my setting, a potential negative threat to the organization and directors such as financial misrepresentation and earnings manipulation may motivate a board to rely more on their belief systems. These findings underscore how boards may act in more or less a proactive manner when monitoring and reacting to unethical managerial behaviors based on their ideology and beliefs. They also respond to and reinforce the recent calls to investigate the role of corporate governance in a financial crisis (Aguilera & Jackson, 2010).

Organizational misrepresentation is an important phenomenon that concerns scholars, practitioners, and policy makers, but there remains a dearth of theory and research on this topic (Palmer, Greenwood, & Smith-Crowe, 2016). Of the few studies on the subject, most focus on the causes (Kish-Gerphart, Harrison, & Treviño, 2010) and

rarely discuss the consequences once malfeasance has been discovered. By examining the consequences of organizational misrepresentation that befall those responsible, this study extends our understanding of when consequences occur (or not). Previous studies suggest that social mechanisms such as the pervasiveness of misrepresentation, media attention, and CEO power may mitigate any likely consequences (Pozner, 2007; Wiersema & Zhang, 2013). By focusing on behaviorally oriented mechanisms, I discuss how the beliefs and ideologies of directors play a crucial role in the aftermath of financial misrepresentation.

The findings of this study also broaden the scope of upper echelon theory through an examination of the political inclinations of boards of directors. Upper echelon theory focuses on the influence of executives' personal beliefs and preferences (i.e., top management team and CEO), and how the composition of managers with different characteristics can change strategic decisions (Finkelstein et al., 2009). My dissertation extends the theory by demonstrating that directors' personal beliefs and preferences also matter when making critical organizational-level decisions such as designing governance structure, adopting certain policies and monitoring management.

Finally, this is the first study I am aware of that looks at the impact of the political ideology of board members on significant organizational change via governance structure and CEO replacement. While a few studies have examined the role of political ideology of CEOs and executives, except for a recent study by Gupta & Wowak (2017), this research shifts focus to the board. As such, it contributes to an emerging body of literature that examines political ideology in organizations (Briscoe, Chin, & Hambrick, 2014; Chin et al., 2013; Christensen et al., 2015; Gupta et al., 2017) by complementing

and extending research to nuanced organization-level behaviors and outcomes.

### **Limitations and future research**

One limitation of this work is the generalizability of findings to institutional environments outside of the United States. Different governance and policy structures may moderate the power dynamics between the CEO and the board. In countries like Germany where other stakeholder groups are represented on the board (Fiss & Zajac, 2004), the ideology of board members might play a different role. Gauging the political ideology of individual board members could prove difficult in many settings, since donations to political parties are often restricted, and campaign finance laws of specific countries dictate the extent to which monetary support may be offered to a candidate or political party, and whether such information can be disclosed to the public.

Nevertheless, I believe that fundamental tenets of political ideology such as avoiding uncertainty and managing threats, likely play important roles in the boards of other countries as well.

Several interesting and significant opportunities for future research exist, based on this work, including changes in board ideology. Since firms elect directors annually, a higher turnover rate could change board ideology over time. I observed firms in my own dataset that dramatically changed ideological stances over time, due to altered board composition. Since I found these had significant effects on their decisions and actions, it would be interesting to know how and why changes in board ideology occur.

Other studies could examine the degree of uniformity or variance in these beliefs and how these may influence governance structure and monitoring effectiveness. Future studies could also examine what boards might do, depending on their ideology, when

faced with financial misconduct. As seen in hypothesis 2, boards with different ideological leanings can have conflicting opinions regarding regulatory, economic, and societal issues. Hence, future researchers could look at political ideology and the actions taken by elites (i.e., boards) to investigate how ideological bias and perceptions influence other aspects of corporate governance. I hope that this study spurs other scholars toward a better understanding of the interaction between political ideology and the actions taken by key decision makers within the firm.

## **APPENDIX: A HISTORICAL BACKGROUND OF MODERN LIBERALISM AND CONSERVATISM**

Values emphasized in modern liberal and conservative thought have been influenced by the history of Western liberalism and conservatism (Gross, Medvetz, & Russell, 2011; Hartz, 1955; Smith, 1993). Political liberalism has a long history that can be traced back to the seventeenth century. The idea of liberalism emerged as a reaction to the religious conformity enforced by the government and the ascribed status in Europe. In the aftermath of the political turmoil over religious conformity between the crown and parliament in England, philosopher John Locke advocated for religious tolerance and freedom based on the premise that humans inherently exist in “a State of Perfect Freedom to order their Actions . . . as they think fit . . . without asking leave, or depending on the Will of any other Man” (Locke, 1960 [1689]: 287). In line with this thinking, Locke believed that social status was not fixed and that humans were born equal. It would be irrational and contrary to the will of God to accord someone absolute power. Hence, government must be limited or constitutional, based on the social contract (or consent).

Influenced by Locke’s thought, political liberalism espouses the concept of individual liberty and rights, assuming that people are rational, self-interested, and competitive. It emphasizes the importance of equal opportunity, for individuals to enjoy liberty, and live as they choose. Hence, laws, customs, and conditions that block individual choice (e.g., aristocracy, discrimination based on race or gender) are obstacles to be removed as they can impede individual liberty.

