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Political Contributions and the Auditor-Client Relationship

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POLITICAL CONTRIBUTIONS AND THE AUDITOR-CLIENT RELATIONSHIP

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I dedicate this work to my loving family. My husband (Danny), parents (Pete and Diana) sisters (Deann and Jaime), and brother (Paul) provided me with lots of love, support, and laughter throughout the entire program.

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ABSTRACT

I examine how an audit client's political contributions influence the auditor-client relationship. Prior research suggests opposing forces from political contributions on the auditor's assessment of audit risk. Prior research also suggests political contributions can increase a firm's social prestige and influence, which I conjecture can increase the client's bargaining power and influence with the auditor. I provide evidence that higher political contributions are associated with higher audit fees, a lower likelihood of a material weakness, a lower likelihood of an auditor switch, poorer accruals quality, and higher nonaudit fees than non-connected clients. Higher audit fees suggest greater audit risk, while longer audit tenure, poorer accruals quality, and higher nonaudit fees suggest a stronger auditor-client economic bond. The combination of higher audit risk, a stronger auditor-client economic bond, and fewer reported material weaknesses is most consistent with the notion that clients use their political clout and social prestige to weaken auditor independence.

CHAPTER ONE

INTRODUCTION

In this study, I investigate the extent to which an audit client's political connectedness influences the auditor-client relationship. Specifically, I examine the relation between client Political Action Committee (PAC) donations and: (1) audit fees, (2) material weaknesses in internal control over financial reporting, (3) auditor switching, (4) accruals quality, and (5) nonaudit service (NAS) fees. I measure political connectedness using the PAC donations made from corporations to political candidates running for either Presidential, Senate, or House offices.[1] To my knowledge, my study provides the first analyses of how U.S. audit client political contributions influence audit risk, client bargaining power, and auditor independence.[2]

Client political connectedness potentially produces opposing influences on audit risk. Prior research suggests political connectedness can increase audit risk for at least two reasons. First, politically connected clients produce more opaque financial information because connected firms gain protection from regulators and politicians and are likely more successful at petitioning for favorable accounting rules (Chaney et al. 2011; Yu and Yu 2011). More opaque financial information likely makes the auditor's detection of fraud more difficult, which increases inherent risk.[3] Additionally, prior research links political contributions to poorer corporate governance

[1] A corporate PAC is formed by the firm and makes donations to political candidates of the firm's choosing. The source of the donations made to candidates is contributions from firm employees, family members of employees, or shareholders of the firm. I provide further detail regarding PACs in Section 4.1.

[2] Within this paper I use the term "client" to refer to an *audit* client.

[3] Inherent risk is the susceptibility of a relevant assertion—related account balances, classes of transactions, and disclosures—to a material misstatement (AU Section 312 2006, pt. 21).

due to increased agency problems (Aggarwal et al. 2012). Increased agency problems likely increase control risk.[4]

Prior research also suggests client political connections can decrease audit risk. For example, politically connected firms experience stronger future returns (Cooper et al. 2010), enjoy lower costs of equity (Boubakri et al. 2012) and debt (Houston et al. 2012), and are more conditionally conservative (Kong et al. 2011). These studies suggest political donations are economically beneficial to the firm, and thus likely reduce engagement risk.[5] In total, political contributions can increase audit risk (higher inherent and control risk as explained above) or decrease audit risk (lower engagement risk).

Political contributions also potentially increase client bargaining power. Political contributions create political ties that potentially raise the prestige of the client through membership in elite economic, military, or political circles (D'Aveni 1990). Additionally, political contributions increase the political social capital—interpersonal connections that can enhance one's professional advancement—and the political clout of the client's managers (Aslan and Grinstein 2011). Moreover, Srinidi and Gul (2007) and Sharma et al. (2011) conclude that client importance (neither study addresses political contributions) can lead to more auditor acquiescence, and more auditor acquiescence implies lower auditor independence. Thus, if political contributions increase the prestige, political social capital, and/or political clout of clients, those connected clients may be able to bargain for client-preferred audit outcomes, such as fewer negative audit reports and lower fees.

[4] Control risk is the risk that a material misstatement will not be prevented or detected on a timely basis by the entity's internal control (AU Section 312 2006, pt. 21).

[5] Engagement risk refers to the overall business risk associated with engaging a particular client and arises from potential nonpayment of fees, reputational damage, or litigation costs (Houston et al. 1999).

Using a sample constructed from combining the Federal Election Commission PAC contributions, *Compustat*, and *Audit Analytics* databases for the period 2000 through 2010, I find that firms making more political contributions pay higher audit fees. Prior research suggests higher audit fees and audit risk are positively related (Bedard and Johnstone 2004; Charles et al. 2010). Thus, my audit fee results are consistent with higher audit risk for politically connected clients. However, I also find that more politically connected clients receive fewer material weaknesses and switch auditors less frequently. A reported material weakness is a signal of higher audit risk (PCAOB 2004) and risk avoidance is a leading motive for auditor switching (Johnstone and Bedard 2004). Thus, if politically connected firms posed higher audit risk, I should find more material weaknesses and more frequent auditor switching, not fewer material weaknesses and less switching.

The combination of these results is also consistent with client-auditor economic bonding. Specifically, prior research argues that client importance (i.e., higher fee-generating clients) can lead to more auditor acquiescence (Frankel et al. 2002; Sharma et al. 2011). This is consistent with the higher audit fees and fewer material weaknesses that I find for more politically connected clients. The economic bond argument is also consistent with the reduced auditor switching (i.e. longer tenure with the same auditor) that I find for politically connected clients. Moreover, in my final two tests, I find that client political contributions are associated with poorer accruals quality and higher NAS fees. This further supports an economic bond, and potentially weakened auditor independence, between politically connected clients and their auditors because prior research suggests poorer accruals quality and higher NAS fees are symptomatic of impaired auditor independence (Ashbaugh et al. 2003; Francis and Ke 2006; Khurana and Raman 2006; Schmidt 2012).

Overall, I interpret my evidence as consistent with the importance and political clout associated with politically connected clients creating an economic bond between clients and auditors, which pressures auditor independence. Specifically, auditors view clients with political connections as more attractive than non-connected firms since they generate higher fees (both audit and nonaudit) for the auditor and have greater political and social clout. Because of this economic bond and the desire to be associated with politically connected clients, auditors are more willing to acquiesce in the reporting of material weaknesses, maintain longer relationships, and allow more accounting discretion for connected clients. While I am unable to provide direct evidence of auditor acquiescence and economic bonding, the totality of my results is most consistent with this economic bond-auditor acquiescence interpretation.

My study makes numerous contributions beyond prior accounting research. First, I contribute to research on political connectedness.[6] Some prior literature suggests various benefits from political connections. For instance, past studies suggest politically connected firms enjoy lower costs of equity (Boubakri et al. 2012) and debt (Chaney et al. 2011; Houston et al. 2012). Other studies suggest that politically connected firms have greater influence over regulators (Faccio et al. 2006; Correia 2012). In contrast to this evidence that politically connected firms are associated with lower risk, however, other research finds that political connectedness is associated with lower earnings and accounting quality (Chaney et al. 2011; Correia 2012). I investigate how political connectedness impacts another important stakeholder: the auditor. The external audit is an important aspect of public U.S. companies' operations, and

[6] Another line of accounting research that is tangentially related to my study suggests that firms participate in the political process by attempting to make themselves less visible to politicians and regulators. This is known as the political cost hypothesis, which assumes politicians have the power to intrude into the affairs of corporations and redistribute wealth away from them via corporate taxes, regulations, subsidies, etc. To counter this threat, the political cost hypothesis suggests firms take steps (i.e., choose accounting methods) to voluntarily minimize their reported income when they are either directly or indirectly targeted by political action. While I acknowledge this literature also explores a form of firm political involvement, its connection to my study is minimal.

the consequences of political connections for the audit has received very little attention from researchers.[7]

My study also contributes to audit research investigating client attributes that influence audit and NAS fees, material weaknesses, and auditor switching, such as the client firm's size, complexity, risk, and profitability (Simunic 1980; Doyle et al. 2007; Chow and Rice 1982). This literature has yet to examine how political involvement influences these key audit attributes. Moreover, past literature suggests that political contributions potentially increase client bargaining power, an attribute that prior research measures as either the size of the client or the size of a client relative to its auditor's industry clientele (Casterella et al. 2004). Past research does not recognize political contributions as a client attribute that may also increase client bargaining power and influence.

Last, this study will potentially be of interest to regulators. A Supreme Court decision made in 2010 (*Citizens United vs. Federal Election Commission*) allows corporations to make unlimited, anonymous political expenditures in order to broadcast election advertisements for particular candidates. This decision triggered turmoil among stakeholders, who are demanding disclosure of such spending by firms. Recent appeals to the SEC may result in requiring corporations to disclose the amounts of such political contributions in their annual filings (Wilkinson and Dwyer 2011). Thus, whether political contributions translate into increased risk for auditors is likely of interest to regulators. Hence, my study contributes to an area that is timely and important to both regulators and investors.

[7] I am aware of one exception. Gul (2006) finds that during the 1997 Asian Financial Crisis, politically connected Malaysian firms are charged higher fees than non-politically connected firms and that following the crisis, connected firms experience lower fees. He identifies whether a firm has close relationships with Malaysian government officials and uses this as his measure of political connectedness.

The remainder of this paper is organized as follows. Chapter 2 provides a summary of prior literature as well as the motivation for my analyses. Chapter 3 describes my research questions, while Chapter 4 provides my research design. Next, Chapter 5 presents the results of my analysis, and Chapter 6 concludes.

CHAPTER TWO

PRIOR LITERATURE AND MOTIVATION

2.1 Political Contributions and Audit Risk

Auditing standards define audit risk as "the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated" (AU Section 312 2006, pt. 8).[8] Below I discuss research suggesting political contributions reduce pressure from regulators for the firm to produce transparent financial information, which increases inherent risk. Prior research also suggests political contributions are associated with poorer corporate governance, which increases control risk. Alternatively, other research finds that political contributions are associated with stronger financial performance. Audit research suggests that auditors assess a lower level of engagement risk for firms with stronger, more stable economic performance, which suggests political contributions may in fact lower an auditor's assessment of risk.

First, prior research provides evidence consistent with politically connected firms having more opaque financials, which increases the auditor's difficulty at detecting fraud and therefore heightens inherent risk. Correia (2012) documents that firms with greater political expenditures have lower Audit Integrity accounting scores[9] and a greater likelihood of shareholder litigation.

[8] Audit risk is comprised of three components: (1) inherent risk, (2) control risk, and (3) detection risk. Inherent risk is the susceptibility of a relevant assertion to a misstatement that could be material (AU Section 312 2006, pt. 21). Control risk is the risk that a material misstatement will not be prevented or detected on a timely basis by the entity's internal control (AU Section 312 2006, pt. 21). Detection risk refers to the risk that the auditor will not detect a material misstatement, which is a function of the effectiveness of an audit procedure and of its application by the auditor (AU Section 312 2006, pt. 24). Outside of these three risks, an audit firm is also exposed to other risks, including nonpayment of fees or reputational damage (a reduction of future cash inflows), or litigation costs (an increase in cash outflows). These risks, along with those previously described within the audit risk model, fall into a broad category of risk known as engagement risk (or business risk).

[9] Audit Integrity is a research company that conducts analysis of corporate behavior by measuring the transparency and statistical reliability of a company's financial reporting and governance practices. The accounting score attempts to capture the likelihood of misrepresentation in the company's financials.

Likewise, Chaney et al. (2011) provide international evidence that earnings quality, measured using discretionary accruals, is lower for politically connected firms. The authors contend that political ties allow firms to provide lower quality accounting information due to less pressure from politicians and regulators. Further, Jones et al. (2008) find that lower earnings quality (measured using discretionary accruals models) is associated with a greater incidence of both fraud and non-fraudulent restatements, which further indicates that connected firms, who are associated with poorer earnings quality, are likely associated with greater fraud risk. In support of this argument, Yu and Yu (2011) find that fraudulent firms that lobby have a lower probability of being detected and avoid detection longer than fraudulent firms that do not lobby. The authors assert that lobbying makes fraud more difficult to uncover because firms can directly petition the fraud watchdogs and can lobby for favorable regulation rules. Their evidence suggests that lobbying is associated with more opaque financials, which affords the manager more opportunity to commit fraud. Thus, it is plausible that auditors infer politically connected clients will tend toward more opaque financials, leading to greater likelihood of fraud. This should cause the auditors to increase their assessment of inherent risk.

The political connectedness of a client also potentially increases the auditor's assessment of control risk.[10] Many of the control risk factors that auditors must consider, such as personnel policies and procedures, are related to the corporate governance structure of the firm (Messier and Austen 2000). Aggarwal et al. (2012) provide evidence that higher political donations are associated with poorer corporate governance and assert that donations are indicative of agency problems within the firm. Specifically, they find that firms with weaker corporate governance—larger boards, CEOs who are also chairman of the board, higher abnormal CEO compensation,

[10] Note that the previously mentioned inherent risk factors associated with political ties—opaque financial information and greater susceptibility to fraud—similarly affect control risk since these are client attributes that likely influence an auditor's assessment of both inherent and control risk.

lower block ownership, and lower institutional ownership—are associated with larger donations. Moreover, prior audit research documents that stronger corporate governance lowers an auditor's assessment of control risk (Tsui et al. 2001; Krishnan and Visvanathan 2009). Thus, client political donations potentially increase an auditor's assessment of control risk.

In contrast, other research supports the notion that political ties decrease engagement risk. Past research documents that PAC contributions are positively correlated with future returns, accounting earnings, and cash flows from operations (Cooper et al. 2010; Chen et al. 2010).[11] Moreover, prior studies find that politically connected firms experience lower costs of equity and debt and are more conditionally conservative (Boubakri et al. 2012; Chaney et al. 2011; Houston et al. 2012). These studies propose firms receive real economic benefits from political contributions because they gain access to positive net present value projects. Strong, stable returns reduce an auditor's engagement risk because they reduce the probability of shareholder lawsuits, whereas weak, negative, or high variance returns heighten engagement risk since they increase the probability of litigation (Simunic and Stein 1996). Firms with stronger financial performance are also more likely to pay their audit fees, which lowers engagement risk. Thus, these studies suggest that client political contributions can reduce engagement risk.

In summary, the past literature suggests political contributions are associated with more opaque financials, which likely increases the auditor's assessment of inherent risk, and poorer corporate governance, which likely increases the auditor's assessment of control risk. However, research also suggests political connections contribute to stronger economic performance, which likely lowers the auditor's assessment of engagement risk.

[11] Aggarwal et al. (2012), however, document that firm political donations are negatively correlated with returns. The authors focus on soft money and 527 Committee donations (rather than PAC contributions) as their measure of political connectedness and also specify their asset pricing tests differently than Cooper et al. (2010).

2.2 Political Contributions, Client Bargaining Power, and Auditor Independence

Prior research suggests clients can acquire bargaining power in several different ways. For example, as a client's size increases relative to its auditor's industry clientele, the bargaining power of the client increases. Studies support this by documenting that as a client's relative size increases, audit fees decline (Casterella et al. 2004; Huang et al. 2007). Francis and Wang (2005) find that clients paying relatively higher fees in the first year of disclosure paid lower fees in the year following mandated audit fee disclosures, consistent with the notion that fee disclosures increased client bargaining power.

