

# Political Connection and the Demand for Industry Specialist Auditors

Lily Brooks<sup>1</sup>, CPA, PhD

<sup>1</sup> Assistant Professor, Department of Accounting, Washington State University, Pullman, WA 99164, USA

Correspondence: Lily Brooks, CPA, PhD, Assistant Professor, Department of Accounting, Washington State University, Pullman, WA 99164, USA

Received: November 8, 2015

Accepted: January 30, 2016

Online Published: February 4, 2016

doi:10.5430/afr.v5n1p210

URL: <http://dx.doi.org/10.5430/afr.v5n1p210>

## Abstract

Prior literature suggests that political connected firms are more likely to be associated with lower financial reporting quality than non-political connected firms. Industry specialist auditors have a higher reputation to provide high quality audit. Thus, I hypothesize that political connected firms have a higher demand for industry specialists in order to minimize the agency costs associated with political connection. Consistent with my prediction, I find a significant positive association between political connection and the demand for industry specialist auditors. Additional analyses indicate that client firms with political connects and firms with industry specialists are less likely to switch auditors. Moreover, for client firms that do switch auditors, I find that higher propensity for political connected firms to engage in upward and lateral switches than non-political connected firms. This study furthers our understanding on the impact of political connection on auditor choice in a U.S. setting.

**Keywords:** Political connection, Political contributions, Industry specialist auditors, Agency cost, Auditor switches

## 1. Introduction

Recent studies have documented that political connected firms enjoy various economic benefits. For instance, these connected firms can gain easy access to legislators (e.g., Hall & Wayman, 1990; Milyo, Primo, & Groseclose, 2010) and have greater influence over regulators (Faccio, Masulis, & McConnell 2006), and thus receiving more government contracts (Goldman, Rocholl, & So, 2009; Tahoun, 2014) and improving access to debt capital Chaney, Faccio, & Parsley, 2011; Houston, Jiang, Lin, & Ma, 2014). During extreme events, the established political connections can also serve as an insurance mechanism (Duchin & Sosyura, 2012; Faccio et al., 2006). Despite of the benefits derived from political connections, agency and governance issues may plague political connected firms, leading to value-destruction rent-seeking activities. To alleviate the agency costs associated with political connected firms, Guedham, Pittman, & Saffar (2014), in a cross-country setting, document that political connected firms are more likely to select Big 4 auditors due to their international reputation to provide a quality audit and their insurance value associated with their ‘deep pockets’. However, how does political connection impact auditor-client contract decision in the U.S. audit market is an underexplored area. Despite the proliferation of studies investigating the antecedents and the outcomes of the selection of Big N auditors (e.g., Chaney et al., 2004; Landsman, Nelson, & Rountree, 2009; Kim & Park, 2014), the cross-sectional variation on the demand for industry specialist auditors is largely unknown (Gul, Fung, & Jaggi, 2009). According to two survey reports released by the General Accounting Office (GAO), approximately 80 percent of companies viewed industry expertise or specialization as of “great” or “very great importance” in selecting an external auditor (GAO 2003, 2008). Extent literature suggests that industry specialist auditors offer improved detection of fraudulent income reporting (Johnson, Jamal & Berryman 1991), possess better industry-specific analytical tasks (Solomon, Shields, & Whittington 1999), better ability to constrain discretionary accruals (Balsam, Krishnan, & Yang 2003; Reichelt & Wang 2010), and are more likely to issue going concern opinion for firms engaging in insider trading (Chen, Martin, & Wang 2013).

This study aims to examine the association between political connection and the demand for industry specialist auditors. I conjecture that political connected firms are more likely to demand industry specialist than non-connected firms for several reasons. First, one advantage of retaining and hiring an industry specialist is his or her reputation to supply a quality audit. Chaney et al. (2011) document that political connected firms have more opaque financial reporting quality in terms of discretionary accruals in an international setting. Further, Yu & Yu (2011) indicate that fraud detection risk is higher for political connected firms than for non-connected firms. To mitigate the agency costs facing the political connected firms, a quality audit is desirable. As a supporting evidence, Beasley and Petroni (2001)

report that independent members of the board of directors tend to hire more Big N industry specialist auditors. Consequently, industry specialists enjoy a fee premium for reputation to provide a high audit quality (e.g., Craswell, Francis, & Taylor 1995; Dunn & Mayhew 2002; Chung & Kallapur 2003; Lim & Tan 2008; Cairney & Stewart 2015). In an experimental setting, Boritz, Kochetova-Kozloski, & Robinson (2015) suggest that fraud specialists are more effective in modifying audit programs in response to identified fraud risk factors. The second advantage arises from its potential to enhance audit efficiency in order to expedite the information dissemination process (Moroney, 2007). It is conceivable that timely financial reporting is an important component for financial reporting transparency. A third benefit may lie in the value-added services provided by industry specialist auditors in terms of higher investment efficiency (Francis, Michas, & Stein, 2013). Nevertheless, if industry specialists are more skillful in detecting fraudulent financial reporting (Johnson, Jamal & Berryman, 1991), then political connected firms may be reluctant to recruit these auditors.

This study makes a unique contribution to the literature in at least two ways. First, studying the impact of political connection activities on auditor choice for specialists can help understand the determinants of auditor selection behavior. Prior literature has studied various corporate governance factors (Abbott and Parker 2000; Chaney, Jeter, and Shivakumar 2004) and ownership structure (Srinidhi, He, and Firth, 2014, Kang 2014) in the auditor-client selection process. This study takes advantage of the public disclosure information on political connection activities on potential agency problem to interpret the demand for industry specialist auditors. This study suggests that in the face of agency conflict, the market forces incentivize political connected firms to retain a high quality auditor and select a high quality auditor. This finding may partially alleviate investors' concerns regarding agency costs associated with political contributions. The significant positive association between political connection and the demand for industry specialist highlights the importance on the disclosure of political spending. However, further study may examine whether this assumption is valid by directly investigating the audit outcomes of demanding industry specialist auditors for political connected firms.

The remainder of the paper is organized as follows. Section 2 reviews related literature and develops the hypothesis. Section 3 delineates the research design. Section 4 discusses the empirical results. Section 5 concludes the paper.

## **2. Literature Review and Hypothesis Development**

### *2.1 Auditor Industry Expertise and Audit Quality*

Economic theory contends that agency costs arise from the separation of ownership and decision control in corporations (Fama & Jensen, 1983). Agency costs arise when the owner-manager sells equity claims on the corporation and when debt claims exist against the corporation. Monitoring mechanisms are implemented to minimize agency costs by limiting the self-serving bias and rent-extraction behavior of top management (Jensen & Meckling, 1976). Beyond the board of directors and its audit committee as key decision control internal monitoring mechanisms, independent external auditors are hired to monitor the manager and mitigate the agency costs (Watts & Zimmerman, 1986). Since industry-wide and firm-specific factors result in differences in demand for monitoring, audit firms differentiate their products through industry specialization (Craswell et al., 1995), especially among the largest accounting firms (Francis, Stokes, & Anderson, 1999; Hogan & Jeter, 1999). It allows firms to improve audit efficiency, create barriers to entry, and improve audit quality (Solomon et al., 1999). Industry specialist auditors have better monitoring ability for three reasons. First, specialist auditors may be perceived to provide high quality audit services, leading to a signal value for quality audit. Higher audit quality could be achieved through better audit technologies (Dopuch & Simunic, 1982), economies-of-scale (Caves, 1992), and knowledge-sharing practices such as benchmarking of best practices, the use of the standardized industry-related audit programs, and the use of professionals with expertise from other offices through consulting and travel (Francis, Reichelt, & Wang, 2005). Second, specialist auditors may provide higher quality assurance services. Both experimental and empirical evidence support the notion that industry specialists have the competence to provide a high quality audit. In an experimental setting, some studies indicate that auditor industry knowledge improves auditors' task-level performance such as higher confidence in inherent risk assessment (Taylor, 2000), error detection during sequential audit review (Owhoso, Messier, & Lynch, 2002), improved detection of fraudulent income reporting (Johnson et al., 1991), and better industry-specific analytical tasks (Solomon et al., 1999). In addition, Green (2008) find that, compared to non-specialists, industry specialists conduct a more focused and efficient information search and are better able to generate and identify the correct cause when performing the task of analytical procedures. Moreover, O'Keefe, Simunic, & Steini (1994) show that industry specialist auditors are more in compliance with generally accepted auditing standards (GAAS). Consequently, client firms report lower abnormal accruals when the external auditors are industry specialists at the national-level (Balsam et al., 2003) and at the city-level (Reichelt & Wang, 2010). As a

supporting evidence, outside members of the board of directors are more likely to employ Big N industry specialist auditors (Beasley & Petroni, 2001).