While liberals pursued social, political, and religious liberty, economic liberty

became the central quest of Protestant ethics (i.e., individual effort and frugality to achieve salvation), which contributed to the development of capitalism as a driving force in the advancement of Western society (Weber, 2002 [1905]). The natural progression of liberal ideas was to adopt a “*laissez faire, laissez passer*” model, which suggests that the best way to achieve a progressive society was to let people pursue their private interests, be left alone to compete in the market, and maintain a small government with minimal influence on economic exchange (Smith, 1776 [1937]). In general, liberal ideas and values have triumphed in Western society, which significantly influenced conservatism in the United States (Heywood, 1992).

Throughout the Industrial Revolution in England and the Great Depression in the United States, people found that the consequences of *laissez faire* were not so desirable. Wealth was unevenly distributed, and due to an under-regulated business environment, the poor and working class were exploited through harsh conditions. Liberal leaders began to question *laissez faire* capitalism, and how it stifled individual liberty and raised concerns for the public well-being. While continuing to advocate the value of individual liberty, liberals changed their positions regarding economic theory and the role of government, voiced by British economist Keynes and practiced by Franklin D. Roosevelt. They argued that government should provide equal opportunity and individual liberty (Green, 1986 [1895]) and regulate economic conditions (Keynes, 1936). This modern liberalism, known as welfare liberalism, advises that government step in to promote social justice and act on such social issues as poverty, ignorance, and illness that interfere with individual liberty and equal opportunities. It endorses government spending on programs like welfare, education, and healthcare. This idea became a dominant form of

liberalism in Western society, particularly the United States, and by the mid-twentieth century had become what we generally call liberalism.

The ideology of modern conservatism has also had an interesting history. Basic values and premises of conservatism remained, but what conservatism has advocated for has changed over time. Early conservatism was an attempt to preserve or conserve the aristocracy during the French Revolution, defending the social order and insisting on strong government (Burke, 1999 [1790]). Classic conservative theory began with an assumption of human nature that differs from the liberal view, the religious premise that humans are inherently marked by original sin and imperfection. Unlike liberals, conservatives were skeptical of human reason. Classic conservatism emphasized the individual as part of a greater whole and was pessimistic about the promotion of individual freedom and equality in a competitive society. For conservatives, membership in a society was organically and gradually interwoven, forming an intricate social fabric. Natural conservative ideology highlighted social peace, harmony, order, and stability as its goal. Radical ideas, desires, and lack of restraint were considered obstacles to achieving social fabric and could even create chaos, as occurred during the French Revolution. For these reasons, conservative ideology seeks to "conserve" existing social, economic, and political arrangements and hierarchies.

For early conservatives, government naturally reflects society by incorporating its history, habits, and prejudices. They preferred that the government be run by enlightened representatives drawn from the aristocracy who had leadership ability and experience. Classic conservatism suggests that having a strong government will maintain the desired arrangement of society. Assumptions, values, goals, and some ideas of this traditional

conservatism were adopted by modern American conservatives, who gradually moved away from some of these ideas, especially in economic and governance models.

As *laissez faire* capitalism replaced agricultural and aristocratic society defended by early conservatives, conservatives began to accommodate changes and classical liberalism became the new norm. As Mark Twain noted, “The radical of one century is the conservative of the next.” With the Great Depression, some liberals shifted their views toward a welfare state while those left behind included businesspeople and industrialists who had long held traditional liberal views. Thus began the modern conservative movement which combined elements of traditional conservatism that stressed the value of traditional Christian institutions and Western culture in the United States (Gross et al., 2011). These new conservatives, sometimes called individualist conservatives, did not accept the idea that society is a delicate fabric and that an individual is part of the greater whole. Rather, they advocated for individualized views of society and individual freedom and responsibility. Ronald Reagan was a champion of this new conservatism, and was advised by economists such as Milton Friedman, who believed in small government and *laissez-faire* capitalism.

Although political conservatism in the United States evolved from traditional conservatism, the fundamental premise of conservatives is to preserve the status quo and work for social peace and stability (Ball & Dagger, 1998). While conservatives do not reject change, viewing it as a necessary part of human life and society, they prefer gradual and careful reform over revolution, believing that revolution, which is not tested nor proven, can dismantle social stability and create chaos. Conservatives prefer tested experience and empirical evidence in order to support or reject changes.

Kerlinger (1984) offers a comprehensive lists of values held by modern liberals and conservatives:

*Liberalism* is set of political, economic, religious, educational and other social beliefs that emphasize freedom of the individual, constitutional participatory government and democracy, the rule of law, free negotiation, discussion and tolerance of different views, constructive social progress and change, egalitarianism and the rights of minorities, secular rationality and rational approaches to social problems, and positive government action to remedy social deficiencies and to improve human welfare. . . . *Conservatism* is a set of political, economic, religious, educational and other social beliefs characterized by emphasis on the status quo and social stability, religion and morality, liberty and freedom, the natural inequality of men, the uncertainty of progress, and the weakness of human reason. It is further characterized by distrust of popular democracy and majority rule and by support of individualism and individual initiative, the sanctity of private property, and the central importance of business and industry in the society. (p. 15-17)

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