Political contributions can also increase client bargaining power by increasing the client's prestige. Prestige is described as status, i.e. membership in an elite social circle such as the economic, military, or political (D'Aveni 1990). Within an audit firm's portfolio of clients, certain clients have more professional and community prestige, and auditors likely view such clients as offering desirable future employment. Bamber and Iyer (2007) find that an audit firm's client identification—wherein the auditor so strongly views himself a member of the client firm that he adopts its beliefs—increases in the prestige of the client. Moreover, they find that auditors' acquiescence to the client-preferred treatment increases with the extent to which they identify with the client. Thus, if political contributions earn a client additional prestige (at least in the auditor's view), which translates into greater auditor acquiescence, it is plausible that this buys the client bargaining power over other aspects of the auditor-client relationship as well.

Other research supports the idea that the prestige associated with a client's political connectedness can help clients avoid adverse outcomes. D'Aveni (1990) finds that political prestige, determined by whether top executives held former political positions, is negatively

associated with bankruptcy incidence. Political prestige may translate into increased bargaining power for a politically connected client because, as D'Aveni (1990) argues, prestige indicates that management is competent, credible, and trustworthy, which likely increases an audit firm's willingness to work for, and potentially bargain with, the client.[12] Thus, it is plausible that political contributions enhance the prestige associated with a client, which increases the client's bargaining power.

Another way in which political contributions can give clients more bargaining power with auditors is by providing politically connected client executives with a form of social capital, which they can use as a bargaining tool. Social capital refers to the kinds of interpersonal connections that can enhance one's professional advancement (Zweigenhaft 1992). Aslan and Grinstein (2011) argue that political connectedness can be treated as one form of "social capital" (i.e., political social capital), and executives can use this capital to increase their compensation through either market power, managerial power, or both. In support of the market power view, CEOs can ensure their own switching costs—job search expenses, time without pay, or lower future pay—are less than the firm's switching costs—recruitment expenses, paying a higher compensation to attract talent, and training expenses—through the value their political social capital brings to the firm. For example, CEOs with political capital obtain numerous benefits of considerable strategic value to the firm, including obtaining favors, such as government bailouts (Faccio et al. 2006); lowering bankruptcy risk (D'Aveni 1990); lowering SEC enforcement costs (Correia 2012); and gaining preferential access to financing (Claessens et al. 2008).[13] Further, the managerial power view contends that executives derive power from their political ties, which

[12] Note that such management characteristics may also be associated with lower inherent risk for politically connected clients. If this is the case, political ties will lower inherent risk and result in lower audit fees, which provides the same outcome as predicted based on increased client bargaining power.

[13] Such benefits related to a CEO's political capital may even lower engagement risk, which lowers audit fees.

allows them to obtain rents from their firms by using their influence in boardrooms to transfer wealth from shareholders. Both views are consistent with Aslan and Grinstein's (2011) evidence that a CEO's political connectedness is positively related to CEO compensation levels. More importantly, they find that politically connected executives experience much lower pay-performance sensitivity. This suggests political social capital provides executives with bargaining power with their boards. Similarly, audit clients may be able to use the social capital derived from political contributions in order to exert influence over auditors. Overall, it is likely that political contributions are associated with prestige and increased social capital, which both potentially increase a client's bargaining power.

One of the potential implications of the importance and increased bargaining power that clients derive from their political contributions is impaired auditor independence. Specifically, it is possible that clients use their political clout to influence auditor decision-making. Additionally, auditors likely deem politically connected clients as important to their business and may form a strong client-auditor relationship that affords the client greater auditor acquiescence. Several studies investigate the relation between client importance and auditor independence. DeAngelo (1981) argues that the economic significance of client fees increases the auditor's incentive to compromise independence. This perspective suggests that, due to a stronger economic bond, auditors are more likely to acquiesce to requests from more economically important clients. Empirical evidence linking client importance to impaired independence is mixed. Some research finds no association between client importance and measures of auditor independence, such as the likelihood of issuing a going concern opinion and the level of abnormal accruals (Reynolds and Francis 2001; Chung and Kallapur 2003; Li 2009). These studies argue that, if client importance threatens auditor independence, then such clients likely

receive fewer going concern opinions and have more discretion over accruals, but they do not find evidence to support this perspective. In contrast, Sharma et al. (2011) find a positive relation between client importance and performance-adjusted discretionary total and current accruals, suggesting client importance does impair auditor independence.

Although prior research generally measures client importance using client fees, it is plausible that political connectedness is another attribute that increases the importance of a client to an auditor. Client political contributions are likely associated with more prestige (D'Aveni 1990) and a more expansive political network, which an auditor may value for reputational reasons and/or for their own networking purposes. Prior research documents that client political prestige also generates more auditor acquiescence (Bamber and Iyer 2007; Stefaniak et al. 2012). Thus, past literature suggests that if auditors regard politically connected clients as more important (due to either economic dependence derived from higher fee revenue, or cognitive-based reasons, such as the prestige associated with the client), or if clients can use their political clout to encourage greater auditor acquiescence, then political contributions potentially threaten auditor independence.

2.3 Summary

Overall, several forces exist regarding the influence of client political contributions on the auditor-client relationship. Past literature suggests client political contributions could either: (1) affect audit risk, and/or (2) affect the client's bargaining power over the auditor, thus threatening auditor independence. With regards to audit risk implications, prior research suggests political contributions are associated with more opaque financial information and poorer corporate governance, which likely increases the auditor's assessment of inherent risk and

control risk, respectively, while other studies suggest political contributions promote stronger economic performance, which likely decreases engagement risk. Moreover, past studies suggest clients with stronger political connections are potentially associated with greater prestige, a more expansive political and social network, and greater political clout than non-connected clients, all of which provides connected clients with increased bargaining power over their auditors. If politically connected clients obtain bargaining power over their auditors due to the prestige and/or political clout associated with their connections, then it is plausible auditor independence will be impaired.

CHAPTER THREE

RESEARCH QUESTIONS

In this paper, I investigate the extent to which client political contributions affect the auditor-client relationship. Moreover, I posit that client political ties likely impact the auditor-client relationship via audit risk and bargaining power/auditor independence. Thus, in order to examine how client political contributions potentially influence audit risk and auditor independence, I employ audit variables that past studies typically use to analyze audit risk (i.e., (1) audit fees, (2) material weaknesses in internal control, and (3) auditor switching) and weakened auditor independence (i.e. (4) accruals quality and (5) nonaudit service fees).[14] Thus, below I describe how client political contributions likely impact each of these five audit outcomes.

First, the audit literature finds that heightened risk, including increases in any of the audit risk components, is associated with higher audit fees (Bedard and Johnstone 2004; Charles et al. 2010). As described in Section 2.1, prior research suggests that a client's political connectedness increases an auditor's assessment of inherent risk due to the opaque financial information associated with connected firms and increases control risk due to the poorer corporate governance associated with connected firms. Thus, the increased risk related to connected clients potentially increases audit fees.

Political contributions may, however, be associated with lower audit fees. In particular, political contributions potentially decrease engagement risk since prior research finds connected firms exhibit stronger, more stable returns (Cooper et al. 2010). Other research also suggests

[14] As I describe in more detail in the following sections, I do acknowledge that some of the audit variables in my analysis could provide insight into both the riskiness of the audit *and* the existence of threatened auditor independence.

political connectedness increases the client's bargaining power due to the political prestige, political clout, and the sense of client importance associated with such political connections (D'Aveni 1990; Aslan and Grinstein 2011). Overall, these studies suggest political contributions potentially lower an auditor's assessment of risk and/or strengthen the client's bargaining power, both of which generate the expectation of lower audit fees for connected firms. Thus, it is likely there are competing forces on the relation between political contributions and audit fees. My first research question is:

***RQ1**: Is client political connectedness related to audit fees?*

Next, political contributions could influence the likelihood of a material weakness in two ways. First, if politically connected clients do impose greater audit risks, then political contributions potentially increase the likelihood of a material weakness as well. By definition, a material weakness suggests heightened audit risk since it is defined as "a significant deficiency…that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented" (PCAOB 2004). Indeed, prior research documents that material weaknesses are more likely to be reported for firms that exhibit greater risk-related characteristics, such as being younger, financially weaker, and more complex (Ashbaugh-Skaife et al. 2007; Doyle et al. 2007). Therefore, since prior research suggests politically connected clients are riskier than non-connected clients, a positive relation between political contributions and material weaknesses may exist.

Second, political contributions could alternatively reduce the likelihood of a material weakness. The auditor decides whether or not to report a client's material weakness in their internal control over financial reporting. If, however, a client holds some amount of bargaining power over the auditor (due to the client importance or political clout associated with their

political contributions), then it is plausible that the auditor may allow the client to correct any weaknesses before officially reporting them. Thus, politically connected firms can potentially better avoid auditor reporting of material weaknesses due to their bargaining power and/or impaired auditor independence. Overall, it appears there are competing forces on the relation between political connections and the likelihood of material weaknesses. Thus, my second research question is:

***RQ2**: Is client political connectedness related to the likelihood of a material weakness in internal control over financial reporting?*

The impact of political connectedness on auditor switching is also likely influenced by opposing forces. Prior research on client portfolio management suggests that an audit firm's client acceptance and discontinuance decisions are based primarily on risk avoidance considerations. Indeed, past empirical studies document a positive association between client risk factors and auditor switches (Johnstone and Bedard 2004; Choi et al. 2004). If politically connected clients pose greater audit risk (e.g. due to more opaque financial information and poorer corporate governance, as I explain above), then auditor switching is likely more frequent among politically connected firms.

Conversely, based on other research, a negative relation between political contributions and auditor switching is also possible. First, auditors may view politically connected firms as less risky due to their stronger financial performance, as I described previously. Further, earlier research finds that auditor switching is more likely to occur following the receipt of an unfavorable audit opinion and for clients in financial distress (Chow and Rice 1982; Francis 1984). Since prior research documents that political connectedness is associated with stronger, more stable economic performance, it is possible that politically connected firms are less prone

to auditor switching driven by poor performance. Last, other research suggests that auditor switching can occur when managers and auditors disagree regarding the appropriate application of GAAP (Antle and Nalebuff 1991). If, however, politically connected clients utilize the bargaining power gained from their connections over auditors or experience a lack of auditor independence, they may gain more auditor acquiescence, have fewer disagreements and, accordingly, switch auditors less often. Thus, examining the relation between political contributions and auditor switching may also shed light on potential threats to auditor independence. Auditors that form strong economic bonds with their clients likely stay with those clients over a longer period since the arrangement is economically beneficial for both the auditor and the client. Thus, my next research question is:

***RQ3**: Is client political connectedness related to the likelihood of an auditor switch?*

Moreover, within the audit literature, several studies investigate the extent to which auditor-client bonding is associated with evidence that the financial statements reflect potential earnings management behavior. Many of these studies utilize accruals quality in order to detect the influence of a strong auditor-client bond on auditor independence. Specifically, this stream of literature contends that if auditor independence is impaired, the auditor will allow their client more discretion regarding accounting accruals, which ultimately lowers the quality of the client's financial information as well as the quality of the audit.[15] As described in greater detail in Section 2.2, client political contributions potentially weaken auditor independence since such

[15] This same line of reasoning also suggests clients facing weakened auditor independence have a higher likelihood of a financial restatement. In untabulated analysis, however, I find no relation between political contributions and financial restatements, which is consistent with the evidence provided by Correia (2012), who finds no relation between restatements and PAC contributions. For this test, I collapse my sample into one observation per firm by taking an average of each variable in the restatements regression over the sample period (2000-2010). Since accounting misstatements generally occur in one year but may not be uncovered and restated for several years in the future, this collapsed approach reduces any timing issues related to when political contributions are made versus the timing of a financial misstatement and restatement.

connections are likely linked to client political social capital, political clout, and/or client importance, which increases the client's bargaining power over the auditor. If political connections increase client bargaining power, and thus weaken auditor independence, then it is likely that auditors allow connected clients more accounting discretion, which would translate into poorer accruals quality.[16]

As mentioned previously, prior research (not within the audit literature) does find that politically connected firms have poorer earnings quality (Chaney et al. 2011), but this research uses a different measure of political ties over an earlier period than my sample. Accordingly, I investigate the relation between political connections and accruals quality in order to better understand the auditor-connected client relationship in conjunction with the other results I obtain using my study's sample of U.S. firms over the period 2000-2010. Thus, my fourth research question is:

***RQ4**: Is client political connectedness related to accruals quality?*

Last, prior research suggests that audit firms often use the audit function as a loss leader, or as a service that attracts clients willing to pay for more *lucrative* nonaudit services (Khurana and Raman 2006). Past audit independence research examines whether higher NAS fees increase the economic dependence of an auditor on the client by examining whether NAS fees are associated with weaker auditor independence (i.e., more discretionary accruals, fewer restatements, fewer going concern opinions). In particular, the audit literature provides consistent evidence that NAS fees threaten auditor independence in appearance (Francis and Ke

[16] I also consider the relation between client political contributions and going concern opinions since prior audit research argues that auditors with weakened auditor independence are less likely to issue a going concern opinion (DeFond et al. 2002). In untabulated analysis, however, I find no relation between client political contributions and going concern opinions using a subsample of distressed clients.

2006; Khurana and Raman 2006; Schmidt 2012).[17] Many studies also find support for a link between NAS fees and lower auditor independence in fact (Frankel et al. 2002; Paterson and Valencia 2011; Srinidhi and Gul 2007).[18] In summary, prior research supports the notion that higher NAS fees reflect weakened auditor independence. Thus, to assess the potential for weakened auditor independence due to lucrative NAS fees, I examine whether politically connected clients pay higher NAS fees to auditors than non-connected clients. My final research question is:

***RQ5**: Is client political connectedness related to nonaudit service (NAS) fees?*

[17] Auditor independence in appearance refers to the perception of auditor independence, which is potentially as serious as direct evidence of factual impairment (Francis and Ke 2006). SAS No. 1 states, "Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people believe likely to influence independence."

[18] Audit firms argue that knowledge spillovers gained by providing both audit services and NASs for a client increase the quality of the audit. Moreover, the legal liability exposure and the auditor's desire to uphold a reputation for integrity ensure that auditors remain independent. In support of this perspective, several studies document *no* significant relation between NAS fees and measures of auditor independence in fact, such as discretionary accruals (Ashbaugh et al. 2003; Reynolds et al. 2004), going concern opinions (DeFond et al. 2002), and restatements (Kinney et al. 2004).

CHAPTER FOUR

METHODOLOGY

4.1 Data

A Political Action Committee (PAC) is a legal entity created in order to raise and spend money to elect and defeat candidates during election campaigns. PACs may be organized by labor unions, trade associations, and corporations. This study focuses on contributions from corporate PACs, which are funded by shareholders and individuals (or family members of individuals) employed by the sponsoring corporation. Corporate PAC funds may not come from a corporation's treasury. PACs may receive up to $5,000 from any individual, and PACs can give $5,000 to a candidate committee per election and $15,000 annually to any national party committee.[19]

The administrative policies related to a corporate PAC, as well as the extent of a firm's disclosure regarding their PAC practices and actual donations, vary considerably among firms. Many companies disclose that some level of board oversight exists for their political contributions, and some firms designate a specific board committee to oversee the PAC and its spending (CPA 2012). Other firms remain silent regarding the administration of their PAC. In general, firms disclose that the purpose of the PAC is to donate to candidates that demonstrate support for public policy issues that are important to the firm's business, without regard to the personal political preferences of the firm's officers and executives.[20]

[19] Note that PACs can, and often do, contribute to more than one candidate committee.