### *2.2 Benefits and Costs of Political Connection*

Prior literature suggests that political connected firms may face less financial constraints (Cull, Li, Sun, & Xu, Lixin, 2015) because political contributions facilitate these firms to gain easy access to legislators (e.g., Hall & Wayman, 1990; Milyo et al., 2010) and have greater influence over regulators (Faccio, Masulis, & McConnell 2006). Hence, firms with political connection receive more government contracts (Goldman, Rocholl, & So, 2009; Tahoun, 2014) and improve access to debt capital (Houston et al., 2014). Furthermore, the established political connections can also serve as an insurance mechanism against extreme events (Duchin & Sosyura, 2012; Faccio et al., 2006). Empirical evidence documents that both investors and creditors consider firms with political connection as less risky than non-connected firms, leading to lower cost of equity capital (Boubakri, Guedhami, Mishra, & Saffar, 2012) and reduced cost of debt (Chaney et al., 2011; Houston et al., 2014; Infante and Piazza. 2014). Other studies indicate that political connection has the potential to reduce litigation risk. For instance, Correia (2014) provides evidence that political connected firms are less likely to be subject to SEC enforcement actions. Under a tax-related setting, some studies suggest that political connection can generate tax benefits (Brown, Drake, & Wellman (2015), diminishes the audit rates by IRS (Hunter & Nelson, 1995, Young, Reksulak, & Shughart, 2001) and reduces the political costs of being tax aggressive (e.g., Mills et al., 2013), hence leading to higher tax aggressiveness activities (Kim & Zhang, 2015). Further, D'Aveni (1990) suggest that firms with political and director connections are less likely to be associated with bankruptcy, suggesting that political connection increases client firms' prestige. Moreover, Yu & Yu (2011) find that fraudulent firms that engage in lobby activities have a lower probability of being detected and can avoid detection longer than fraudulent firms that do not lobby. These firms can directly petition the fraud watchdogs and can lobby for favorable regulation rules. Lower enforcement actions from both SEC and IRS and lower detection rate of fraud may foster managers' risk-taking appetite. As a support, Boubakri et al. (2013) document that political connections are positively associated with corporate risk-taking for a sample of international firms.

Therefore, despite of the benefits derived from political connections, agency and governance issues may plague political connected firms, leading to value-destruction rent-seeking activities. In a related work, Bertrand, Kramarz, Schoar, & Thesmar (2008) show that political connections can also entail costs to firms. Aggarwal, Meschke, & Wang (2012) show that political donations are more indicative of agency problems within the firm and that they do not generate returns for shareholders. Instead, they argue that donations are a form of perquisite consumption for top managers. Managers may have personal preferences over candidates and parties they wish to support that are simply unrelated to their firm's activities. Aggarwal et al. (2012) report that an increase in donations of \$10,000 is associated with a reduction in firm's annual average excess returns of 13.9 basis points. For example, Chaney et al. (2011) find lower accounting quality (in terms of discretionary accruals) for political connected firms for an international sample from Faccio (2006) for 26 countries over the period of 1997 to 2000. Lower quality accounting information may increase the opportunity for insiders to conceal their expropriation activities and impede efficient monitoring (e.g., El Ghouli et al., 2014; Guedhami & Pittman, 2006). Lower quality monitoring can exacerbate information asymmetry problems. Under an IPO setting in China, Fan, Wang, & Zhang (2007) find that in post-IPO stock returns of privatized firms with politically connected CEOs underperform those without a connection. The cost of political connection extends to post-IPO earnings growth, sales growth, and change in returns on sales. Consequently, Aggarwal et al. (2012) find that firms with high political expenditures exhibit lower future returns and their results are consistent with those from cross-country and international studies, which often document lower performance for political connected firms (Faccio, 2007, 2010; Bertrand et al., 2006).

### *2.3 Hypothesis Development*

Prior literature documents that industry specialist auditors have both higher ability and better reputation to provide a high quality audit than non-industry specialist auditors. Relative to non-connected firms, political connected firms enjoy various benefits in terms of lower costs for equity capital (Boubakri et al., 2012) and debt capital (Chaney et al., 2011; Houston et al., 2014), lower bankruptcy risk (D'Aveni, 1990), higher propensity of being bailed out by governments at extremely events (Faccio et al., 2006), less likely to be prosecuted by SEC (Correia 2014). These economic benefits exacerbate the risk-taking behavior of managers in these connected firms, leading to more aggressive tax avoidance (Kim & Zhang, 2015), lower financial reporting quality (Chaney et al., 2011), and less and later detection for fraudulent financial reporting (Yu & Yu, 2011). Agency theory shows that the separation of ownership and control introduces the information asymmetry and moral hazard problems (Jensen & Meckling, 1997).

Literature suggests that the information asymmetry is higher for political connected firms than non-connected firms. Consequently, in order to mitigate the agency costs associated with high information asymmetry in political connected firms, I expect the demand for high quality auditors would be higher for political connected firms than non-connected firms. These discussions lead to the following hypothesis:

**H1:** *Ceteris paribus*, political connected firms have a higher demand for industry specialist auditors than non-connected firms.

### 3. Research design

#### 3.1 Proxies for Political Connection

I measure political connection using the following three proxies: the existence of lobbying expenditures ( $PC^{LOB}$ ), the existence of the amount of PAC contributions made by the firm ( $PC^{PAC}$ ), and the existence of board members with political connections ( $PC^{DIR}$ ). Lobbying activities data come from the Center for Responsive Politics (CRP). The Lobbying Disclosure Act of 1995 requires the reporting of payments made by individuals or entities for lobbying activities. The Secretary of the Senate's Office of Public Records (SOPR) is charged with administering the reporting of the lobbying activities. CRP maintains a publicly available database of these reports, and the data exists from 1998 onward. Lobbying expenses cannot be traced to specific politicians. If a firm lobbies an individual congressman, the disclosure report indicates that the firm lobbied the "U.S. House of Representatives" or the "U.S. Senate." If a firm lobbies bureaucratic agencies, these must be listed in the report. The determination of the amount of expenses that were allocated to lobbying each agency is not possible, as firms are not required to disclose this information.

Most of U.S. studies use PAC contributions as a proxy for political connection (see Milyo et al. (2010) for a review). A PAC is a political committee that is organized to raise money to elect or defeat candidates. It can be sponsored by a corporation that can cover the PAC's operating costs but cannot contribute directly to the PAC. Instead, PACs solicit contributions from executives, employees, and shareholders of the firm. The decision to distribute PAC contributions typically belongs to the top executives of the firm. The data on PAC contributions comes from the Federal Election Commission's (FEC) website ([www.fec.gov](http://www.fec.gov)). I match each Compustat firm to the connected organization field in the "Committee Master" files to determine whether the firm has a PAC in each election cycle. I then match these databases with both the "Contributions to Candidates from Committees" and the "Candidate Master" files to obtain information on the timing and the recipients of all of the contributions made by the firm between 1979 and 2013.