[20] Duke Energy and Honeywell are two firms that disclose information on their websites regarding their PAC practices. This information can be found here: http://www.duke-energy.com/corporate-governance/political-participation.asp and http://investor.honeywell.com/phoenix.zhtml?c=94774&p=irol-PolContributions. Such disclosures, however, were absent from each firm's Form 10-K.

The Federal Election Commission (FEC) administers and enforces federal campaign finance laws and, within its role, tracks and publicly discloses on its website campaign contributions for Senate, House of Representatives, and Presidential races. In this study, I first use the FEC's Committee Master Files from 1979 through 2010 to generate a list of all historical PACs. Within these files, the FEC has an "Interest Group Category" field, which consists of corporations, labor and membership organizations, trade associations, and cooperatives. I limit the sample to PACs that list "corporation" as its interest group category. For these observations, there is a field for the "Connected Organization's Name", or the name of the corporation that formed the PAC. I use statistical software to conduct a string comparison to match company names between the FEC data and *Compustat*.[21] The FEC has separate files named "Contributions to Candidates from Committees", which I then use to compute measures of firm-year campaign contributions from corporate-sponsored PACs (described in more detail below).

Several studies use PAC contributions to measure a firm's level of political connectedness (Cooper et al. 2010; Correia 2012). Based on their campaign contributions data, Cooper et al. (2010) find that corporate PAC contributions represent just a small percentage of candidates' campaign financing. They note, however, that if firms make large contributions relative to other contributors, they will likely gain a candidate's attention even if the amount represents only a small fraction of the candidate's total campaign funds. Thus, based on prior

[21] I use the SAS function "COMPGED" to conduct a fuzzy name match file merge. Specifically, "Generalized edit distance (GED) is a generalization of Levenshtein edit distance, which is a measure of dissimilarity between two strings. The Levenshtein edit distance is the number of deletions, insertions, or replacements of single characters that are required to transform string-1 into string-2." COMPGED computes this distance for all string matches, and then I reviewed each pair of strings manually and chose the best name match.

(See: http://support.sas.com/documentation/cdl/en/lrdict/64316/HTML/default/viewer.htm#a002206133.htm)

literature, it is likely that PAC contributions appropriately capture a firm's political connectedness.[22]

I use income statement and balance sheet data from the *Compustat* Fundamentals Annual file. I obtain audit-related data from *Audit Analytics*. In particular, I obtain audit fees from the Audit Fees file, material weaknesses from the SOX 404 Internal Controls file, and going concern opinions from the Audit Opinions file. Audit fee data became publicly available in 2000 and material weakness disclosures were required for periods ending after November 2004, so these data limitations restrict my sample, which ends in 2010, to more recent years.[23]

4.2 Political Connectedness Measures

I use three measures of political connectedness that stem from the amount of PAC contributions made by each firm. The dollar amount of PAC contributions and number of unique candidates supported per firm-year are computed from the period beginning November of year *t-1* through October of year *t,* since Election Day falls in November of each election year.

The first two measures of political connectedness follow prior research (Cooper et al. 2010, Aslan and Grinstein 2011). The first measure, *POLCON_TOT*, is the rolling firm-year sum of total PAC contributions (U.S. dollar amount) over year *t-5* through *t-1*. The second measure, *POLCON_CAND*, is the number of unique candidates supported annually, summed over year *t-5* through *t-1* for each firm-year. Thus, *POLCON_TOT* captures aggregate dollar

[22] Some prior accounting and finance studies in the area of political connectedness remove firms within regulated industries from their sample (Chaney et al. 2011), whereas most studies in this area do not remove firms within regulated industries (Cooper et al. 2010; Yu and Yu 2011; Faccio et al. 2006; Goldman et al. 2008). In untabulated analyses, I run each of my main tests removing firms within regulated industries. The direction and significance levels on the coefficients of interest remain unchanged.

[23] As previously mentioned, a 2010 Supreme Court ruling (*Citizens United vs. Federal Election Commission*) allows corporations to make unlimited, anonymous political expenditures in order to broadcast election advertisements for particular candidates. As a robustness check (untabulated), I remove all observations from 2010. I find that the direction and significance of the coefficients of interest for each of my main tests remains unchanged.

amounts contributed, whereas *POLCON_CAND* captures the extent to which firms spread their donations in order to become connected to multiple candidates. The sample of firm-years with these measures is then merged with *Compustat* and *Audit Analytics* data to create a merged PAC-*Compustat-Audit Analytics* sample. Any firm-years in which the firm does not participate in the political process (i.e., does not form a corporate PAC or make any corporate PAC donations), the amount of donations/number of candidates supported will be set to zero for that firm-year within the rolling five-year window that comprises *POLCON_TOT* and *POLCON_CAND*. My third political connectedness variable, *POLCON_DUM*, is a binary variable which equals one if in year *t-1*, firm *i* made a PAC contribution greater than zero, and equals zero otherwise.

Note that I measure political connectedness in the years *t-5* through *t-1* and measure the audit variables (audit fees, material weaknesses, auditor switching, accounting quality, and NAS fees) in year *t* in order to ensure all political donations are made prior to the determination of the audit variable of interest. In an untabulated robustness check, I re-run each of my main tests using a contemporaneous measure of political connectedness, and I find that the coefficients on the independent variables of interest remain significant and in the same direction as in the lagged approach.

4.3 Research Design

As mentioned in Chapter 3, in order to examine how client political contributions impact audit risk and auditor independence, I employ five audit-related outcome variables which prior studies typically use to analyze audit risk—audit fees, internal control material weaknesses, auditor switching—and weakened auditor independence—accruals quality and NAS fees. The

following sections describe my approach to the examination of the relation between client political contributions and each of these audit variables.

To examine my first research question, whether political contributions influence audit fees, I estimate the following regression:

$$LOG\_AUDITFEES_{it} = \alpha_1 + \beta_1 POLCON_{it-1} + \beta_2 LOG\_ASSET_{it} + \beta_3 INVREC_{it} + \beta_4 LOSS_{it} + \beta_5 ROA_{it} + \beta_6 LEV_{it} + \beta_7 FOREIGN_{it} + \beta_8 BIG4_{it} + \beta_9 OPINION_{it} + \beta_{10} LOG\_AUDITLAG_{it} + \beta_{11} NAS_{it} + \beta_{12} SWITCH_{it} + \beta_{13} LOG\_BUS\_SEG_{it} + \beta_{14} LOG\_GEO\_SEG_{it} + \beta_{15} BTM_{it} + e_t \quad (1)$$

where:

LOG_AUDITFEES = the natural logarithm of audit fees for firm *i* in year *t*[24]

POLCON = one of three political connectedness variables, measured at the end of October each year t_x, for firm *i*:

1) *POLCON_DUM*: an indicator variable which equals 1 when firm *i* makes any corporate PAC contribution in year *t-1*, and 0 otherwise

2) *POLCON_TOT*: the natural logarithm of one plus the total amount of corporate PAC contributions made by firm *i* to all candidates running for the President, the Senate, and the House of Representatives over a 5-year rolling window (years *t-5* to *t-1*)

3) *POLCON_CAND*: the natural logarithm of one plus the number of unique candidates supported by the corporate PAC of firm *i* over a 5-year rolling window (years *t-5* to *t-1*)

LOG_ASSET = the natural logarithm of total assets for firm *i* in year *t*

INVREC = [(inventory + accounts receivable) / total assets] for firm *i* in year *t*

LOSS = an indicator variable which equals 1 if firm *i* has net income < 0 in either of the two previous fiscal years (years *t* or *t-1*), and 0 otherwise

ROA = net income / total assets for firm *i* in year *t*

LEV = total debt / total assets for firm *i* in year *t*

[24] See Appendix A for variable definitions, including data sources and specific variable names from the databases.

FOREIGN = an indicator variable which equals 1 if foreign exchange income (loss) is greater or less than zero for firm *i* in year *t*, and 0 otherwise

BIG4 = an indicator variable which equals 1 if the auditor of firm *i* is a Big 4 auditor in year *t*, and 0 otherwise

OPINION = an indicator variable which equals 1 if firm *i* received a going concern opinion in year *t*, and 0 otherwise

LOG_AUDITLAG = the natural logarithm of the number of days between the end of fiscal year *t* and the signature date of the audit opinion for firm *i*

NAS = an indicator variable which equals 1 if firm *i* had nonaudit fees greater than zero in year *t*, and 0 otherwise

SWITCH = an indicator variable which equals 1 if firm *i* changed auditors in year *t*, and 0 otherwise

LOG_BUS_SEG = the natural logarithm of the number of business segments for firm *i* in year *t*

LOG_GEO_SEG = the natural logarithm of the number of geographic segments for firm *i* in year *t*

BTM = book-to-market ratio, calculated as common/ordinary equity divided by market value of equity

I follow prior audit literature and include control variables within equation (1) that have been shown to impact audit fees (Hay et al. 2006). I control for certain client firm characteristics that influence audit fees, such as firm size (*LOG_ASSET*), complexity (*FOREIGN, LOG_BUS_SEG, LOG_GEO_SEG, BTM*), and risk (*LEV, INVREC*). I also control for the profitability of the firm (*ROA*) and the financial health of the firm (*LOSS*). Additionally, I include a control for any potential audit problems by including *OPINION*, since problems in completing an audit may increase the risk assumed by the auditor. Shifting away from the client and toward auditor and engagement attributes, I control for audit quality (*BIG4*) and the efficiency of the audit (*LOG_AUDITLAG*), since a longer delay likely indicates difficulty in

resolving audit issues or more complex reports to prepare (Hay et al. 2006). Next, I control for nonaudit services (*NAS*) since the provision of these services may create synergies between audit and nonaudit services, or they may lead to additional audit effort. Last, I control for initial engagement years (*SWITCH*) since clients often obtain reduced fees from a new audit firm in order to win the new client's business (also known as low-balling). Following prior research, I also control for industry (2-digit SIC) and year fixed effects and report robust standard errors, clustered at the firm level. I test whether the coefficient on *POLCON* (β_1) is significantly different from zero. If β_1 is significantly different from zero, I can conclude that client political connectedness is related to audit fees.

Next, to test whether client political contributions influence the likelihood of material weaknesses (*RQ2*), I estimate the following logistic regression:

$$\begin{aligned} Prob(MW)_{it} = f(\,&\alpha_1 + \beta_1 POLCON_{it-1} + \beta_2 LOG\_MARKETCAP_{it} + \beta_3 LOG\_SEGMENT_{it} \\ &+ \beta_4 LOSS_{it} + \beta_5 FOREIGN_{it} + \beta_6 LOG\_AGE_{it} + \beta_7 RESTR_{it} + \beta_8 BIG4_{it} \\ &+ \beta_9 SWITCH_{it}) \end{aligned} \quad (2)$$

where:

> *MW* = either: (1) a binary variable which equals 1 if the auditor discloses a material weakness in internal control for firm *i* in year *t*, and 0 otherwise (*MWBIN*), or (2) an ordered variable which equals 1 if the auditor discloses 1 material weakness for firm *i* in year *t*, 2 if the auditor discloses 2 material weaknesses for firm *i* in year *t*, 3 if the auditor discloses 3 or more material weaknesses for firm *i* in year *t*, and 0 otherwise (*MW*)[25]
>
> *LOG_MARKETCAP* = the natural logarithm of the market value of equity for firm *i* in year *t*
>
> *LOG_SEGMENT* = the natural logarithm of the total number of business and geographic segments for firm *i* in year *t*
>
> *LOG_AGE* = the natural logarithm of the number of years firm *i* has existed on *Compustat* as of year *t*
>
> *RESTR* = -1 * (pre-tax restructuring costs / market value of equity) for firm *i* in year *t*

[25] I estimate an ordered logistic regression when using the ordered dependent variable (*MW*).

All other variables are as defined previously.

I include control variables that prior research has shown are significant determinants of material weaknesses. Doyle et al. (2007) find that material weaknesses are more likely for firms that are smaller, younger, financially weaker, more complex, and/or undergoing restructuring. Thus, I include controls for firm size (*LOG_MARKETCAP*), firm age (*LOG_AGE*), financial distress (*LOSS*), complexity (*FOREIGN* and *LOG_SEGMENT*), and restructuring charges (*RESTR*). I also include a control for the engagement of a Big 4 auditor (*BIG4*) since prior research has shown firms that engage Big *n* auditors are more likely to disclose material weaknesses (Ashbaugh-Skaife et al. 2007). Last, I control for auditor switch years (*SWITCH*) since, post-SOX, auditors may decide retaining a client with poor internal controls is too risky and resign from the engagement (Browning 2005). Following prior research, I include 2-digit SIC industry dummies, and standard errors are calculated using Huber/White robust estimates.[26] I test whether the coefficient on *POLCON* (β_1) is significantly different from zero. If β_1 is significantly different from zero, I infer that political connectedness is related to the likelihood of a material weakness.

Moreover, to test whether client political contributions impact the likelihood of auditor switching (*RQ3*), I estimate the following logistic regression:

$$\begin{aligned} Prob(SWITCH)_{it} = f(&\alpha_1 + \beta_1 POLCON_{it-1} + \beta_2 LOG\_MARKETCAP_{it} + \beta_3 CH\_LIAB_{it} \\ &+ \beta_4 CH\_LEV_{it} + \beta_5 OPINION_{it-1} + \beta_6 NEGCH\_AUDITFEES_{it} \\ &+ \beta_7 CH\_REV_{it} + \beta_8 BIG4_{it}) \end{aligned} \quad (3)$$

where:

SWITCH = an indicator variable which equals 1 if firm *i* changed auditors in year *t*, and 0 otherwise

[26] Adding year fixed effects does not change the direction or the significance of my variables of interest.

CH_LIAB = percentage change in total debt, calculated as $(LIAB_t - LIAB_{t-1}) / LIAB_{t-1}$

CH_LEV = percentage change in leverage (total debt/total assets), calculated as $(LEV_t - LEV_{t-1}) / LEV_{t-1}$

NEGCH_AUDITFEES = an indicator variable which equals 1 if audit fees decreased in year *t* (compared to year *t-1*), and 0 otherwise

CH_REV = percentage change in total revenue, calculated as $(REV_t - REV_{t-1}) / REV_{t-1}$

All other variables are as defined previously.

I control for characteristics that prior studies have documented are related to a firm's decision to switch auditors. Prior research finds firm size is an important determinant in auditor choice decisions (Francis and Wilson 1988), so I include a control for both firm size (*LOG_MARKETCAP*) as well as the percentage change in total revenue (*CH_REV*) to account for any significant changes in the firm's size. I include controls for the change in liabilities (*CH_LIAB*) and change in leverage (*CH_LEV*) because as levels of debt and leverage change, firms may switch auditors to obtain the level of monitoring appropriate for their circumstances (Tate 2007). I control for a decrease in audit fees (*NEGCH_AUDITFEES*) since firms may switch auditors in order to reduce their audit fee (Tate 2007). I include an indicator for a going concern opinion in year *t-1* since prior research finds that firms are more likely to switch auditors following a qualified opinion (Chow and Rice 1982). Last, I include a Big 4 indicator (*BIG4*) to control for the ceiling effect, whereby firms that already have a high quality auditor may not in fact change auditors when undergoing changes in their contracting environment, whereas firms that do not engage Big 4 auditors have the ability to switch to a higher quality auditor (Tate 2007). Following prior research, I include 2-digit SIC industry dummies, and standard errors are

calculated using Huber/White robust estimates.[27] I test whether the coefficient on *POLCON* (β_1) is significantly different from zero. If β_1 is significantly different from zero, I can conclude that political connectedness is related to the likelihood of an auditor switch.

To examine my fourth research question, whether political contributions influence accruals quality, I estimate the following regression:

$$AQ_{it} = \alpha_1 + \beta_1 POLCON_{it-1} + \beta_2 LOG\_ASSET_{it} + \beta_3 LEV_{it} + \beta_4 MTB_{it} + \beta_5 LOG\_TENURE_{it} + \beta_6 LOSS_{it} + \beta_7 LITIGATION_{it} + \beta_8 BIG4_{it} + \beta_9 NEWFIN_{it} + \beta_{10} LAG\_ACCR_{it} + \beta_{11} ACQUIS_{it} + \beta_{12} CFO_{it} + e_t \quad (4)$$

where:

> *AQ* = accruals quality, measured using the McNichols (2002) modification of the Dechow and Dichev (2002) accruals quality model. Within each year and 2-digit SIC industry with at least 20 observations, I estimate the Dechow and Dichev (2002) model of total current accruals regressed on lagged, concurrent, and future period's cash from operations. Following McNichols (2002), I adjust the Dechow and Dichev (2002) model by including change in revenues from year *t-1* to year *t* and gross property, plant, and equipment. All independent variables are scaled by average total assets. I utilize the absolute value of the firm-specific residual from this model to measure accruals quality. *AQ* is then the standard deviation of this residual over the previous five years.[28]
>
> *MTB* = market-to-book ratio, calculated as market value of equity divided by common/ordinary equity for firm *i* in year *t*
>
> *LOG_TENURE* = the natural logarithm of the number of years of auditor tenure for firm *i* in year *t*
>
> *LITIGATION* = an indicator variable which equals 1 if firm *i* operates in a high-litigation industry (SIC codes of 2833–2836, 3570–3577, 3600–3674, 5200–5961, and 7370–7374), and 0 otherwise
>
> *NEWFIN* = an indicator variable which equals 1 if firm *i* issued equity (greater than $10M) or debt (greater than $1M) in year *t*, and 0 otherwise.

[27] Adding year fixed effects does not change the direction or the significance of my variables of interest.

[28] As a robustness test, I measure accruals quality as the absolute value of abnormal accruals and calculate abnormal accruals using the Jones (1991) model. My results are in the same direction and of the same significance when using this alternate measure of accruals quality.

LAG_ACCR = last year's total accruals, calculated as income before extraordinary items + depreciation – cash flow from operating activities, scaled by total assets for firm *i* in year *t*

ACQUIS = an indicator variable which equals 1 if acquisitions are greater than zero for firm *i* in year *t*, and 0 otherwise

All other variables are as defined previously.

I include controls based on prior audit research that utilizes models of accruals quality (Ashbaugh et al. 2003; Chung and Kallapur 2003). I include *LOG_ASSETS* to control for any potential firm size effects. Prior research finds leverage and growth are associated with abnormal accruals, so I include *LEV* and *MTB* to control for these factors. I also include auditor tenure (*LOG_TENURE*) following Frankel et al. (2002), since some research suggests auditor independence decreases in the length of auditor tenure. I control for financing (*NEWFIN*) and acquisition (*ACQUIS*) activities since both of these actions may be associated with the amount of abnormal accruals. Some prior studies suggest Big 4 auditors are less likely to allow earnings management than non-Big 4 auditors, so I control for the size of the audit firm (*BIG4*). I include controls for performance (*LOSS* and *CFO*) following Frankel et al. (2002), and I include last year's accruals (*LAG_ACCR*) in order to capture the reversal of accruals over time. Following prior research, I also control for industry (2-digit SIC) and year fixed effects and report robust standard errors, clustered at the firm level. I test whether the coefficient on *POLCON* (β_1) is significantly different from zero. If β_1 is significantly greater (less) than zero, I can conclude that political connectedness is related poorer (higher) accruals quality.[29]

Last, I estimate the following OLS regression to test whether client political contributions are related to NAS fees (*RQ5*):

[29] Note that higher values of *AQ* indicate poorer accruals quality. Thus, a positive coefficient on β_1 in Model (4) indicates politically connected clients suffer from *poorer* accruals quality.

$$LOG\_NASFEES_{it} = \sigma_1 + \beta_1 POLCON_{it-1} + \beta_2 LOG\_ASSET_{it} + \beta_3 INVREC_{it} + \beta_4 LOSS_{it} + \beta_5 ROA_{it} + \beta_6 LEV_{it} + \beta_7 FOREIGN_{it} + \beta_8 BIG4_{it} + \beta_9 OPINION_{it} + \beta_{10} SWITCH_{it} + \beta_{11} LOG\_BUS\_SEG_{it} + \beta_{12} LOG\_GEO\_SEG_{it} + \beta_{13} BTM_{it} + \beta_{14} NEWFIN_{it} + \beta_{15} LOG\_AUDITFEES_{it} + e_t \quad (5)$$

where:

LOG_NASFEES = the natural logarithm of nonaudit fees for firm *i* in year *t*

All other variables are as defined previously.

In identifying control variables, I follow nonaudit fee models from prior research (DeFond et al. 2002; Whisenant et al. 2003). Most of the control variables are identical to my earlier audit fee model. In the NAS fee model, however, I remove the control variable for *NAS*, since I am now using NAS fees as the dependent variable and *LOG_AUDITLAG*, since this is not considered a determinant of NAS fees. Additionally, I add the control variable *NEWFIN* to the above equation based on prior findings that NAS fees are increasing in new financing costs, but they do not directly influence audit fees (Whisenant et al. 2003). If political contributions are related to NAS fees, then I expect the coefficient on *POLCON* (β_1) to be significantly different from zero.

CHAPTER FIVE

RESULTS

5.1 Main Analyses

Table 1 reports the descriptive statistics for my sample. I winsorize all continuous, non-logged control variables at the first and 99th percentiles to mitigate the influence of outliers. The table shows descriptive statistics for the entire merged PAC-*Compustat-Audit Analytics* sample (81,197 observations).[30] The mean of *POLCON_DUM* indicates that only approximately 6% of the firm-year observations in the PAC-*Compustat-Audit Analytics* sample indicate active PAC participation. This is comparable to Cooper et al.'s (2010) finding that 9.49% of firms listed on the combined *CRSP*/*Compustat* database participate in the contribution process. Moreover, the means of several variables commonly used in audit fees studies are comparable to the means in my study. For example, I (Whisenant et al. 2003) report a mean of 12.655 (12.482) for *LOG_AUDITFEES*, 0.283 (0.270) for *INVREC*, and 0.446 (0.495) for *LOSS*. As shown in Table 1, not all variables are available for each observation in the sample, which partially explains the sample size differences among my various tests (i.e., each test utilizes different combinations of these variables within their respective models). Additionally, not all of the audit outcome variables are available the entire sample period (2000-2010), which also contributes to the difference in sample size among my tests.[31]

[30] Roughly 12,000 unique firms comprise the entire sample. The number of unique firms for the: (1) audit fee, (2) material weakness, (3) auditor switching, (4) accruals quality, and (5) NAS fee tests is roughly: (1) 7,000, (2) 4,000, (3) 8,700, (4) 6,000, and (5) 7,000, respectively.

[31] In untabulated analysis, I re-estimate each of the regressions from my main analyses using a consistent sample (the 39,550 firm-year observations from the audit fees test), and the direction and significance of the coefficients of interest in each test remain unchanged.

Table 2 provides the Pearson correlation among the three political connectedness measures—*POLCON_DUM* and the unlogged versions of *POLCON_TOT* and *POLCON_CAND*. Consistent with prior research (Cooper et al. 2010), I show the correlation among the political connectedness variables using the *unlogged* version of *POLCON_TOT* and *POLCON_CAND* since this provides a more meaningful analysis than the correlation of logged values. Additionally, this table only serves to present the correlations among the three different measures of my independent variable of interest (*POLCON*), rather than a correlation between a dependent and independent variable of interest that I will later test in a multivariate setting. I find all three measures of political connectedness are significantly correlated with one another.

I first test whether political contributions are associated with audit fees. The three columns in Table 3 display the results for estimating equation (1) for each of the three political connectedness measures (*POLCON_DUM*, *POLCON_TOT*, and *POLCON_CAND*, respectively), which are the independent variables of interest. All of the control variables within the audit fee model are in the correct direction as predicted by prior research, and all of the control variables (except for leverage (*LEV)*, which is insignificant) are significant at the one percent level. Moreover, the R^2 of each model is roughly .83. Overall, the audit fee model appears to be well-specified. For all three measures of political connectedness, the coefficient on client political contributions is significantly positive at the one percent level.[32] This result suggests that political connectedness is associated with higher audit fees.

[32] Audit research to date provides conflicting results regarding whether the relation between corporate governance and audit fees is positive or negative (Hay et al. 2006). In untabulated analysis, however, I re-estimate equation (1) with the inclusion of a control variable for corporate governance (*CORPGOV*), which reduces my sample size from roughly 40,000 to 10,000 observations. I define *CORPGOV* based on Bebchuk et al.'s (2006) "E-Index", which ranges from 0 to 6 based on the presence or absence of six corporate governance variables. I find that *POLCON_DUM* and *POLCON_TOT* (*POLCON_CAND*) remain significantly positively associated with audit fees at the five percent (one percent) level.

Next, Table 4 provides the results of estimating equation (2), which tests whether political contributions are related to the likelihood of a material weakness. The first three columns provide the results of the logistic regression using the binary dependent variable (*MWBIN*). Columns (4) through (6) provide the results of an ordered logistic regression using the ordered dependent variable (*MW*), which ranges from 0 to 3, depending on the number of material weaknesses an auditor reports for a given firm. Irrespective of the dependent variable (*MWBIN* or *MW*) or the political connectedness measure (*POLCON_DUM*, *POLCON_TOT*, or *POLCON_CAND*), I find that political contributions are significantly negatively related to the likelihood of material weaknesses at the one percent level.[33]

I provide the results of estimating equation (3), which tests whether client political contributions are related to the likelihood of auditor switching, in Table 5. The three columns display the results for estimating equation (3) for each of the three political connectedness measures (*POLCON_DUM*, *POLCON_TOT*, and *POLCON_CAND*, respectively). I find that political contributions are significantly negatively related to the likelihood of auditor switching at the one percent level, regardless of the political connectedness measure. This result implies politically connected firms endure longer relationships with their auditors.[34] Such long-term relations support a potential economic bond characterization of the relationship between politically connected clients and auditors. In other words, the notion of an auditor generating

[33] Prior research provides some evidence that corporate governance influences the incidence of material weaknesses (Krishnan 2005; Hoitash et al. 2009). Other research, however, finds corporate governance is unrelated to the likelihood of a material weakness (Doyle et al. 2007; Lin et al. 2011). Despite this mixed evidence, I re-run my material weakness analysis with the inclusion of a corporate governance control variable (*CORPGOV*). Although my sample size reduces from around 17,000 to roughly 7,000 observations, in untabulated analysis, I find that *POLCON_DUM* and *POLCON_TOT* (*POLCON_CAND*) are significantly negatively related to material weaknesses at the five percent (eleven percent) level.

[34] An alternative to examining the incidence of auditor switches is to examine auditor tenure. In untabulated analysis, I regress auditor tenure on *POLCON* as well as various control variables that prior research documents as determinants of auditor tenure. I find that all three measures of political connectedness are positively associated with auditor tenure, thus supporting my result that connected firms switch auditors less often.

substantial fee revenue from politically connected clients and thus acquiescing more with regards to the reporting of material weaknesses, is a fruitful arrangement for both the connected client and the auditor, such that connected clients are less likely to switch auditors

To gain further insight into potential client-auditor bonding, I next investigate the relation between client political contributions and accruals quality. I report the results of estimating equation (4) in Table 6, using *POLCON_DUM* (Column 1), *POLCON_TOT* (Column 2), and *POLCON_CAND* (Column 3) as the independent variables of interest in each column. I find that regardless of the measure of client political contributions, each coefficient is significantly positive at the one percent level. In other words, clients with strong political connections experience poorer accruals quality. This suggests auditors of politically connected clients are less stringent regarding accounting accruals and allow managers more discretion. This result is consistent with prior research that documents an association between political connectedness and poorer earnings quality (Chaney et al. 2011). My analysis differs from Chaney et al. (2011), however, in that they classify a company as politically connected if, at some point between 1997 and 2001, at least one of its large shareholders or top directors is a member of parliament, a minister or a head of state, or is tightly related to a politician or party. Thus, both my measure of political participation (PAC contributions) and my sample period (2000-2010) differ significantly from those nused in Chaney et al. (2011), which make this earnings quality analysis an important contribution of my study.

In my final test, I examine the relation between PAC contributions and NAS fees since higher NAS fees are generally indicative of a strong client-auditor bond. Table 7 provides the results of estimating equation (5). Each column represents the results of estimating the NAS fees model using one of the three measures of political connectedness (*POLCON_DUM*,

POLCON_TOT, and *POLCON_CAND*, respectively) as the independent variable of interest. I find that each measure is positively related to NAS fees at the one percent level. This evidence provides additional support for the existence of an economic bond between auditors and their politically connected clients. Auditors earn significantly more audit *and* NAS fee revenue from politically connected clients, which suggest a strong economic bond between these parties and the potential for weakened auditor independence.

In total, although my audit fee results are consistent with greater audit risk for politically connected clients, my material weakness and auditor switching results are not. If politically connected clients posed higher risk, I should find more material weakness and a greater likelihood of switching. Instead, I find fewer material weaknesses and less switching. An alternate interpretation, however, is economic bonding. In support of this interpretation is my evidence that politically connected clients suffer from poorer accruals quality and pay significantly higher NAS fees. Thus, the interpretation of the combined results of all of my tests is most consistent with the notion that politically connected clients likely have a strong economic bond with their auditors. My evidence suggests politically connected clients generate substantial fees for the auditor, and the economic bond and importance associated with politically connected clients potentially impairs auditor independence. Specifically, auditors earn substantial audit fee revenue from politically connected clients (and also likely view them as important, desirable clients) and, in return, report fewer material weaknesses for connected clients, remain engaged with connected clients longer, and allow more accounting discretion than non-connected clients.

5.2 Controlling for Endogeneity

A potential limitation to my audit fees analysis is that it is likely that political involvement and audit fees are endogenously determined. In particular, it is possible some unobserved determinant(s) of audit fees also explain political contributions, leading to biased OLS estimates. In order to address this potential endogeneity, I use two instrumental variable approaches—the first is a two-stage test, and the second is a simultaneous equations, three-stage test.

The use of an instrumental variables approach requires I specify at least one exogenous variable (i.e., instrument) that determines political connectedness but is generally unrelated to audit fees. I select one instrumental variable—the percent of a firm's industry that is politically active within a year (*%POLACTIVE*). The selection of this variable follows prior political connectedness research that shows the number of politically active firms in the firm's industry is a significant determinant of political participation (Cooper et al. 2010). The intuitive appeal of *%POLACTIVE* is that the greater the number of firms that contribute to political candidates within an industry, the more likely it is that the industry is characterized by a desire to influence politicians, and thus the more likely the firm will also follow its peers and the industry's need to engage in political activities to influence regulation. Thus, I first conduct a two-stage instrumental variables test. I estimate a first stage regression in which the dependent variable is one of my three political connectedness measures and the independent variables include the instrument I selected (*%POLACTIVE*), as well as all the control variables from equation (1), the audit fee model. Then, in the second stage audit fee model, I use the predicted coefficients on the political connectedness variable from the first stage regression to measure political connectedness.