I hand-collect the third measure of political connections based on political connection information directly from EDGAR, which gathers information from the Securities and Exchange Commission (SEC) filings of public firms. Following Goldman, Rocholl, & So (2009), I define a company as politically connected if at least one member of its board of directors (BOD) holds or held an important political or regulatory position, (Note 1) SEC rules require that public companies provide a proxy statement in its *DEF 14A* file containing a brief description of each board member's career background. Based on this information, I am able to identify whether each board member is politically connected. More specifically, I search each sample firm's *DEF 14A* filing from EDGAR and then use a web-crawling program (Note 3) to search for key words that can identify the director's title of political position.

#### 3.2 Proxy for Industry Specialist

Early studies on auditor industry expertise have used either relative sales of a client firm within an industry or relative assets of a client firm within a given industry (e.g., Balsam et al., 2003; Krishnan, 2003; Mayhew & Wilkins, 2003; Dunn & Mayhew, 2002). Later studies measure industry specialization based on the relative audit fees earned by an audit firm as a proportion of the total audit fees earned by all auditors in that particular industry at the global level (Carson 2009), the national level (Craswell et al. 1995) and at the city - level (e.g., Ferguson, Francis, & Stokes, 2003; Francis et al., 2005; Reichelt & Wang, 2010). Similar to Cheng, Martin, and Wang (2013), *SPEC* is coded 1 if the incumbent auditor ranks as a top-two firm in the client's industry (two-digit SIC) in terms of market share, and 0 otherwise. Different from Cheng, Martin, & Wang (2013) who measure market share based on sales, I measure market share based on audit fees. (Note 2) I define an industry specialist as an indicator variable equal to 1 if the auditor is the city-level two leading auditors based on market-share of audit fees in a 2-digit SIC code and year combination, and zero otherwise.

#### 3.3 Multivariate Model

To examine the association between political connection and the demand for industry specialist auditors, I augment control variables from auditor-choice literature (e.g., Gul et al., 2009; Chaney, Jeter, & Shivakumar, 2004; Gul et al., 2009; Landsman et al., 2009; Kim & Park, 2014; Libby & Tan, 1994). I run a logistic regression as follows:

$$Pr(SPEC_{it}=1|x) = F(\beta_0 + \beta_1 PC_{it} + \beta_2 SIZE_{it} + \beta_3 LSEG_{it} + \beta_4 DForeign_{it} + \beta_5 ROA_{it} + \beta_6 LEV_{it} + \beta_7 LOSS_{it} + \beta_8 INVREC_{it} + \beta_9 LIT_{it} + \beta_{10} AGE_{it} + \beta_{11} ICW_{it} + \beta_{12} absACC_{it} + \beta_{13} BigN_{it} + \beta_{14} GOV_{it} + \beta_{15} ISSUE_{it} + \beta_{16} BtM_{it} + \beta_{17} IMR_{it} + \beta_j DumIND + \beta_k DumYRS) \quad (1)$$

Where for firm  $i$  and year  $t$

- SPEC* = Industry specialist auditors, defined as the leading two auditors in an industry at a city-level for client firm  $i$  in year  $t$ , adapted from Chen, Martin, & Wang (2013);
- PC* = One of our three proxies of political connections: 1) Lobby expenses ( $PC^{LOB}$ ), an indicator that takes the value of one if the client firm has non-zero lobby expenses, and zero otherwise. 2) corporate campaign contributions ( $PC^{PAC}$ , an indicator that takes the value of one if the client firm has non-zero campaign contributions, and zero otherwise); 3) the employment of former politicians as corporate directors ( $PC^{DIR}$ , an indicator that takes the value of one if the firm has at least one former politician on board, and zero otherwise);
- SIZE* = Natural logarithm of total assets;
- LSEG* = Natural logarithm of the number of unique business segments;
- DForeign* = An indicator variable equal to 1 if the client firm engage in foreign operations, and 0 otherwise;
- ROA* = Return-on-assets, computed as the ratio of earnings before extraordinary items, scaled by total assets;
- LEV* = Leverage, calculated as total long-term liabilities divided by total assets;
- LOSS* = An indicator variable equal to 1 if there is a loss in the current fiscal year, and 0 otherwise;
- INVREC* = The sum of inventory and accounts receivable at the beginning of the year  $t$  for firm  $i$ , scaled by total assets;
- LIT* = Indicator variable that takes the value of 1 if the firm operates in a high-litigation industry, and 0 otherwise. High-litigation industries are industries with sic codes 2833-2836, 3570-3577, 3600-3674, 5200-5961, and 7370-7374 (Frankel, Johnson, & Nelson, 2002; Ashbaugh, LaFond, & Mayhew, 2003);
- AGE* = Firm age, measured as the natural log of the number of years the firm has appeared in Compustat.
- ICW* = An indicator variable equal to 1 if the client firm has at least one material internal control weakness, and 0 otherwise;
- absACC* = Absolute value of discretionary accruals, calculated as the absolute value of the residual from performance-adjusted modified Jones model (Kothari, Andrew, & Wasley, 2005);
- BigN* = Big 4/5 auditors, an indicator variable equal to 1 if the client firm is audited by one of the Big 4/5 auditors, and zero otherwise;
- GOV* = Corporate governance strength, proxied by Anti-Entrenchment index, calculated as  $(-1) * \text{Entrenchment index}$ , following Bebchuk et al. (2009).
- ISSUE* = An indicator variable equal to 1 if the sum of long-term debt and equity issued during the past three years is more than 5% of total assets, and 0 otherwise;
- BtM* = Book-to-Market, calculated as total assets to market value plus debt;
- IMR* = The inverse Mills ratio.

The dependent variable *SPEC* refers to industry specialist auditors, defined as the leading two auditors in an industry at a city-level for client firm  $i$  at year  $t$ . The variables of interest *PC* denote each of the three proxies for political connection:  $PC^{LOB}$ ,  $PC^{PAC}$ , and  $PC^{DIR}$ .  $PC^{LOB}$  is an indicator that takes the value of one if the client firm has non-zero lobby expenses, and zero otherwise.  $PC^{PAC}$  is an indicator that takes the value of one if the client firm has non-zero

campaign contributions, and zero otherwise.  $PC^{DIR}$  is an indicator that takes the value of one if the firm has at least one former politician on board, and zero otherwise. A significant positive coefficient on  $PC$  ( $\beta_1 > 0$ ) would support my hypothesis that the demand for industry specialist auditors is higher for political-connected firms than non-connection firms.

The model controls for firm size ( $SIZE$ ), firm complexity ( $DForeign$  and  $INVREC$ ), and firm risk ( $LEV$ ,  $ROA$ ,  $LOSS$ , and  $LIT$ ). Firm age ( $AGE$ ) is included because Gul, Fung, & Jaggi (2009) find a significant negative association between firm age and the selection of industry specialist auditors.  $LIT$  is included to control for litigation risk. It is conceivable that firms in more litigious industries are motivated to retain high quality auditors to enhance credibility to audited financial statements. However, it is also plausible that industry specialists maybe motivated to resign from the client firms in more litigious industries to minimize potential litigation risk. Firms with low-quality internal controls ( $ICW$ ) and high discretionary accruals ( $absACC$ ) are more likely to retain high-quality auditors in order to reduce the agency costs.  $BigN$  is included to control for clients' demand for brand-name auditors. I also include a corporate governance variable ( $GOV$ ), measured as negative one times Entrenchment-index (Bebchuk et al., 2009) so that corporate governance strength increases with  $GOV$ . Direction of  $GOV$  is not clear *ex-ante*. It is possible that firms with strong corporate governance have higher incentives to retain high quality auditors to signal to the market on the reliability of financial disclosures. However, it is also possible that strong corporate governance and high quality auditors are substitutes to the market for credible signals of high quality financial statements. Due to the lack of variation in audit committee characteristics in the post-SOX period (e.g., all the major stock exchanges NYSE, NASDAQ, and AMEX all require 100 percent independence of audit committee members) and the insignificant coefficients on audit-committee related variables in Kang (2014), I do not control for audit committee characteristics. However, in my robustness test, I control for additional control mechanisms such as institutional ownership ( $IOR$ ), CEO and Chair duality ( $CEOChair$ ), and management ownership ( $MgtOWN$ ) (see 4.3.4 for Robustness Test). I further control for capital market incentives using equity offering ( $ISSUE$ ) and book-to-market ratio ( $BtM$ ). Moreover, an inverse-mills ratio ( $IMR$ ) is included as a self-selection correction term to control for endogeneity issues associated with client firms' choice to engage in political connection activities. Year and industry fixed effects are used to account for cross-sectional variations in selection of auditors over time and across industries. In addition, control variables in the second stage equation are also included, as suggested in Larcker & Rusticus (2007).

## 4. Empirical Results

### 4.1 Sample Selection and Descriptive Statistics

#### 4.1.1 Sample Selection

The initial sample starts with 72,741 firm-year observations at the intersection between Compustat database and Audit Analytics database (auditor-related information) for the sample period of 2000 to 2013. Then, I eliminate 21,333 observations without available data for my dependent variable and control variables. I further merge with the political connection data. This leads to my final sample with 51,408 firm-year observations (7,867 unique firms) over the period of 2000 to 2013.

#### 4.1.2 Descriptive Statistics

Panel A of Table 1 reports the descriptive statistics for all variables. The mean of  $SPEC$  is 0.4518, suggesting that around 45.18% of my sample firms retain an industry specialist auditor. I am unable to compare with the mean value of  $SPEC$  with that in Chen et al. (2013) who do not report its value. However, the alternative measures of industry specialists – industry leader ( $SPEC2$ ) and specialist auditor with a minimum 50% of market share ( $SPEC3$ ) in the additional analyses have a mean of 0.1780 and 0.2280 (untabulated), comparable to 0.1785 reported in Whitworth and Lambert (2014) and a mean of 0.2820 for the industry leader reported in Kang (2014). The mean of  $PC^{LOB}$ ,  $PC^{PAC}$ , and  $PC^{DIR}$  are 0.1625, 0.1402, and 0.1518, indicating that an average 16.25%, 14.02%, and 15.18% of the sample firms have political connections based on lobby expenses, political contributions and political connections via board of directors. These numbers are comparable to Kim and Zhang's (2014) study that report a 0.150 for  $PC^{LOB}$ , 0.079 for  $PC^{PAC}$ , and 0.135 for  $PC^{DIR}$  of their sample firms for the period of 1999 to 2009. The descriptive statistics of other control variables are generally comparable with those reported in previous studies.

Panel B and Panel C of Table 1 report the sample composition over time and across industries based on Fama French twelve industries. Panel A shows an increasing trend in the number of politically connected firms before 2004, but a decreasing trend from 2004 onwards. Approximately 15% of the sample firms are politically connected, consistent with the notion that political activism is widespread in the U.S. Some variation in annual observations are noted. However, there is no large cluster of firms in any given year. Panel C shows that the business equipment industry has

the highest percentage of firm-year observations (22.54%), followed by other industries (13.81%), healthcare industries (13.35%), the manufacturing industry (10.75%), and retail industry (10.37%). The least represented industry is the durables industry, consists of only 2.60% of the firm-year observations.

Table 1. Descriptive Statistics

<b>Panel A: Variable Distribution</b>						
<b>Variables</b>	<b>N</b>	<b>MEAN</b>	<b>STD</b>	<b>Q1</b>	<b>MEDIAN</b>	<b>Q3</b>
<i>SPEC</i>	51,408	0.4518	0.4977	0.0000	0.0000	1.0000
<i>PC<sup>LOB</sup></i>	51,408	0.1621	0.3685	0.0000	0.0000	0.0000
<i>PC<sup>PAC</sup></i>	51,408	0.1402	0.3472	0.0000	0.0000	0.0000
<i>PC<sup>DIR</sup></i>	51,408	0.1518	0.5545	0.0000	0.0000	0.0000
<i>SIZE</i>	51,408	5.6501	2.4470	4.0347	5.7289	7.3456
<i>LSEG</i>	51,408	1.2157	0.8293	0.0000	1.3863	1.7918
<i>DForeign</i>	51,408	0.2777	0.4479	0.0000	0.0000	1.0000
<i>ROA</i>	51,408	-0.1963	1.0001	-0.0893	0.0211	0.0655
<i>LEV</i>	51,408	0.2799	0.4989	0.0133	0.1758	0.3655
<i>LOSS</i>	51,408	0.3937	0.4886	0.0000	0.0000	1.0000
<i>INVREC</i>	51,408	0.2815	0.2508	0.0888	0.2239	0.3998
<i>AGE</i>	51,408	19.5263	14.8503	8.0000	15.0000	26.0000
<i>ICW</i>	51,408	0.0283	0.1657	0.0000	0.0000	0.0000
<i>absACC</i>	51,408	0.1217	0.2753	0.0257	0.0602	0.1269
<i>BigN</i>	51,408	0.7414	0.4379	0.0000	1.0000	1.0000
<i>GOV</i>	51,408	-0.9978	1.3497	-2.0000	0.0000	0.0000
<i>ISSUE</i>	51,408	0.4678	0.4990	0.0000	0.0000	1.0000
<i>BtM</i>	51,408	0.4630	1.2530	0.2221	0.4528	0.7811
<i>IMR</i>	51,408	1.8336	0.7145	1.3420	1.8257	2.3044

  

<b>Panel B: Sample Distribution over Fiscal Year</b>				
<b>Fiscal Year</b>	<b>Frequency</b>	<b>Cum. Frequency</b>	<b>Percent</b>	<b>Cum. Percent</b>
2000	3,700	3,700	7.20%	7.20%
2001	4,328	8,028	8.42%	15.62%
2002	4,476	12,504	8.71%	24.32%
2003	4,427	16,931	8.61%	32.93%
2004	4,361	21,292	8.48%	41.42%
2005	4,093	25,385	7.96%	49.38%
2006	3,887	29,272	7.56%	56.94%
2007	3,776	33,048	7.35%	64.29%
2008	3,458	36,506	6.73%	71.01%
2009	3,333	39,839	6.48%	77.50%
2010	3,200	43,039	6.22%	83.72%
2011	3,125	46,164	6.08%	89.80%
2012	2,805	48,969	5.46%	95.26%
2013	2,439	51,408	4.74%	100.00%

*Panel C: Sample Distribution across Industries*

Industries	Frequency	Cum. Frequency	Percent	Cum. Percent
Food	2,597	2,597	5.05%	5.05%
Durables	1,335	3,932	2.60%	7.65%
Manufacturing	5,526	9,458	10.75%	18.40%
Energy	2,189	11,647	4.26%	22.66%
Chemicals	1,358	13,005	2.64%	25.30%
Business Equipment	11,589	24,594	22.54%	47.84%
Telecommunication	1,601	26,195	3.11%	50.96%
Utility	1,455	27,650	2.83%	53.79%
Retail	5,331	32,981	10.37%	64.16%
Healthcare	6,864	39,845	13.35%	77.51%
Finance	4,463	44,308	8.68%	86.19%
Other	7,100	51,408	13.81%	100.00%

This table reports sample descriptive statistics for 51,408 firm-year observations (7,867) for the sample period of 2000 to 2013. See Appendix A for all variable definitions.