Table 8 reports the second stage results of this instrumental variable test. The control variables are suppressed for ease of exposition. All three measures of predicted political connectedness (*PRED_POLCON_DUM*, *PRED_POLCON_TOT*, and *PRED_POLCON_CAND*) remain significantly positively associated with audit fees at the one percent level. Thus, after taking into consideration the endogeneity of audit fees and political contributions, I continue to find evidence that politically connected clients pay higher audit fees than non-connected clients.[35]

Next, prior audit research documents that audit and NAS fees are simultaneously determined (Whisenant et al. 2003; DeFond et al. 2002). This suggests that research examining the relation between audit fees and another variable of interest should also consider the simultaneity of nonaudit fees in fee determination. Thus, to address the potential statistical misspecification, or simultaneous-equations bias, in the single-equation audit fees model in my main analysis, I next estimate a system of three simultaneous equations for each of the endogenous variables (NAS fees, audit fees, and political contributions), using a three-stage-least-squares (3SLS) regression framework. The first two stages of 3SLS are identical to two-stage-least-squares (2SLS), such that instrumental variables are used to obtain predicted values of the endogenous variables, and these predicted values are used in the second stage regressions. In the third stage of 3SLS, the 2SLS residuals are used to estimate the cross-equation error covariance matrix and generate correlation coefficients, which are more efficient than 2SLS. Overall, 3SLS not only treats NAS fees, audit fees, and political contributions as endogenous,

[35] Since choosing a "perfect" instrumental variable is challenging, I also run this analysis (untabulated) a second time using two instrumental variables—the natural logarithm of the number of employees (*LOG_EMP*) and membership in a regulated industry (*REG*). Prior political connectedness research also shows both of these variables are significant determinants of political participation (Cooper et al. 2010). This research suggests that the greater number of firm employees, the more potential contributors to a PAC, and the more regulated a firm's industry, the more likely the firm will engage in political activities to influence regulation. My results in both Tables 8 and 9 are robust to the use of these instrumental variables as well.

but also takes the cross-equation error correlations into account to improve large sample efficiency.

As mentioned above, the 3SLS simultaneous equations approach also requires the specification of at least one exogenous, instrumental variable for the endogenous variables. Based on prior research (Whisenant et al. 2003; DeFond et al. 2002), I specify explanatory exogenous variables conjectured to be unique in their direct influence on audit and NAS fees. I choose new financing (*NEWFIN*) as an attribute that explains NAS fees, but is generally unrelated to audit fees or political contributions and audit lag (*LOG_AUDITLAG*) as a characteristic that explains audit fees but is generally unrelated to NAS fees and political contributions. Moreover, based on prior research (Cooper et al. 2010), I specify one exogenous variable that determines political connectedness, the percent of a firm's industry that is politically active within the year (*%POLACTIVE*), that in general, is unrelated to audit and NAS fees. Thus, I estimate the following system of equations:

$$\begin{aligned} LOG\_NASFEES_{it} = {} & \sigma_1 + \delta_1 POLCON_{it} + \delta_2 LOG\_ASSET_{it} + \delta_3 INVREC_{it} + \delta_4 LOSS_{it} + \\ & \delta_5 ROA_{it} + \delta_6 LEV_{it} + \delta_7 FOREIGN_{it} + \delta_8 BIG4_{it} + \delta_9 OPINION_{it} + \\ & \delta_{10} SWITCH_{it} + \delta_{11} LOG\_BUS\_SEG_{it} + \delta_{12} LOG\_GEO\_SEG_{it} + \delta_{13} BTM_{it} + \\ & \delta_{14} NEWFIN_{it} + \delta_{15} LOG\_AUDITFEES_{it} + e_t \end{aligned} \quad (6)$$

$$\begin{aligned} LOG\_AUDITFEES_{it} = {} & \alpha_1 + \beta_1 POLCON_{it} + \beta_2 LOG\_ASSET_{it} + \beta_3 INVREC_{it} + \beta_4 LOSS_{it} + \\ & \beta_5 ROA_{it} + \beta_6 LEV_{it} + \beta_7 FOREIGN_{it} + \beta_8 BIG4_{it} + \beta_9 OPINION_{it} + \\ & \beta_{10} LOG\_AUDITLAG_{it} + \beta_{12} SWITCH_{it} + \beta_{13} LOG\_BUS\_SEG_{it} + \\ & \beta_{14} LOG\_GEO\_SEG_{it} + \beta_{15} BTM_{it} + \beta_{11} LOG\_NASFEES_{it} + e_t \end{aligned} \quad (7)$$

$$\begin{aligned} POLCON_{it} = {} & \omega_1 + \mu_1 LOG\_ASSET_{it} + \mu_2 LEV_{it} + \mu_3 LOG\_BUS\_SEG_{it} + \mu_4 LOG\_GEO\_SEG_{it} + \\ & \mu_5 BTM_{it} + \mu_6 \%POLACTIVE_{it} + \mu_7 LOG\_AUDITFEES_{it} + \mu_8 LOG\_NASFEES_{it} + \\ & e_t \end{aligned} \quad (8)$$

where:

%POLACTIVE = the number of firms within firm *i*'s industry that make at least one PAC contribution in year *t* divided by the total number of firms within firm *i*'s industry in year *t*

All other variables are as defined previously.

Table 9 provides the results of the estimation of the NAS fees, audit fees, and political contributions models, as a system of three equations.[36] All control variables are suppressed for ease of exposition. I find that all three measures of political connectedness are significantly (at the one percent level) positively related to both nonaudit (see columns 1, 4, and 7) and audit fees (see columns 2, 5, and 8).[37] Overall, after taking into account the endogeneity of NAS fees, audit fees, and political contributions, I continue to find support for a positive relation between political contributions and audit fees.

[36] Note that for my main audit fees analysis, I use the lagged value of political connectedness ($POLCON_{t-1}$) in order to minimize the overlap between the determination of the dependent (audit fees) and independent (political connectedness) variables. For the simultaneous equations analysis, however, I use the contemporaneous value of political connectedness ($POLCON_t$), since the potential for the simultaneous determination of audit fees, nonaudit fees, and political connectedness requires I use a contemporaneous measure that coincides with the period of the audit and nonaudit fees.

[37] I repeat this analysis (untabulated) using the 2SLS approach, and all coefficients of interest remain in the same direction and at the same level of significance.

CHAPTER SIX

CONCLUSION

In this study, I investigate the relation between client corporate PAC contributions and: (1) audit fees, (2) material weaknesses, (3) auditor switching, (4) accruals quality, and (5) NAS fees. Based on prior research, client political contributions potentially increase an auditor's assessment of inherent and control risk, since past studies find politically connected firms are associated with more opaque financial statements (Chaney et al. 2011) and poorer corporate governance (Aggarwal et al. 2012). Other research, however, suggests that connected firms enjoy more stable, stronger economic performance and lower costs of equity and debt (Cooper et al. 2010; Boubakri et al. 2012; Houston et al. 2012), which likely lowers engagement risk. Moreover, prior research suggests political contributions increase a client's bargaining power through the political prestige (D'Aveni 1990) and social capital (Aslan and Grinstein 2011) gained from such connections. Last, to the extent that politically connected clients are viewed as important to the auditor, client political contributions potentially impair auditor independence since prior literature finds that client importance (measured using fee revenue) threatens auditor independence. I seek to better understand the influence of client political contributions on the opposing forces of higher audit risk, lower audit risk, greater client bargaining power, and lower auditor independence.

I provide evidence that political contributions are associated with higher audit fees, fewer material weaknesses, less auditor switching, poorer accruals quality, and higher NAS fees. I conclude that these results are most consistent with the existence of a strong bond between auditors and politically connected clients, likely driven by the importance and political clout associated with connected clients as well as the substantial (audit and nonaudit) fee revenue

generated by connected clients. My evidence that connected clients obtain greater auditor acquiescence with regards to the reporting of material weaknesses, auditor switching, and discretion over accruals may indicate that this strong client and economic bond potentially weakens auditor independence.

This study provides several contributions and likely appeals to academic researchers, practitioners, and regulators. First, the political connectedness literature in accounting and finance documents the influence of political ties on several stakeholders, including shareholders (Boubakri et al. 2012), debt holders (Houston et al. 2012), and regulators (Faccio et al. 2006; Correia 2012). The results of these studies indicate that political connections are risk-reducing, however, which is at odds with literature that finds connected firms suffer from lower earnings quality (Chaney et al. 2011). Thus, my study examines the influence of political connections on another important stakeholder, the auditor, and sheds light on the link between political ties and risk. Moreover, I contribute to the audit literature by examining a unique setting (political involvement) in which I can examine the competing forces of audit risk, client bargaining power, and auditor independence and make inferences regarding how these forces influence important audit outcomes—audit fees, material weaknesses, auditor switches, accruals quality, and NAS fees. Overall, this study furthers the knowledge in both the political connectedness and auditing streams of literature.

I expect my study to be of interest to managers, who make the decision to become politically active, and auditors, who must assess how a politically active client differs from a politically inactive client. My study is also potentially of interest to regulators, particularly during a time when corporate political spending is on the forefront of regulatory news due to the 2010 Supreme Court Ruling (*Citizens United vs. Federal Election Commission*), which allows

unlimited, undisclosed corporate spending on campaign advertisements for political candidates. In general, the extent to which client political contributions impact a client's audit risk level, client bargaining power, and auditor independence is likely of interest to each of these stakeholders.

APPENDIX A

VARIABLE DEFINITIONS

Dependent and independent variables of interest

Variable Name	Description
LOG_AUDITFEES	the natural logarithm of audit fees for firm *i* in year *t* from Audit Analytics (*MATCHFY_SUM_AUDFEES*)
MW	either: (1) a binary variable which equals 1 if the auditor discloses a material weakness for firm *i* in year *t*, and 0 otherwise (*MWBIN*), or (2) an ordered variable which equals 1 if the auditor discloses 1 material weakness for firm *i* in year *t*, 2 if the auditor discloses 2 material weaknesses for firm *i* in year *t*, 3 if the auditor discloses 3 or more material weaknesses for firm *i* in year *t*, and 0 otherwise (*MW*), using *COUNT_WEAK* from Audit Analytics
SWITCH	an indicator variable which equals 1 if firm *i* changed auditors in year *t*, and 0 otherwise (using *AU* from Compustat)
AQ	accruals quality, measured using the McNichols (2002) modification of the Dechow and Dichev (2002) accruals quality model. Within each year and 2-digit SIC industry with at least 20 observations, I estimate the Dechow and Dichev (2002) model of total current accruals regressed on lagged, concurrent, and future period's cash from operations. Following McNichols (2002), I adjust the Dechow and Dichev (2002) model by including change in revenues from year *t-1* to year *t* and gross property, plant, and equipment. All independent variables are scaled by average total assets. I utilize the absolute value of the firm-specific residual from this model to measure accruals quality. *AQ* is then the standard deviation of this residual over the previous five years.
LOG_NASFEES	the natural logarithm of nonaudit fees for firm *i* in year *t* from Audit Analytics (*MATCHFY_SUM_NONAUD*)
POLCON_TOT	the natural logarithm of one plus the total amount of corporate PAC contributions made by firm *i* to all candidates running for the President, the Senate, and the House of Representatives over a 5-year rolling window (years *t-5* to *t-1*)
POLCON_CAND	the natural logarithm of one plus the number of unique candidates supported by the corporate PAC of firm *i* over a 5-year rolling window (years *t-5* to *t-1*)
POLCON_DUM	an indicator variable which equals 1 when firm *i* makes any corporate PAC contribution in year *t-1*, and 0 otherwise

Control variables (in alphabetical order)

Variable Name	Description
ACCR	total accruals, calculated as income before extraordinary items (*IB*) + depreciation (*DPC*) – cash flow from operating activities (*OANCF*), scaled by total assets (*AT*) from Compustat for firm *i* in year *t*
ACQUIS	an indicator variable which equals 1 if acquisitions (*AQC* from Compustat) are greater than zero for firm *i* in year *t*, and 0 otherwise
LOG_AGE	the natural logarithm of the number of years firm *i* has existed on *Compustat* as of year *t*
LOG_ASSET	the natural logarithm of total assets (*AT*) from Compustat for firm *i* in year *t*
LOG_AUDITLAG	the number of days between the end of fiscal year *t* (*FISCAL_YEAR_END_OP* from Audit Analytics) and the signature date of the audit opinion (*SIGN_DATE_OF_OP_S* from Audit Analytics) for firm *i*
BIG4	an indicator variable which equals 1 if the auditor of firm *i* is a Big 4 auditor in year *t*, and 0 otherwise (using *AUDITOR_FKEY* from Audit Analytics)
BTM	book-to-market ratio, calculated as common/ordinary equity (*CEQ* from Compustat) divided by market value of equity *(CSHO*PRCC_F* from Compustat)
LOG_BUS_SEG	the natural logarithm of the number of business segments from the Compustat Segments file for firm *i* in year *t*
CFO	cash flow from operations, calculated as cash flow from operating activities (*OANCF*) scaled by total assets (*AT*) from Compustat for firm *i* in year *t*
CH_LEV	percentage change in leverage (total debt (*DLC* + *DLCC*) / total assets (*AT*) from Compustat), calculated as $(LEV_t - LEV_{t-1}) / LEV_{t-1}$
CH_LIAB	percentage change in total debt (*DLC* + *DLTT* from Compustat), calculated as $(LIAB_t - LIAB_{t-1}) / LIAB_{t-1}$
CH_REV	percentage change in total revenue (*REVT* from Compustat), calculated as $(REV_t - REV_{t-1}) / REV_{t-1}$
CORPGOV	a corporate governance variable termed the "E-Index" based on Bebchuk et al. (2009) that ranges from 0 to 6 based on the presence or absence of six corporate governance variables; (*CBOARD*, *LABYLAW*, *LACHTR*, *SUPERMAJOR*, *GPARACHUTE*, and *PPIL* from the Risk Metrics Governance Legacy database and *CBOARD*, *LABLYW*, *LACHTR*, *SUPERMAJOR_PCNT*, *GPARACHUTE*, and *PPILL* from the Risk Metrics Governance database)

Variable Name	Description
LOG_EMP	the natural logarithm of the number of employees (*EMP* from Compustat) for firm *i* in year *t*
FOREIGN	an indicator variable which equals 1 if foreign exchange income (loss) (*FCA* from Compustat) is greater or less than zero for firm *i* in year *t*, and 0 otherwise
LOG_GEO_SEG	the natural logarithm of the number of geographic segments from the Compustat Segments file for firm *i* in year *t*
INVREC	[inventory (*INVT*) + accounts receivable (*RECT*)] / total assets (*AT*) from Compustat for firm *i* in year *t*
LEV	total debt (*DLC* + *DLTT*) / total assets (*AT*) from Compustat for firm *i* in year *t*
LITIGATION	an indicator variable which equals 1 if firm *i* operates in a high-litigation industry (SIC codes of 2833–2836, 3570–3577, 3600–3674, 5200–5961, and 7370–7374), and 0 otherwise
LOSS	an indicator variable which equals 1 if firm *i* has net income (*NI* from Compustat) < 0 in either of the two previous fiscal years (years *t* or *t-1*), and 0 otherwise
LOG_MARKETCAP	the natural logarithm of the market value of equity (*CSHO*PRCC_F* from Compustat) for firm *i* in year *t*
MTB	market-to-book ratio, calculated as market value of equity (*CSHO*PRCC_F* from Compustat) divided by common/ordinary equity (*CEQ* from Compustat) for firm *i* in year *t*
NAS	an indicator variable which equals 1 if firm *i* had nonaudit fees (*MATCHFY_SUM_NONAUD* from Audit Analytics) greater than zero in year *t*, and 0 otherwise
NEGCH_AUDITFEES	an indicator variable which equals 1 if audit fees (*MATCHFY_SUM_AUDFEES* from Audit Analytics) decreased in year *t* (compared to year *t-1*), and 0 otherwise
NEWFIN	an indicator variable which equals 1 if firm *i* issued equity (greater than $10M, using *SSTK* from Compustat) or debt (greater than $1M, using *DLTIS* from Compustat) in year *t*, and 0 otherwise
%POLACTIVE	the number of firms within firm *i*'s industry that make at least one PAC contribution in year *t* divided by the total number of firms within firm *i*'s industry in year *t*
OPINION	an indicator variable which equals 1 if firm *i* received a going concern opinion in year *t*, and 0 otherwise (using *GOING_CONCERN* from Audit Analytics)
REG	an indicator variable which equals 1 if firm *i* is in a regulated industry (*SIC* 6xxx or 49xx, from Compustat), and 0 otherwise