Table 2. Correlation Matrix

Variable	<i>SPEC</i>	<i>PC<sup>LOB</sup></i>	<i>PC<sup>PAC</sup></i>	<i>PC<sup>DIR</sup></i>	<i>SIZE</i>	<i>LSEG</i>	<i>DF<sub>foreign</sub></i>	<i>ROA</i>	<i>LEV</i>	<i>LOSS</i>
	1	2	3	4	5	6	7	8	9	10
<i>SPEC</i>	1									
<i>PC<sup>LOB</sup></i>	0.132	1								
<i>PC<sup>PAC</sup></i>	0.184	0.517	1							
<i>PC<sup>DIR</sup></i>	0.007	0.050	0.071	1						
<i>SIZE</i>	0.315	0.392	0.464	0.114	1					
<i>LSEG</i>	0.072	0.071	0.084	-0.001	0.242	1				
<i>DF<sub>foreign</sub></i>	0.109	0.160	0.172	-0.006	0.352	0.306	1			
<i>ROA</i>	0.122	0.071	0.092	-0.024	0.422	0.174	0.143	1		
<i>LEV</i>	-0.031	-0.019	0.008	0.054	-0.168	-0.106	-0.093	-0.546	1	
<i>LOSS</i>	-0.148	-0.132	-0.186	0.034	-0.413	-0.153	-0.270	-0.333	0.149	1
<i>INVREC</i>	-0.017	-0.084	-0.065	-0.021	-0.071	0.081	0.076	0.118	-0.042	-0.169
<i>AGE</i>	0.170	0.259	0.377	0.064	0.375	0.184	0.229	0.135	-0.025	-0.259
<i>ICW</i>	0.015	0.000	-0.008	0.037	0.037	0.022	0.024	0.015	-0.009	0.029
<i>absACC</i>	-0.109	-0.062	-0.087	-0.035	-0.302	-0.144	-0.106	-0.396	0.231	0.191
<i>B<sub>g</sub>N</i>	0.310	0.186	0.210	0.013	0.565	0.173	0.218	0.230	-0.143	-0.202
<i>GOV</i>	0.212	0.298	0.348	0.006	0.531	0.186	0.307	0.159	-0.069	-0.281
<i>ISSUE</i>	0.000	0.013	0.016	0.016	0.009	-0.079	-0.061	-0.100	0.174	0.096
<i>B<sub>t</sub>M</i>	0.032	-0.012	-0.009	-0.080	0.112	0.043	0.007	0.217	-0.370	-0.084
<i>IMR</i>	-0.268	-0.439	-0.472	-0.090	-0.825	-0.181	-0.337	-0.162	0.134	0.250

*To Be Continued (Next Page)*



Table 2. Correlation Matrix (Continued)

Variable		<i>INVREC</i>	<i>AGE</i>	<i>ICW</i>	<i>absACC</i>	<i>BigN</i>	<i>GOV</i>	<i>ISSUE</i>	<i>BtM</i>	<i>IMR</i>
		11	12	13	14	15	16	17	18	19
<i>SPEC</i>	1	0.012	0.139	0.015	-0.143	0.310	0.224	<b>0.000</b>	0.053	-0.267
<i>PC<sup>LOB</sup></i>	2	-0.061	0.203	<b>0.000</b>	-0.083	0.186	0.306	0.013	-0.043	-0.434
<i>PC<sup>PAC</sup></i>	3	-0.037	0.304	-0.008	-0.137	0.210	0.356	0.016	-0.015	-0.464
<i>PC<sup>DIR</sup></i>	4	-0.039	0.036	<b>0.029</b>	-0.039	<b>0.012</b>	<b>0.018</b>	<b>-0.003</b>	<b>0.007</b>	-0.081
<i>SIZE</i>	5	-0.031	0.317	0.035	-0.339	0.557	0.597	0.026	0.119	-0.829
<i>LSEG</i>	6	0.173	0.220	0.027	-0.115	0.190	0.232	-0.076	0.084	-0.228
<i>D<sub>Foreign</sub></i>	7	0.167	0.221	0.024	-0.098	0.218	0.325	-0.061	-0.021	-0.342
<i>ROA</i>	8	0.259	0.255	-0.029	-0.162	0.195	0.309	-0.138	<b>0.001</b>	-0.231
<i>LEV</i>	9	-0.038	0.081	<b>-0.004</b>	-0.095	0.015	0.050	0.316	-0.099	-0.108
<i>LOSS</i>	10	-0.223	-0.266	0.029	0.215	-0.202	-0.307	0.096	-0.076	0.252
<i>INVREC</i>	11		0.120	0.009	0.015	-0.059	0.020	-0.031	0.083	0.133
<i>AGE</i>	12	0.023		<b>0.005</b>	-0.203	0.063	0.318	-0.122	0.111	-0.354
<i>ICW</i>	13	<b>0.005</b>	<b>-0.004</b>		<b>-0.003</b>	0.013	0.014	<b>0.001</b>	<b>-0.006</b>	-0.031
<i>absACC</i>	14	0.068	-0.132	<b>-0.007</b>		-0.187	-0.189	0.097	-0.229	0.226
<i>BigN</i>	15	-0.115	0.108	0.013	-0.191		0.386	-0.011	0.067	-0.477
<i>GOV</i>	16	-0.055	0.325	0.009	-0.137	0.356		-0.041	<b>-0.004</b>	-0.633
<i>ISSUE</i>	17	0.023	-0.092	<b>0.001</b>	0.115	-0.011	-0.034		-0.171	-0.035
<i>BtM</i>	18	0.052	0.026	-0.016	-0.133	0.065	0.009	-0.071		0.019
<i>IMR</i>	19	0.200	-0.423	-0.031	0.183	-0.478	-0.584	-0.035	<b>0.006</b>	

All coefficients in bold are significant at 5% level. The above corner of the table reports average Spearman correlation coefficients, and the below corner reports average Pearson correlation coefficients. Refer to Appendix A for all variable definitions.

#### 4.2 Multivariate Analysis

Table 3 reports the multiple regression results of political connections on the demand for industry specialists from estimating Model (1). Consistent with **H1** that political-connected firms are more likely to retain industry specialist auditors than non-political connected firms, I observe a significant positive coefficient on *PC<sup>LOB</sup>* (coefficient = 0.1624,  $p < 0.001$ ), *PC<sup>PAC</sup>* (coefficient = 0.3235,  $p < 0.001$ ) and *PC<sup>DIR</sup>* (coefficient = 0.3239,  $p < 0.001$ ). Reflecting its material economic impact, the coefficient estimate for *PC* translates into political affiliations increasing the likelihood of appointing an industry specialist auditor by 49.97 percent, 32.35 percent 54.23 percent for *PC<sup>LOB</sup>*, *PC<sup>PAC</sup>*, and *PC<sup>DIR</sup>*, with all other variables assigned their mean values. This result is consistent with the prediction in **H1** that politically connected firms are associated with greater demand for industry specialist auditors.