Variable Name	**Description**
RESTR	-1 * [pre-tax restructuring costs (*RCP* from Compustat) / market value of equity (*CSHO*PRCC_F* from Compustat)] for firm *i* in year *t*
ROA	net income (*NI*) / total assets (*AT*) from Compustat for firm *i* in year *t*
LOG_SEGMENT	the natural logarithm of the total number of business and geographic segments from the Compustat Segments file for firm *i* in year *t*
LOG_TENURE	the natural logarithm of the number of years of auditor tenure for firm *i* in year *t* (using *AU* from Compustat to identify a change in auditor)

APPENDIX B

TABLES

TABLE 1

Descriptive statistics

Variables	*N*	Mean	Median	Standard Deviation	25th	75th
LOG_AUDITFEES	80,759	12.655	12.599	1.664	11.436	13.811
MWBIN	26,658	0.080	0.000	0.272	0.000	0.000
MW	26,658	0.140	0.000	0.531	0.000	0.000
SWITCH	68,037	0.077	0.000	0.267	0.000	0.000
AQ	36,944	17.046	9.815	23.278	5.527	18.046
LOG_NASFEES	80,759	9.971	11.035	4.219	9.260	12.541
POLCON_DUM	81,197	0.056	0.000	0.230	0.000	0.000
POLCON_TOT	81,197	0.702	0.000	2.765	0.000	0.000
POLCON_CAND	81,197	0.256	0.000	1.064	0.000	0.000
ACCR	69,789	-3.883	-0.011	506.580	-0.063	0.017
ACQUIS	81,197	0.244	0.000	0.430	0.000	0.000
LOG_AGE	81,197	2.442	2.485	0.841	1.946	2.996
LOG_ASSET	74,484	5.503	5.712	2.845	3.776	7.358
LOG_AUDITLAG	79,715	4.125	4.159	0.486	3.912	4.382
BIG4	81,197	0.679	1.000	0.467	0.000	1.000
BTM	69,979	0.462	0.483	1.475	0.225	0.824
LOG_BUS_SEG	61,375	0.491	0.000	0.645	0.000	1.099
CFO	71,247	-0.095	0.047	0.633	-0.030	0.111
CH_LEV	60,962	7.218	-0.038	604.719	-0.242	0.159
CH_LIAB	61,176	8.945	-0.005	593.136	-0.211	0.240
CH_REV	69,650	2.095	0.074	117.261	-0.051	0.239
CORPGOV	15,526	2.092	2.000	1.417	1.000	3.000
LOG_EMP	69,578	-0.521	-0.562	2.483	-2.163	1.251
FOREIGN	81,197	0.196	0.000	0.397	0.000	0.000
LOG_GEO_SEG	48,863	0.685	0.693	0.708	0.000	1.386
INVREC	73,047	0.283	0.221	0.242	0.078	0.438
LEV	74,239	0.321	0.176	0.622	0.024	0.379
LITIGATION	81,197	0.254	0.000	0.435	0.000	1.000
LOSS	81,197	0.446	0.000	0.497	0.000	1.000
LOG_MARKETCAP	75,910	5.207	5.222	2.476	3.619	6.828
MTB	69,962	2.482	1.676	7.336	0.910	3.042

Table 1 - *Continued*

Variables	*N*	Mean	Median	Standard Deviation	25th	75th
NAS	81,197	0.870	1.000	0.337	1.000	1.000
NEGCH_AUDITFEES	69,532	0.328	0.000	0.470	0.000	1.000
NEWFIN	81,197	0.492	0.000	0.500	0.000	1.000
OPINION	79,899	0.102	0.000	0.303	0.000	0.000
%POLACTIVE	81,197	0.044	0.022	0.070	0.000	0.051
REG	81,197	0.295	0.000	0.456	0.000	1.000
RESTR	80,558	-2.100	0.000	589.648	0.000	0.000
ROA	74,287	-0.315	0.011	1.454	-0.096	0.055
LOG_SEGMENT	44,755	1.387	1.386	0.568	0.693	1.792
LOG_TENURE	71,117	1.609	1.609	0.902	1.099	2.303

This table presents the descriptive statistics for the full sample of the merged PAC contribution-*Compustat-Audit Analytics* databases. *LOG_AUDITFEES* is the natural logarithm of audit fees for firm *i* in year *t*. *MWBIN* is a binary variable which equals 1 if the auditor discloses a material weakness for firm *i* in year *t*, and 0 otherwise. *MW* is an ordered variable which equals 1 if the auditor discloses 1 material weakness for firm *i* in year *t*, 2 if the auditor discloses 2 material weaknesses for firm *i* in year *t*, 3 if the auditor discloses 3 or more material weaknesses for firm *i* in year *t*, and 0 otherwise. *SWITCH* is an indicator variable which equals 1 if firm *i* changed auditors in year *t*, and 0 otherwise. *AQ* is accruals quality, measured using the McNichols (2002) modification of the Dechow and Dichev (2002) accruals quality model. Within each year and 2-digit SIC industry with at least 20 observations, I estimate the Dechow and Dichev (2002) model of total current accruals regressed on lagged, concurrent, and future period's cash from operations. Following McNichols (2002), I adjust the Dechow and Dichev (2002) model by including change in revenues from year *t-1* to year *t* and gross property, plant, and equipment. All independent variables are scaled by average total assets. I utilize the absolute value of the firm-specific residual from this model to measure accruals quality. *AQ* is then the standard deviation of this residual over the previous five years. *LOG_NASFEES* is the natural logarithm of nonaudit fees for firm *i* in year *t*. *POLCON_DUM* is an indicator variable which equals one when firm *i* makes any corporate PAC contribution in year *t-1*, and 0 otherwise. *POLCON_TOT* is the natural logarithm of one plus the total amount of corporate PAC contributions made by firm *i* to all candidates running for the President, the Senate, and the House of Representatives over a 5-year rolling window (years *t-5* to *t-1*). *POLCON_CAND* is the natural logarithm of one plus the number of unique candidates supported by the corporate PAC of firm *i* over a 5-year rolling window (years *t-5* to *t-1*). *ACCR* is total accruals, calculated as income before extraordinary items + depreciation – cash flow from operating activities, scaled by total assets for firm *i* in year *t*. *ACQUIS* is an indicator variable which equals 1 if acquisitions are greater than zero for firm *i* in year *t*, and 0 otherwise. *LOG_AGE* is the natural logarithm of the number of years firm *i* has existed on *Compustat* as of year *t*. *LOG_ASSET* is the natural logarithm of total assets for firm *i* in year *t*. *LOG_AUDITLAG* is the natural logarithm of the number of days between the end of fiscal year *t* and the signature date of the audit opinion for firm *i*. *BIG4* is an indicator variable which equals 1 if the auditor of firm *i* is a Big 4 auditor in year *t*, and 0 otherwise. *BTM* is book-to-market ratio, calculated as common/ordinary equity divided by market value of equity. *LOG_BUS_SEG* is the natural logarithm of the number of business segments for firm *i* in year *t*. *CFO* is cash flow from operations, calculated as cash flow from operating activities scaled by total assets for firm *i* in year *t*. *CH_LEV* is the percentage change in leverage (total debt/total assets), calculated as $(LEV_t - LEV_{t-1}) / LEV_{t-1}$. *CH_LIAB* is the percentage change in total debt, calculated as $(LIAB_t - LIAB_{t-1}) / LIAB_{t-1}$. *CH_REV* is the percentage change in total revenue, calculated as $(REV_t - REV_{t-1}) / REV_{t-1}$. *CORPGOV* is a corporate governance variable termed the "E-Index" based on Bebchuk et al. (2009) that ranges from 0 to 6 based on the presence or absence of six corporate governance variables. *LOG_EMP* is the natural logarithm of the number of employees for firm *i* in year *t*. *FOREIGN* is an indicator variable which equals 1 if foreign exchange income (loss) is greater or less than zero for firm *i* in year *t*, and 0 otherwise. *LOG_GEO_SEG* is the natural logarithm of the number of geographic segments for firm *i* in year *t*.

Table 1 - *Continued*

INVREC is [(inventory + accounts receivable) / total assets] for firm *i* in year *t*. *LEV* is total debt / total assets for firm *i* in year *t*. *LITIGATION* is an indicator variable which equals 1 if firm *i* operates in a high-litigation industry (SIC codes of 2833–2836, 3570–3577, 3600–3674, 5200–5961, and 7370–7374), and 0 otherwise. *LOSS* is an indicator variable which equals 1 if firm *i* has net income < 0 in either of the two previous fiscal years (years *t* or *t-1*), and 0 otherwise. *LOG_MARKETCAP* is the natural logarithm of the market value of equity for firm *i* in year *t*. *MTB* is market-to-book ratio, calculated as market value of equity divided by common/ordinary equity. *NAS* is an indicator variable which equals 1 if firm *i* had nonaudit fees greater than zero in year *t*, and 0 otherwise. *NEGCH_AUDITFEES* is an indicator variable which equals 1 if audit fees decreased in year *t* (compared to year *t-1*), and 0 otherwise. *NEWFIN* is an indicator variable which equals to 1 if firm *i* issued equity (greater than $10M) or debt (greater than $1M) in year *t*, and 0 otherwise. *OPINION* is an indicator variable which equals 1 if firm *i* received a going concern opinion in year *t*, and 0 otherwise. *%POLACTIVE* is the number of firms within firm *i*'s industry that make at least one PAC contribution in year *t* divided by the total number of firms within firm *i*'s industry in year *t*. *REG* is an indicator variable which equals 1 if firm *i* is in a regulated industry (*SIC* 6xxx or 49xx), and 0 otherwise. *RESTR* is -1 * (pre-tax restructuring costs / market value of equity) for firm *i* in year *t*. *ROA* is net income / total assets for firm *i* in year *t*. *LOG_SEGMENT* is the natural logarithm of the total number of business and geographic segments for firm *i* in year *t*. *LOG_TENURE* is the natural logarithm of the number of years of auditor tenure for firm *i* in year *t*.

TABLE 2

Correlation matrix for political connectedness measures

	POLCON_DUM	*POLCON_TOT* (unlogged)	*POLCON_CAND* (unlogged)
POLCON_DUM	1		
POLCON_TOT (unlogged)	0.462***	1	
POLCON_CAND (unlogged)	0.560***	0.956***	1

The above table presents correlation coefficients across the three measures of political connectedness. *POLCON_DUM* is an indicator variable which equals 1 when firm *i* makes any corporate PAC contribution in year *t-1*, and 0 otherwise. *POLCON_TOT* (unlogged) is the total amount of corporate PAC contributions made by firm *i* to all candidates running for the President, the Senate, and the House of Representatives over a 5-year rolling window (years *t-5* to *t-1*). *POLCON_CAND* (unlogged) is the number of unique candidates supported by the corporate PAC of firm *i* over a 5-year rolling window (years *t-5* to *t-1*). *** denotes significance at the 1% level.

TABLE 3

Relation between political contributions and audit fees

Variables	(1)	(2)	(3)
Intercept	8.249***	8.250***	8.250***
	(53.01)	(53.03)	(53.11)
POLCON_DUM	0.168***		
	(5.61)		
POLCON_TOT		0.012***	
		(5.98)	
POLCON_CAND			0.045***
			(6.60)
LOG_ASSET	0.486***	0.485***	0.484***
	(97.60)	(96.45)	(95.79)
INVREC	0.293***	0.292***	0.290***
	(7.25)	(7.22)	(7.19)
LOSS	0.152***	0.152***	0.152***
	(14.05)	(14.02)	(14.02)
ROA	-0.121***	-0.120***	-0.120***
	(-15.72)	(-15.65)	(-15.58)
LEV	0.007	0.007	0.007
	(0.40)	(0.39)	(0.42)
FOREIGN	0.042***	0.044***	0.045***
	(2.64)	(2.70)	(2.77)
BIG4	0.299***	0.300***	0.302***
	(18.96)	(19.02)	(19.10)
OPINION	0.163***	0.161***	0.159***
	(7.74)	(7.66)	(7.57)
LOG_AUDITLAG	0.165***	0.166***	0.166***
	(10.87)	(10.94)	(10.96)
NAS	0.053***	0.053***	0.053***
	(2.64)	(2.65)	(2.67)
SWITCH	-0.056***	-0.056***	-0.055***
	(-3.70)	(-3.70)	(-3.69)
LOG_BUS_SEG	0.112***	0.111***	0.111***
	(10.14)	(10.07)	(10.03)
LOG_GEO_SEG	0.189***	0.189***	0.189***
	(14.83)	(14.84)	(14.87)
BTM	-0.031***	-0.031***	-0.031***
	(-7.64)	(-7.61)	(-7.60)

TABLE 3 - *Continued*

	(1)	(2)	(3)
Year FE?	YES	YES	YES
Industry FE?	YES	YES	YES
Observations	39,550	39,550	39,550
R-squared	0.830	0.830	0.831

This table presents the results of estimating the following OLS regression: $LOG\_AUDITFEES_{it} = \alpha_1 + \beta_1 POLCON_{it-1} + \beta_2 LOG\_ASSET_{it} + \beta_3 INVREC_{it} + \beta_4 LOSS_{it} + \beta_5 ROA_{it} + \beta_6 LEV_{it} + \beta_7 FOREIGN_{it} + \beta_8 BIG4_{it} + \beta_9 OPINION_{it} + \beta_{10} LOG\_AUDITLAG_{it} + \beta_{11} NAS_{it} + \beta_{12} SWITCH_{it} + \beta_{13} LOG\_BUS\_SEG_{it} + \beta_{14} LOG\_GEO\_SEG_{it} + \beta_{15} BTM_{it} + e_t$. *LOG_AUDITFEES* is the natural logarithm of audit fees for firm *i* in year *t*. *POLCON* is one of three political connectedness variables, measured at the end of October each year t_x, for firm *i*: (1) *POLCON_DUM* is an indicator variable which equals 1 when firm *i* makes any corporate PAC contribution in year *t-1*, and 0 otherwise, (2) *POLCON_TOT* is the natural logarithm of one plus the total amount of corporate PAC contributions made by firm *i* to all candidates running for the President, the Senate, and the House of Representatives over a 5-year rolling window (years *t-5* to *t-1*), and (3) *POLCON_CAND* is the natural logarithm of one plus the number of unique candidates supported by the corporate PAC of firm *i* over a 5-year rolling window (years *t-5* to *t-1*). *LOG_ASSET* is the natural logarithm of total assets for firm *i* in year *t*. *INVREC* is [(inventory + accounts receivable) / total assets] for firm *i* in year *t*. *LOSS* is an indicator variable which equals 1 if firm *i* has net income < 0 in either of the two previous fiscal years (years *t* or *t-1*), and 0 otherwise. *ROA* is net income / total assets for firm *i* in year *t*. *LEV* is total debt / total assets for firm *i* in year *t*. *FOREIGN* is an indicator variable which equals 1 if foreign exchange income (loss) is greater or less than zero for firm *i* in year *t*, and 0 otherwise. *BIG4* is an indicator variable which equals 1 if the auditor of firm *i* is a Big 4 auditor in year *t*, and 0 otherwise. *OPINION* is an indicator variable which equals 1 if firm *i* received a going concern opinion in year *t*, and 0 otherwise. *LOG_AUDITLAG* is the natural logarithm of the number of days between the end of fiscal year *t* and the signature date of the audit opinion for firm *i*. *NAS* is an indicator variable which equals 1 if firm *i* had nonaudit fees greater than zero in year *t*, and 0 otherwise. *SWITCH* is an indicator variable which equals 1 if firm *i* changed auditors in year *t*, and 0 otherwise. *LOG_BUS_SEG* is the natural logarithm of the number of business segments for firm *i* in year *t*. *LOG_GEO_SEG* is the natural logarithm of the number of geographic segments for firm *i* in year *t*. *BTM* is book-to-market ratio, calculated as common/ordinary equity divided by market value of equity. All models include year and industry fixed effects. Standard errors are heteroskedasticity robust, clustered at the firm level. *t*-statistics are provided in parentheses. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