The sign and significance level of the control variables are broadly consistent with prior literature (Abbott and Parker 2000, Gul et al. 2009; and Kang 2014). For instance, I find a significant positive coefficient on *LSEG*, *D<sub>Foreign</sub>*, *LOSS*, *INVREC*, *BtM*, *BigN*, *ICW*, and *GOV*, but a significant negative coefficient on *SIZE*, *ROA*, *LEV*, *ISSUE*, *AGE* and *IMR*. This is consistent with the notion that larger and more complex clients and firms with more foreign sales, higher risky clients, and better governed firms are more to appoint industry specialist auditors. Economic effects for continuous independent variables represent the effect of a one standard deviation increase from the mean has on the predicted probability of appointing industry specialist auditors, with other variables assigned their mean values. The adjusted  $R^2$  for each model is approximately 17%, and the control variables are statistically significant in the expected directions, comparable to those reported by Gul et al. (2009). The discriminatory power of the model is reasonable (ROC = 0.76), provides evidence that my model exhibits sufficient ability to discriminate between the different companies. Hosmer & Lemeshow (2000) suggest an acceptable performance for a statistic of ROC = 0.70].

Table 3. Political Connection and the Demand for Industry Specialist Auditors

	Model 1			Model 2			Model 3		
	Coeff.	Pvalue	Econ.	Coeff.	Pvalue	Econ.	Coeff.	Pvalue	Econ.
$PC^{LOB}$	0.1624	<0.001	49.97%%						
$PC^{PAC}$				0.3235	<0.000	54.51%%			
$PC^{DIR}$							0.3239	<0.001	54.23%%
$SIZE$	-0.793	<0.000	12.02%	-0.8198	<0.000	11.41%	-0.7698	<0.001	12.59%
$LSEG$	0.0013	0.972	12.02%	0.0040	0.914	11.41%	-0.0012	0.975	12.59%
$DForeign$	0.1420	0.004	46.06%	0.1481	0.003	46.18%	0.1360	0.006	46.02%
$ROA$	-0.1325	<0.001	48.40%	-0.1303	<0.001	48.58%	-0.1390	<0.001	48.29%
$LEV$	-0.4412	<0.001	43.94%	-0.4586	<0.001	44.05%	-0.4420	<0.001	43.82%
$LOSS$	0.1198	0.003	41.63%	0.1228	0.003	41.54%	0.1203	0.003	41.61%
$INVREC$	0.2538	0.016	47.98%	0.2475	0.016	48.11%	0.2398	0.024	47.98%
$LIT$	0.0992	0.127	48.82%	0.1045	0.108	48.97%	0.0988	0.128	48.79%
$AGE$	-0.0343	<0.001	47.65%	-0.0366	<0.001	47.74%	-0.0335	<0.001	47.61%
$ICW$	0.3430	<0.001	54.35%	0.3540	<0.001	33.33%	0.3398	<0.001	34.28%
$absACC$	-0.0276	0.500	45.60%	-0.0301	0.55	45.65%	-0.0232	0.420	45.63%
$BigN$	0.9139	<0.001	48.37%	0.9158	<0.001	48.51%	0.9094	<0.001	48.30%
$GOV$	0.2988	<0.001	56.36%	0.309	<0.001	47.78%	0.2915	<0.001	47.73%
$ISSUE$	-0.0761	0.016	46.87%	-0.0789	0.016	47.04%	-0.0721	0.023	46.82%
$BtM$	0.0775	<0.001	45.08%	0.0798	<0.001	45.12%	0.0756	<0.001	45.12%
$IMR$	-3.0924	<0.001	3.97%	-3.1484	<0.001	45.76%	-3.0603	<0.001	46.08%
<i>Fixed Effects</i>	Included			Included			Included		
$N$	51,408			51,408			51,408		
$McFadden's R^2$	16.97%			17.08%			16.91%		
$ROC$	0.7646			0.7652			0.7643		

This table reports the logistic regression results for 51,408 firm-year observations (7,867) covering the period of 2000 to 2013. Fixed Effects indicate the year and industry fixed effects, coded as the year and two-digit SIC Code industry indicator variables. The p-values (two-tailed) are based on robust standard errors clustered by firm. The dependent variable is  $SPEC$ , an indicator variable equal to 1 if the external auditor is the leading two city-level industry specialist auditors and zero otherwise. Economic effects for continuous independent variables represent the effect of a one standard deviation increase from the mean (including adjusting the interaction term) has on the predicted probability of the dependent variable being 1 and for indicator variables represent the effect a change from 0 to 1 has on the predicted probability of the dependent variable being 1. The calculations include the constant, as well as all other model variables at their means. Refer to Appendix A for all variable definitions.

### 4.3 Additional Analyses

#### 4.3.1 Alternative Measures of Industry Specialist Auditors

I also test the robustness of my results to two alternative definitions for auditor industry specialists:  $SPEC2$  and  $SPEC3$ .  $SPEC2$  is defined as the leading industry specialist auditors based on market shares and zero otherwise (Craswell et al. 1995), while  $SPEC3$  is defined as an indicator equals to 1 if the auditor captures at least 50 percent of the market share and zero otherwise (Reichelt and Wang 2010). Panel A and Panel B of Table 4 present the results with these two alternative definitions of industry specialist auditors respectively. Consistent with the main conclusion that political connected auditors are more likely to be positively associated with auditor industry specialist auditors, I find the coefficients of  $PC^{LOB}$ ,  $PC^{PAC}$ , and  $PC^{DIR}$  load significantly positive across both panels. Specifically, in panel A, I find that the coefficients on  $PC^{LOB}$ ,  $PC^{PAC}$ , and  $PC^{DIR}$  are 0.0978 ( $t = 1.79$ ), 0.1100 ( $t = 1.71$ ), and 0.2529 ( $t = 2.07$ ), respectively. For panel B, the coefficients on  $PC^{LOB}$ ,  $PC^{PAC}$ , and  $PC^{DIR}$  are 0.1702 ( $t = 3.13$ ), 0.3507 ( $t = 5.17$ ),

and 0.4473 ( $t = 3.19$ ), respectively. Hence, I conclude that the main result is not sensitive to alternative two definitions of auditor industry specialization.

Table 4. Political Connection and the Demand for Industry Specialist Auditors - Alternative Measures of Industry Specialization

	Model 1			Model 2			Model 3		
	Coeff.	P-Value	Econ.	Coeff.	P-Value	Econ.	Coeff.	P-Value	Econ.
<i>Panel A: Dependent Variable = SPEC2</i>									
$PC^{LOB}$	0.1055 (3.30) <sup>***</sup>	<0.001	19.85%						
$PC^{PAC}$				0.0755 (2.01) <sup>**</sup>	0.045	19.48%			
$PC^{DIR}$							0.245 (1.98) <sup>**</sup>	0.055	22.42%
Controls	Included			Included			Included		
Fixed Effects	Included			Included			Included		
$N$	50,530			50,530			50,530		
McFadden's $R^2$	11.78%			11.78%			11.77%		
$ROC$	0.7356			0.7357			0.7355		
	Model 1			Model 2			Model 3		
<i>Panel B: Dependent Variable = SPEC3</i>									
$PC^{LOB}$	0.1817 (5.48) <sup>***</sup>	<0.001	49.97%						
$PC^{PAC}$				0.3235 (8.62) <sup>***</sup>	<0.001	53.12%			
$PC^{DIR}$							0.3239 (2.28) <sup>***</sup>	0.022	54.23%
Controls	Included			Included			Included		
Fixed Effects	Included			Included			Included		
$N$	51,408			51,408			51,408		
McFadden's $R^2$	16.17%			16.27%			16.14%		
$ROC$	0.7588			0.7594			0.7588		

This table reports the logistic regression results for 51,408 firm-year observations (7,867) covering the period of 2000 to 2013. Fixed Effects indicate the year and industry fixed effects, coded as the year and two-digit SIC Code industry indicator variables. \*\*\*, \*\*, \* indicates that the z-statistic of the coefficient is statistically different from zero at the 1%, 5%, 10% level of significance. The p-values (two-tailed) are based on robust standard errors clustered by firm. The dependent variable in panel A is *SPEC2*, an indicator variable equal to 1 if the external auditor is the leading city-level industry specialist auditors and zero otherwise. The dependent variable in panel B is *SPEC3*, an indicator variable equal to 1 if the external auditor is a city-level industry specialist auditor with minimum 50% market share and zero otherwise. Economic effects for continuous independent variables represent the effect of a one standard deviation increase from the mean (including adjusting the interaction term) has on the predicted probability of the dependent variable being 1 and for indicator variables represent the effect a change from 0 to 1 has on the predicted probability of the dependent variable being 1. The calculations include the constant, as well as all other model variables at their means. Refer to Appendix A for all variable definitions.