TABLE 4

Relation between political contributions and material weaknesses

Variables	(1) *MWBIN*	(2) *MWBIN*	(3) *MWBIN*	(4) *MW*	(5) *MW*	(6) *MW*
Intercept 1	-0.727	-0.771	-0.750	0.844*	0.888*	0.868*
	(-1.30)	(-1.38)	(-1.34)	(1.66)	(1.74)	(1.70)
Intercept 2				1.671***	1.715***	1.695***
				(3.29)	(3.36)	(3.32)
Intercept 3				2.270***	2.314***	2.294***
				(4.46)	(4.53)	(4.49)
POLCON_DUM	-0.612***			-0.614***		
	(-4.33)			(-4.38)		
POLCON_TOT		-0.074***			-0.074***	
		(-4.73)			(-4.79)	
POLCON_CAND			-0.147***			-0.147***
			(-4.09)			(-4.15)
LOG_MARKETCAP	-0.190***	-0.185***	-0.187***	-0.189***	-0.185***	-0.186***
	(-8.66)	(-8.48)	(-8.54)	(-8.68)	(-8.50)	(-8.56)
LOG_SEGMENT	0.225***	0.226***	0.225***	0.231***	0.233***	0.231***
	(3.63)	(3.65)	(3.62)	(3.73)	(3.75)	(3.73)
LOSS	0.554***	0.558***	0.557***	0.566***	0.570***	0.569***
	(8.02)	(8.08)	(8.06)	(8.15)	(8.21)	(8.20)
FOREIGN	0.053	0.050	0.051	0.060	0.057	0.058
	(0.79)	(0.74)	(0.76)	(0.88)	(0.84)	(0.86)
LOG_AGE	-0.204***	-0.196***	-0.200***	-0.211***	-0.203***	-0.207***
	(-3.95)	(-3.80)	(-3.87)	(-4.06)	(-3.90)	(-3.98)
RESTR	-0.344	-0.254	-0.282	-0.366	-0.275	-0.306
	(-0.33)	(-0.25)	(-0.27)	(-0.35)	(-0.26)	(-0.29)
BIG4	-0.251***	-0.252***	-0.253***	-0.273***	-0.274***	-0.275***
	(-3.20)	(-3.21)	(-3.22)	(-3.45)	(-3.47)	(-3.48)
SWITCH	0.799***	0.798***	0.800***	0.792***	0.791***	0.793***
	(8.75)	(8.75)	(8.76)	(8.73)	(8.72)	(8.74)
Industry FE?	YES	YES	YES	YES	YES	YES
Observations	17,077	17,077	17,077	17,127	17,127	17,127

This table presents the results of estimating the following logistic (ordered logistic) regression model: $Prob[MWBIN\ (MW)]_{it} = f(\alpha_1 + \beta_1 POLCON_{it-1} + \beta_2 LOG\_MARKETCAP_{it} + \beta_3 LOG\_SEGMENT_{it} + \beta_4 LOSS_{it} + \beta_5 FOREIGN_{it} + \beta_6 LOG\_AGE_{it} + \beta_7 RESTR_{it} + \beta_8 BIG4_{it} + \beta_9 SWITCH_{it})$. *MWBIN* is a binary variable which equals 1 if the auditor discloses a material weakness for firm *i* in year *t*, and 0 otherwise. *MW* is an ordered variable which equals 1 if the auditor discloses 1 material weakness for firm *i* in year *t*, 2 if the auditor discloses 2 material weaknesses for firm *i* in year *t*, 3 if the auditor discloses 3 or more material weaknesses for firm *i* in year *t*, and 0

TABLE 4 - *Continued*

otherwise. *POLCON_DUM* is an indicator variable which equals 1 when firm *i* makes any corporate PAC contribution in year *t-1*, and 0 otherwise. *POLCON_TOT* is the natural logarithm of one plus the total amount of corporate PAC contributions made by firm *i* to all candidates running for the President, the Senate, and the House of Representatives over a 5-year rolling window (years *t-5* to *t-1*). *POLCON_CAND* is the natural logarithm of one plus the number of unique candidates supported by the corporate PAC of firm *i* over a 5-year rolling window (years *t-5* to *t-1*). *LOG_MARKETCAP* is the natural logarithm of the market value of equity for firm *i* in year *t*. *LOG_SEGMENT* is the natural logarithm of the total number of business and geographic segments for firm *i* in year *t*. *LOSS* is an indicator variable which equals 1 if firm *i* has net income < 0 in either of the two previous fiscal years (years *t* or *t-1*), and 0 otherwise. *FOREIGN* is an indicator variable which equals 1 if foreign exchange income (loss) is greater or less than zero for firm *i* in year *t*, and 0 otherwise. *LOG_AGE* is the natural logarithm of the number of years firm *i* has existed on *Compustat* as of year *t*. *RESTR* is -1 * (pre-tax restructuring costs / market value of equity) for firm *i* in year *t*. *BIG4* is an indicator variable which equals 1 if the auditor of firm *i* is a Big 4 auditor in year *t*, and 0 otherwise. *SWITCH* is an indicator variable which equals 1 if firm *i* changed auditors in year *t*, and 0 otherwise. All models include industry fixed effects. Standard errors are Huber/White robust. *z*-statistics are provided in parentheses. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

TABLE 5

Relation between political contributions and auditor switches

Variables	(1)	(2)	(3)
Intercept	-1.434***	-1.440***	-1.437***
	(-4.66)	(-4.68)	(-4.67)
POLCON_DUM	-0.848***		
	(-7.52)		
POLCON_TOT		-0.092***	
		(-7.82)	
POLCON_CAND			-0.201***
			(-7.56)
LOG_MARKETCAP	-0.112***	-0.110***	-0.110***
	(-11.30)	(-11.08)	(-11.05)
CH_LIAB	-0.000	-0.000	-0.000
	(-0.68)	(-0.69)	(-0.70)
CH_LEV	-0.000	-0.000	-0.000
	(-0.75)	(-0.74)	(-0.74)
OPINION	-0.228***	-0.225***	-0.224***
	(-3.32)	(-3.28)	(-3.26)
NEGCH_AUDITFEES	0.460***	0.461***	0.461***
	(12.43)	(12.46)	(12.45)
CH_REV	0.000	0.000	0.000
	(1.37)	(1.36)	(1.36)
BIG4	-0.230***	-0.231***	-0.233***
	(-4.43)	(-4.44)	(-4.48)
Industry FE?	YES	YES	YES
Observations	44,342	44,342	44,342

This table presents the results of estimating the following logistic regression model: $Prob(SWITCH)_{it} = f(\alpha_1 + \beta_1 POLCON_{it-1} + \beta_2 LOG\_MARKETCAP_{it} + \beta_3 CH\_LIAB_{it} + \beta_4 CH\_LEV_{it} + \beta_5 OPINION_{it-1} + \beta_6 NEGCH\_AUDITFEES_{it} + \beta_7 CH\_REV_{it} + \beta_8 BIG4_{it})$. *SWITCH* is an indicator variable which equals 1 if firm *i* changed auditors in year *t*, and 0 otherwise. *POLCON_DUM* is an indicator variable which equals 1 when firm *i* makes any corporate PAC contribution in year *t-1*, and 0 otherwise. *POLCON_TOT* is the natural logarithm of one plus the total amount of corporate PAC contributions made by firm *i* to all candidates running for the President, the Senate, and the House of Representatives over a 5-year rolling window (years *t-5* to *t-1*). *POLCON_CAND* is the natural logarithm of one plus the number of unique candidates supported by the corporate PAC of firm *i* over a 5-year rolling window (years *t-5* to *t-1*). *LOG_MARKETCAP* is the natural logarithm of the market value of equity for firm *i* in year *t*. *CH_LIAB* is the percentage change in total debt, calculated as $(LIAB_t - LIAB_{t-1}) / LIAB_{t-1}$. *CH_LEV* is the percentage change in leverage (total debt/total assets), calculated as $(LEV_t - LEV_{t-1}) / LEV_{t-1}$. *OPINION* is an indicator variable which equals 1 if firm *i* received a going concern opinion in year *t*, and 0 otherwise. *NEGCH_AUDITFEES* is an indicator variable which equals 1 if audit fees decreased in year *t* (compared to year *t-1*), and 0 otherwise. *CH_REV* is the percentage change in total revenue, calculated as $(REV_t - REV_{t-1}) / REV_{t-1}$. *BIG4* is an indicator variable which

TABLE 5 - *Continued*

equals 1 if the auditor of firm *i* is a Big 4 auditor in year *t*, and 0 otherwise. All models include industry fixed effects. Standard errors are Huber/White robust. *z*-statistics are provided in parentheses. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

TABLE 6

Relation between political contributions and accruals quality

Variables	(1)	(2)	(3)
Intercept	19.880***	19.980***	20.090***
	(10.09)	(10.10)	(10.12)
POLCON_DUM	2.125***		
	(5.69)		
POLCON_TOT		0.192***	
		(5.83)	
POLCON_CAND			0.550***
			(6.53)
LOG_ASSET	-2.453***	-2.470***	-2.489***
	(-19.29)	(-19.18)	(-19.14)
LEV	4.175***	4.168***	4.164***
	(5.55)	(5.54)	(5.54)
MTB	0.151***	0.151***	0.151***
	(4.69)	(4.69)	(4.68)
LOG_TENURE	0.573***	0.569***	0.564***
	(3.04)	(3.02)	(2.30)
LOSS	3.021***	3.016***	3.012***
	(8.52)	(8.51)	(8.50)
LITIGATION	2.612***	2.611***	2.587***
	(3.28)	(3.28)	(3.25)
BIG4	-4.707***	-4.688***	-4.653***
	(-8.65)	(-8.62)	(-8.55)
NEWFIN	1.832***	1.843***	1.853***
	(5.21)	(5.24)	(5.27)
LAG_ACCR	-0.017	-0.017	-0.017
	(-1.63)	(-1.63)	(-1.63)
ACQUIS	-0.106	-0.101	-0.098
	(-0.40)	(-0.38)	(-0.37)
CFO	-11.950***	-11.930***	-11.910***
	(-14.79)	(-14.77)	(-14.73)

TABLE 6 - *Continued*

	(1)	(2)	(3)
Year FE?	YES	YES	YES
Industry FE?	YES	YES	YES
Observations	31,166	31,166	31,166
R-squared	0.389	0.389	0.389

This table presents the results of estimating the following OLS regression: $AQ_{it} = \alpha_1 + \beta_1 POLCON_{it-1} + \beta_2 LOG\_ASSET_{it} + \beta_3 LEV_{it} + \beta_4 MTB_{it} + \beta_5 LOG\_TENURE_{it} + \beta_6 LOSS_{it} + \beta_7 LITIGATION_{it} + \beta_8 BIG4_{it} + \beta_9 NEWFIN_{it} + \beta_{10} LAG\_ACCR_{it} + \beta_{11} ACQUIS_{it} + \beta_{12} CFO_{it} + e_t$. *AQ* is accruals quality, measured using the McNichols (2002) modification of the Dechow and Dichev (2002) accruals quality model. Within each year and 2-digit SIC industry with at least 20 observations, I estimate the Dechow and Dichev (2002) model of total current accruals regressed on lagged, concurrent, and future period's cash from operations. Following McNichols (2002), I adjust the Dechow and Dichev (2002) model by including change in revenues from year *t-1* to year *t* and gross property, plant, and equipment. All independent variables are scaled by average total assets. I utilize the absolute value of the firm-specific residual from this model to measure accruals quality. *AQ* is then the standard deviation of this residual over the previous five years. *POLCON* is one of three political connectedness variables, measured at the end of October each year t_x, for firm *i*: (1) *POLCON_DUM* is an indicator variable which equals 1 when firm *i* makes any corporate PAC contribution in year *t-1*, and 0 otherwise, (2) *POLCON_TOT* is the natural logarithm of one plus the total amount of corporate PAC contributions made by firm *i* to all candidates running for the President, the Senate, and the House of Representatives over a 5-year rolling window (years *t-5* to *t-1*), and (3) *POLCON_CAND* is the natural logarithm of one plus the number of unique candidates supported by the corporate PAC of firm *i* over a 5-year rolling window (years *t-5* to *t-1*). *LOG_ASSET* is the natural logarithm of total assets for firm *i* in year *t*. *LEV* is total debt / total assets for firm *i* in year *t*. *MTB* is market-to-book ratio, calculated as market value of equity divided by common/ordinary equity. *LOG_TENURE* is the natural logarithm of the number of years of auditor tenure for firm *i* in year *t*. *LOSS* is an indicator variable which equals 1 if firm *i* has net income < 0 in either of the two previous fiscal years (years *t* or *t-1*), and 0 otherwise. *LITIGATION* is an indicator variable which equals 1 if firm *i* operates in a high-litigation industry (SIC codes of 2833–2836, 3570–3577, 3600–3674, 5200–5961, and 7370–7374), and 0 otherwise. *BIG4* is an indicator variable which equals 1 if the auditor of firm *i* is a Big 4 auditor in year *t*, and 0 otherwise. *NEWFIN* is an indicator variable which equals 1 if firm *i* issued equity (greater than $10M) or debt (greater than $1M) in year *t*, and 0 otherwise. *ACCR* is total accruals, calculated as income before extraordinary items + depreciation – cash flow from operating activities, scaled by total assets for firm *i* in year *t*. *LAG_ACCR* is the prior year's value of *ACCR*. *ACQUIS* is an indicator variable which equals 1 if acquisitions are greater than zero for firm *i* in year *t*, and 0 otherwise. *CFO* is cash flow from operations, calculated as cash flow from operating activities scaled by total assets for firm *i* in year *t*. All models include year and industry fixed effects. Standard errors are heteroskedasticity robust, clustered at the firm level. *t*-statistics are provided in parentheses. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