#### 4.3.2 Political Connection, Auditor Industry Specialist Auditors, and Auditor Switching

I argue that political connected firms are likely to demand high quality auditors such as industry specialist auditors. If this is true, political connected firms would be less likely to switch auditors and client firms with industry specialist auditors would be less inclined to change their external auditors as well. To examine this possibility, I run a logistic regress model as follows:

$$Pr(AC_{it}=1|x) = F(\beta_0 + \beta_1 PC_{it} + \beta_2 SPEC_{it} + \beta_3 SIZE_{it} + \beta_4 LSEG_{it} + \beta_5 DForeign_{it} + \beta_6 ROA_{it} + \beta_7 LEV_{it} + \beta_8 LOSS_{it} + \beta_9 INVREC_{it} + \beta_{10} AGE_{it} + \beta_{11} ICW_{it} + \beta_{12} absACC_{it} + \beta_{13} BigN_{it} + \beta_{14} GOV_{it} + \beta_{15} ISSUE_{it} + \beta_{16} BtM_{it} + \beta_{17} IMR_{it} + \beta_j DumIND + \beta_k DumYRS) \quad (2)$$

Where for firm  $i$  and year  $t$

$AC$  = Auditor switches, an indicator variable equal to 1 if client firm  $i$  switches auditors in year  $t$ , and zero otherwise;

The dependent variable  $AC$ , an indicator variable equal to 1 for client firms with auditor switches, and zero otherwise. The variables of interest are  $PC$  ( $PC^{LOB}$ ,  $PC^{PAC}$ , and  $PC^{DIR}$ ) and  $SPEC$ . I expect a significant negative coefficient on both  $PC$  and  $SPEC$ . All other variables are previously defined. Results of equation (2) are presented in Table 5 below. I find that the coefficient on each political connection proxy and the industry specialist auditor load significantly negative, suggesting that both political connected firms and industry specialist auditors are less likely to be associated with auditor switches. For instance, the coefficients on  $PC^{LOB}$ ,  $PC^{PAC}$ , and  $PC^{DIR}$  are -0.2665 (P-value = <0.001), -0.2189 (P-value = 0.004), and -1.0218 (P-value = 0.015) respectively. Reflecting on the economic significance, I find that the political affiliation decreases the propensity of switching auditors by approximately 7.26 percent, 6.40 percent, and 2.90 percent for  $PC^{LOB}$ ,  $PC^{PAC}$ , and  $PC^{DIR}$ , respectively. The evidence further confirms the main results in Table (3) that political connected firms are more likely to retain industry specialist auditors.

Table 5. Political Connection, Auditor Industry Specialization, and Auditor Changes

Variable	Model 1			Model 2			Model 3		
	Coeff.	P-Value	Econ.	Coeff.	P-Value	Econ.	Coeff.	P-Value	Econ.
$PC^{LOB}$	-0.2665	<0.001	7.26%						
$PC^{PAC}$				-0.2189	0.004	6.41%			
$PC^{DIR}$							-1.0218	0.015	2.90%
<i>SIZE</i>	0.2008	<0.001	18.17%	0.1926	<0.001	19.50%	0.1758	<0.001	18.75%
<i>LSEG</i>	-0.0446	0.054	12.91%	-0.0434	0.061	7.32%	-0.0403	0.082	7.34%
<i>DForeign</i>	-.0981	0.065	7.67%	-0.0996	0.061	7.17%	-0.0083	0.075	7.19%
<i>ROA</i>	-0.0986	<0.001	6.98%	-0.1807	<0.001	6.44%	-0.1729	<0.001	6.49%
<i>LEV</i>	-0.1204	<0.001	6.86%	-0.1265	<0.001	6.78%	-0.1236	<0.001	6.79%
<i>LOSS</i>	0.1364	<0.001	8.40%	0.1334	<0.001	8.76%	0.1304	<0.001	8.73%
<i>INVREC</i>	0.2879	<0.001	7.79%	0.0053	0.817	7.66%	0.3046	0.753	7.67%
<i>LIT</i>	0.0049	0.938	7.37%	0.0028	0.965	7.64%	0.0081	0.897	7.66%
<i>AGE</i>	-0.0005	0.169	7.65%	0.0434	0.138	7.94%	-0.0012	0.334	7.82%
<i>ICW</i>	0.3367	<0.001	10.09%	0.3349	<0.001	10.30%	0.3389	<0.001	10.37%
<i>absABS1</i>	0.0015	0.317	8.30%	0.0009	0.346	8.29%	0.0001	0.364	8.26%
<i>BigN</i>	-1.1831	<0.001	7.13%	-1.1809	<0.001	7.08%	-1.1762	<0.001	7.09%
<i>GOV</i>	0.0001	0.004	7.37%	-0.1012	<0.001	7.73%	-.0894	0.012	7.72%
<i>ISSUE</i>	0.0908	<0.001	5.51%	0.0905	<0.001	5.79%	0.0882	<0.001	5.79%
<i>BtM</i>	-0.0814	<0.001	6.59%	-0.0805	<0.001	6.94%	-0.0775	<0.001	7.01%
<i>IMR</i>	1.1310	<0.001	20.84%	0.3017	<0.001	20.14%	1.0840	<0.001	19.62%
<i>Fixed Effects</i>	Included			Included			Included		
<i>N</i>	51,408			51,408			51,408		
<i>McFadden's R<sup>2</sup></i>	35.02%			35.01%			35.00%		
<i>ROC</i>	0.8589			0.8588			0.8588		

This table reports the logistic regression results for 51,408 firm-year observations (7,867) covering the period of 2000 to 2013. Fixed Effects indicate the year and industry fixed effects, coded as the year and two-digit SIC Code industry indicator variables. The p-values (two-tailed) are based on robust standard errors clustered by firm. The dependent variable is *AC*, an indicator variable equal to 1 if the client firm switches external auditors in the current year and zero otherwise. Economic effects for continuous independent variables represent the effect of a one

standard deviation increase from the mean (including adjusting the interaction term) has on the predicted probability of the dependent variable being 1 and for indicator variables represent the effect a change from 0 to 1 has on the predicted probability of the dependent variable being 1. The calculations include the constant, as well as all other model variables at their means. Refer to Appendix A for all variable definitions.