TABLE 7

Relation between political contributions and NAS fees

Variables	(1)	(2)	(3)
Intercept	6.279***	6.287***	6.287***
	(10.23)	(10.24)	(10.25)
POLCON_DUM	0.278***		
	(3.01)		
POLCON_TOT		0.026***	
		(3.24)	
POLCON_CAND			0.070***
			(3.48)
LOG_ASSET	0.736***	0.734***	0.733***
	(34.93)	(34.40)	(34.14)
INVREC	0.256	0.254	0.252
	(1.21)	(1.21)	(1.20)
LOSS	0.165***	0.164***	0.164***
	(3.12)	(3.11)	(3.11)
ROA	-0.063	-0.062	-0.062
	(-1.51)	(-1.49)	(-1.47)
LEV	-0.015	-0.015	-0.014
	(-0.17)	(-0.17)	(-0.17)
FOREIGN	-0.040	-0.038	-0.037
	(-0.55)	(-0.53)	(-0.51)
BIG4	0.805***	0.807***	0.809***
	(9.00)	(9.02)	(9.03)
OPINION	-0.343***	-0.346***	-0.348***
	(-2.79)	(-2.81)	(-2.83)
SWITCH	-0.648***	-0.648***	-0.648***
	(-7.73)	(-7.73)	(-7.74)
LOG_BUS_SEG	0.119**	0.118**	0.117**
	(2.44)	(2.42)	(2.42)
LOG_GEO_SEG	0.311***	0.311***	0.311***
	(5.43)	(5.43)	(5.43)
BTM	-0.074***	-0.074***	-0.074***
	(-3.54)	(-3.53)	(-3.53)
NEWFIN	0.296***	0.297***	0.298***
	(5.43)	(5.45)	(5.46)

TABLE 7 - *Continued*

	(1)	(2)	(3)
Year FE?	YES	YES	YES
Industry FE?	YES	YES	YES
Observations	39,550	39,550	39,550
R-squared	0.320	0.320	0.320

This table presents the results of estimating the following OLS regression: $LOG\_NASFEES_{it} = \alpha_1 + \beta_1 POLCON_{it-1} + \beta_2 LOG\_ASSET_{it} + \beta_3 INVREC_{it} + \beta_4 LOSS_{it} + \beta_5 ROA_{it} + \beta_6 LEV_{it} + \beta_7 FOREIGN_{it} + \beta_8 BIG4_{it} + \beta_9 OPINION_{it} + \beta_{10} SWITCH_{it} + \beta_{11} LOG\_BUS\_SEG_{it} + \beta_{12} LOG\_GEO\_SEG_{it} + \beta_{13} BTM_{it} + \beta_{14} NEWFIN_{it} + e_t$. *LOG_NASFEES* is the natural logarithm of nonaudit fees for firm *i* in year *t*. *POLCON* is one of three political connectedness variables, measured at the end of October each year t_x, for firm *i*: (1) *POLCON_DUM* is an indicator variable which equals 1 when firm *i* makes any corporate PAC contribution in year *t-1*, and 0 otherwise, (2) *POLCON_TOT* is the natural logarithm of one plus the total amount of corporate PAC contributions made by firm *i* to all candidates running for the President, the Senate, and the House of Representatives over a 5-year rolling window (years *t-5* to *t-1*), and (3) *POLCON_CAND* is the natural logarithm of one plus the number of unique candidates supported by the corporate PAC of firm *i* over a 5-year rolling window (years *t-5* to *t-1*). *LOG_ASSET* is the natural logarithm of total assets for firm *i* in year *t*. *INVREC* is [(inventory + accounts receivable) / total assets] for firm *i* in year *t*. *LOSS* is an indicator variable which equals 1 if firm *i* has net income < 0 in either of the two previous fiscal years (years *t* or *t-1*), and 0 otherwise. *ROA* is net income / total assets for firm *i* in year *t*. *LEV* is total debt / total assets for firm *i* in year *t*. *FOREIGN* is an indicator variable which equals 1 if foreign exchange income (loss) is greater or less than zero for firm *i* in year *t*, and 0 otherwise. *BIG4* is an indicator variable which equals 1 if the auditor of firm *i* is a Big 4 auditor in year *t*, and 0 otherwise. *OPINION* is an indicator variable which equals 1 if firm *i* received a going concern opinion in year *t*, and 0 otherwise. *SWITCH* is an indicator variable which equals 1 if firm *i* changed auditors in year *t*, and 0 otherwise. *LOG_BUS_SEG* is the natural logarithm of the number of business segments for firm *i* in year *t*. *LOG_GEO_SEG* is the natural logarithm of the number of geographic segments for firm *i* in year *t*. *BTM* is book-to-market ratio, calculated as common/ordinary equity divided by market value of equity. *NEWFIN* is an indicator variable which equals 1 if firm *i* issued equity (greater than $10M) or debt (greater than $1M) in year *t*, and 0 otherwise. All models include year and industry fixed effects. Standard errors are heteroskedasticity robust, clustered at the firm level. *t*-statistics are provided in parentheses. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

TABLE 8

Relation between political contributions and audit fees
Second stage regression from instrumental variables approach

Variables	(1)	(2)	(3)
Intercept	8.588***	8.592***	8.598***
	(120.50)	(120.70)	(121.00)
PRED_POLCON_DUM	0.392***		
	(4.32)		
PRED_POLCON_TOT		0.034***	
		(4.31)	
PRED_POLCON_CAND			0.095***
			(4.25)
Year FE?	YES	YES	YES
Observations	39,550	39,550	39,550

This table presents the results of estimating the following second-stage OLS regression in an instrumental variable test: $LOG\_AUDITFEES_{it} = \alpha_1 + \beta_1 PRED\_POLCON_{it} + \beta_2 LOG\_ASSET_{it} + \beta_3 INVREC_{it} + \beta_4 LOSS_{it} + \beta_5 ROA_{it} + \beta_6 LEV_{it} + \beta_7 FOREIGN_{it} + \beta_8 BIG4_{it} + \beta_9 OPINION_{it} + \beta_{10} LOG\_AUDITLAG_{it} + \beta_{11} NAS_{it} + \beta_{12} SWITCH_{it} + \beta_{13} LOG\_BUS\_SEG_{it} + \beta_{14} LOG\_GEO\_SEG_{it} + \beta_{15} BTM_{it} + e_t$. *LOG_AUDITFEES* is the natural logarithm of audit fees for firm *i* in year *t*. *PRED_POLCON* is the predicted value generated from the first stage regression, in which I regress one of three political connectedness variables on each of the control variables from the audit fees model above, as well as one exogenous instrument (*%POLACTIVE* is the number of firms within firm *i*'s industry that make at least one PAC contribution in year *t* divided by the total number of firms within firm *i*'s industry in year *t*.) *POLCON* is one of three political connectedness variables measured at the end of October each year t_x, for firm *i*: (1) *POLCON_DUM* is an indicator variable which equals 1 when firm *i* makes any corporate PAC contribution in year *t-1*, and 0 otherwise, (2) *POLCON_TOT* is the natural logarithm of one plus the total amount of corporate PAC contributions made by firm *i* to all candidates running for the President, the Senate, and the House of Representatives over a 5-year rolling window (years *t-5* to *t-1*), and (3) *POLCON_CAND* is the natural logarithm of one plus the number of unique candidates supported by the corporate PAC of firm *i* over a 5-year rolling window (years *t-5* to *t-1*). *LOG_ASSET* is the natural logarithm of total assets for firm *i* in year *t*. *INVREC* is [(inventory + accounts receivable) / total assets] for firm *i* in year *t*. *LOSS* is an indicator variable which equals 1 if firm *i* has net income < 0 in either of the two previous fiscal years (years *t* or *t-1*), and 0 otherwise. *ROA* is net income / total assets for firm *i* in year *t*. *LEV* is total debt / total assets for firm *i* in year *t*. *FOREIGN* is an indicator variable which equals 1 if foreign exchange income (loss) is greater or less than zero for firm *i* in year *t*, and 0 otherwise. *BIG4* is an indicator variable which equals 1 if the auditor of firm *i* is a Big 4 auditor in year *t*, and 0 otherwise. *OPINION* is an indicator variable which equals 1 if firm *i* received a going concern opinion in year *t*, and 0 otherwise. *LOG_AUDITLAG* is the natural logarithm of the number of days between the end of fiscal year *t* and the signature date of the audit opinion for firm *i*. *NAS* is an indicator variable which equals 1 if firm *i* had nonaudit fees greater than zero in year *t*, and 0 otherwise. *SWITCH* is an indicator variable which equals 1 if firm *i* changed auditors in year *t*, and 0 otherwise. *LOG_BUS_SEG* is the natural logarithm of the number of business segments for firm *i* in year *t*. *LOG_GEO_SEG* is the natural logarithm of the number of geographic segments for firm *i* in year *t*. *BTM* is book-to-market ratio, calculated as common/ordinary equity divided by market value of equity. All models include year fixed effects. Standard errors are heteroskedasticity robust, clustered at the firm level. *t*-statistics are provided in parentheses. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

TABLE 9

Simultaneous, three-equation, 3SLS approach to examine the relation between political contributions, audit fees and NAS fees

Variables	(1) *LOG_ NASFEES*	(2) *LOG_ AUDITFEES*	(3) *POLCON_ DUM*	(4) *LOG_ NASFEES*	(5) *LOG_ AUDITFEES*	(6) *POLCON_ TOT*	(7) *LOG_ NASFEES*	(8) *LOG_ AUDITFEES*	(9) *POLCON_ CAND*
Intercept	42.960***	7.011***	-0.203***	43.420***	6.965***	-3.179***	42.960***	6.991***	-1.359***
	(16.37)	(28.12)	(-4.77)	(16.49)	(27.87)	(-6.33)	(16.18)	(27.85)	(-7.20)
POLCON_DUM	2.460***	0.312***							
	(7.91)	(5.05)							
POLCON_TOT				0.203***	0.025***				
				(7.92)	(4.98)				
POLCON_CAND							0.549***	0.069***	
							(7.77)	(4.98)	
Year FE?	YES	YES	YES	YES	YES	YES	YES	YES	YES
Industry FE?	YES	YES	NO	YES	YES	NO	YES	YES	NO
Observations	39,550	39,550	39,550	39,550	39,550	39,550	39,550	39,550	39,550

This table provides the third-stage results of simultaneously estimating the following system of three equations, using the 3SLS regression method:

$LOG\_NASFEES_{it} = \sigma_1 + \delta_1 POLCON_{it} + \delta_2 LOG\_ASSET_{it} + \delta_3 INVREC_{it} + \delta_4 LOSS_{it} + \delta_5 ROA_{it} + \delta_6 LEV_{it} + \delta_7 FOREIGN_{it} + \delta_8 BIG4_{it} + \delta_9 OPINION_{it} + \delta_{10} SWITCH_{it} + \delta_{11} LOG\_BUS\_SEG_{it} + \delta_{12} LOG\_GEO\_SEG_{it} + \delta_{13} BTM_{it} + \delta_{14} NEWFIN_{it} + \delta_{15} LOG\_AUDITFEES_{it} + e_t.$

$LOG\_AUDITFEES_{it} = \alpha_1 + \beta_1 POLCON_{it} + \beta_2 LOG\_ASSET_{it} + \beta_3 INVREC_{it} + \beta_4 LOSS_{it} + \beta_5 ROA_{it} + \beta_6 LEV_{it} + \beta_7 FOREIGN_{it} + \beta_8 BIG4_{it} + \beta_9 OPINION_{it} + \beta_{10} LOG\_AUDITLAG_{it} + \beta_{11} SWITCH_{it} + \beta_{12} LOG\_BUS\_SEG_{it} + \beta_{13} LOG\_GEO\_SEG_{it} + \beta_{14} BTM_{it} + \beta_{15} LOG\_NASFEES_{it} + e_t.$

$POLCON_{it} = \omega_1 + \mu_1 LOG\_ASSET_t + \mu_2 LEV_{it} + \mu_3 LOG\_BUS\_SEG_{it} + \mu_4 LOG\_GEO\_SEG_{it} + \mu_5 BTM_{it} + \mu_6 \%POLACTIVE_{it} + \mu_7 LOG\_AUDITFEES_{it} + \mu_8 LOG\_NASFEES_{it} + e_t.$

Table 9 - *Continued*

LOG_NASFEES is the natural logarithm of nonaudit fees for firm *i* in year *t*. *LOG_AUDITFEES* is the natural logarithm of audit fees for firm *i* in year *t*. *POLCON* is one of three political connectedness variables, measured at the end of October each year *t*, for firm *i*: (1) *POLCON_DUM* is an indicator variable which equals 1 when firm *i* makes any corporate PAC contribution in year *t*, 0 otherwise, (2) *POLCON_TOT* is the natural logarithm of one plus the total amount of corporate PAC contributions made by firm *i* to all candidates running for the President, the Senate, and the House of Representatives over a 5-year rolling window (years *t-4* to *t*), and (3) *POLCON_CAND* is the natural logarithm of one plus the number of unique candidates supported by the corporate PAC of firm *i* over a 5-year rolling window (years *t-4* to *t*). *LOG_ASSET* is the natural logarithm of total assets for firm *i* in year *t*. *INVREC* is [(inventory + accounts receivable) / total assets] for firm *i* in year *t*. *LOSS* is an indicator variable which equals 1 if firm *i* has net income < 0 in either of the two previous fiscal years (years *t* or *t-1*), and 0 otherwise. *ROA* is net income / total assets for firm *i* in year *t*. *LEV* is total debt / total assets for firm *i* in year *t*. *FOREIGN* is an indicator variable which equals one if foreign exchange income (loss) is greater or less than zero for firm *i* in year *t*, and 0 otherwise. *BIG4* is an indicator variable which equals 1 if the auditor of firm *i* is a Big 4 auditor in year *t*, and 0 otherwise. *OPINION* is an indicator variable which equals 1 if firm *i* received a going concern opinion in year *t*, and 0 otherwise. *SWITCH* is an indicator variable which equals 1 if firm *i* changed auditors in year *t*, and 0 otherwise. *LOG_BUS_SEG* is the natural logarithm of the number of business segments for firm *i* in year *t*. *LOG_GEO_SEG* is the natural logarithm of the number of geographic segments for firm *i* in year *t*. *BTM* is book-to-market ratio, calculated as common/ordinary equity divided by market value of equity. *NEWFIN* is an indicator variable which equals 1 if firm *i* issued equity (greater than $10M) or debt (greater than $1M) in year *t*, and 0 otherwise. *LOG_AUDITLAG* is the natural logarithm of the number of days between the end of fiscal year *t* and the signature date of the audit opinion for firm *i*. *%POLACTIVE* is the number of firms within firm *i*'s industry that make at least one PAC contribution in year *t* divided by the total number of firms within firm *i*'s industry in year *t*. The models include year and industry fixed effects as indicated in the table. *t*-statistics are provided in parentheses. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

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BIOGRAPHICAL SKETCH

I, Dana Marie Wallace, was born in New Jersey in 1984 and moved with my parents to Punta Gorda, FL in 1988. I graduated from Port Charlotte High school in 2002. Immediately following high school, I enrolled in an undergraduate program at the University of North Florida in Jacksonville, FL. I earned a Bachelor of Business Administration with a focus in accounting in 2006 and a Master of Business Administration in 2007, both from the University of North Florida. Upon graduation, I worked as a staff tax accountant for PricewaterhouseCoopers in New York, NY for two years. In 2009, I enrolled in the accounting doctoral program at Florida State University. While in the program, I focused on financial and capital markets research and taught both financial and managerial courses. I will graduate with a PhD in Accounting in the summer of 2013. I will begin an academic career at the University of Central Florida in August of 2013.