#### 4.3.3 Political Connection and Auditor Realignment

Thus far, I have shown that political connected firms are more likely to retain industry specialist auditors than non-industry specialist auditors in Table 3. I have also demonstrated that client firms audited by industry specialist auditors are less likely to undergo auditor turnover after controlling for political connection in Table 5. Knechel, Naiker, & Pacheco (2007) suggest that firms switching between Big 4 auditors experience significant positive abnormal returns when the successor auditor is an industry specialist, and they experience significant negative abnormal returns when the successor auditor is not a specialist. They further indicate that these market reactions derive from changes in perceived audit quality rather than differential costs of using specialist auditors. To the extent that political connection exacerbates information asymmetry and increases earnings opacity, I would expect a higher demand for industry specialist in order to enhance perceived audit quality. Therefore, I conjecture that an upward switch from a non-specialist to an industry specialist or a lateral switch from a specialist to another specialist would be more likely to meet the demand from the capital market for political connected firms than non-connected firms. To test this conjecture, I run a logistic regression using the following model:

$$\begin{aligned} Pr(AC^{UPLateral}_{it}=1|x) = & F(\beta_0 + \beta_1 PC_{it} + \beta_2 SIZE_{it} + \beta_3 LSEG_{it} + \beta_4 DForeign_{it} + \beta_5 ROA_{it} + \beta_6 LEV_{it} + \beta_7 LOSS_{it} \\ & + \beta_8 INVREC_{it} + \beta_9 AGE_{it} + \beta_{10} ICW_{it} + \beta_{11} absACC_{it} + \beta_{12} BigN_{it} + \beta_{13} GOV_{it} + \beta_{14} ISSUE_{it} \\ & + \beta_{15} BtM_{it} + \beta_{16} LNAF_{it} + \beta_{17} GC_{it} + \beta_{18} Restate_{it} + \beta_{19} Beta_{it} + \beta_{20} RVOL_{it} + \beta_{21} IMR_{it} \\ & + \beta_j DumIND + \beta_k DumYRS) \end{aligned} \quad (3)$$

Where for firm  $i$  and year  $t$

$AC^{UPLATERAL}$	=	Up and lateral auditor switches, an indicator variable equal to 1 if client switches from a non-specialist auditor to a specialist auditor or from one specialist auditor to another specialist auditor during current fiscal year, and zero otherwise;
$LNAF$	=	The natural logarithm of non-audit fees;
$GC$	=	An indicator variable equal to one if the auditor issues a going-concern opinion;
$Restate$	=	An indicator variable equal to one if the client firm restate their current-year financial statement;
$Beta$	=	The company's beta estimate using a market model over the fiscal year;
$RVOL$	=	Return volatility;

The dependent variable is  $AC^{UPLateral}$ , an indicator variable equal to 1 for client firms with upward and lateral auditor switches, and zero otherwise. The variable of interest is  $PC$  ( $PC^{LOB}$ ,  $PC^{PAC}$ , and  $PC^{DIR}$ ). I expect a significant positive coefficient on  $PC$ . We further control for non-audit fees ( $LNAF$ ), going-concern opinion ( $GC$ ), financial restatement ( $Restate$ ), market beta ( $Beta$ ), and return volatility ( $RVOL$ ). All other variables are previously defined. Results of equation (3) are presented in Table 6 below. Consistent with my conjecture, I find a positive coefficient on all three proxies for political connection:  $PC^{LOB}$  (coefficient = 0.0650,  $p = 0.693$ ),  $PC^{PAC}$  (coefficient = 0.4457,  $p = 0.023$ ), and  $PC^{DIR}$  (coefficient = 1.6665,  $p = 0.091$ ), all significant at conventional level except for  $PC^{LOB}$  which is insignificant. Regarding the economic significance of the coefficient, I find that political affiliations increase the likelihood of an upward and lateral switches of auditors by around 75.88 percent, 73.66 percent, and 94.57 percent for  $PC^{LOB}$ ,  $PC^{PAC}$ , and  $PC^{DIR}$ , respectively. These results are generally consistent with the conjecture that political connected firms are more likely to be associated with upward and lateral auditor switches than non-political connected firms.

Table 6. Political Connection and Auditor Realignment

Variable	Model 1			Model 2			Model 3		
	Coeff	P-Value	Econ.	Coeff	P-Value	Econ.	Coeff	P-Value	Econ.
<i>PC<sup>LOB</sup></i>	0.0650	0.693	75.88%						
<i>PC<sup>PAC</sup></i>				0.4457	0.023	73.66%			
<i>PC<sup>DIR</sup></i>							1.6665	0.091	94.57%
<i>SIZE</i>	-0.0518	0.216	93.90%	-0.0686	0.102	56.22%	-0.0539	0.194	58.75%
<i>LSEG</i>	0.0966	0.106	73.65%	0.1026	0.085	76.68%	0.0964	0.107	76.46%
<i>DForeign</i>	-0.2367	0.051	71.81%	-0.2302	0.059	72.06%	-0.2285	0.060	71.90%
<i>ROA</i>	-0.0837	0.627	76.80%	-0.0734	0.671	77.10%	-0.0817	0.633	76.48%
<i>LEV</i>	0.1223	0.568	79.72%	0.1380	0.520	79.17%	0.1198	0.574	78.54%
<i>LOSS</i>	-0.0893	0.441	72.56%	-0.0981	0.395	72.48%	-0.0946	0.412	72.61%
<i>INVREC</i>	-0.3209	0.128	72.98%	-0.3197	0.130	73.94%	-0.3250	0.123	73.75%
<i>LIT</i>	0.1520	0.294	76.60%	0.1552	0.285	76.68%	0.1378	0.341	76.46%
<i>AGE</i>	0.0212	<0.001	69.04%	0.0192	<0.001	77.00%	0.0211	<0.001	77.56%
<i>ICW</i>	0.0611	0.804	76.88%	0.0820	0.739	77.39%	0.0632	0.797	76.99%
<i>absACC</i>	-0.5233	0.162	65.01%	-0.5279	0.159	70.47%	-0.5152	0.168	70.51%
<i>BigN</i>	-0.1364	0.306	73.71%	-0.1261	0.345	73.89%	-0.1291	0.333	73.75%
<i>GOV</i>	0.0411	0.365	79.01%	0.0498	0.271	78.09%	0.0393	0.384	77.61%
<i>ISSUE</i>	-0.3119	<0.001	75.15%	-0.3205	<0.001	77.27%	-0.3115	<0.001	76.89%
<i>BtM</i>	0.0605	0.253	93.59%	0.0641	0.224	93.96%	0.0600	0.256	93.57%
<i>LNAF</i>	-0.1362	<0.001	70.22%	-0.1409	<0.001	69.96%	-0.1381	<0.001	70.12%
<i>GC</i>	-0.2385	0.298	70.48%	-0.2368	0.302	70.63%	-0.2346	0.306	70.53%
<i>Restatement</i>	0.0287	0.809	74.78%	0.0302	0.800	74.86%	0.0159	0.894	74.61%
<i>Beta</i>	0.0654	0.027	74.00%	0.0660	0.026	76.42%	0.0640	0.030	76.31%
<i>RVOL</i>	0.6147	0.217	83.11%	0.6013	0.226	75.79%	0.6367	0.201	75.82%
<i>IMR</i>	-1.3358	0.026	91.11%	-1.4310	0.018	48.07%	-1.3970	0.020	50.91%
<i>Fixed Effects</i>	Included			Included			Included		
<i>N</i>	2,844			2,844			2,844		
<i>McFadden's R<sup>2</sup></i>	10.39%			10.55%			10.48%		
<i>ROC</i>	0.7129			0.7138			0.7142		

This table reports the logistic regression results of the auditor-switching sample for 2,844 firm-year observations covering the period of 2000 to 2013. Fixed Effects indicate the year and industry fixed effects, coded as the year and two-digit SIC Code industry indicator variables. The p-values (two-tailed) are based on robust standard errors clustered by firm. The dependent variable is  $AC^{UPLATERAL}$ , an indicator variable equal to 1 if the client firm switches its external auditor from an industry specialist to another industry specialist or from a non-industry specialist to an industry specialist in the current year, and zero otherwise. Economic effects for continuous independent variables represent the effect of a one standard deviation increase from the mean (including adjusting the interaction term) has on the predicted probability of the dependent variable being 1 and for indicator variables represent the effect a change from 0 to 1 has on the predicted probability of the dependent variable being 1. The calculations include the constant, as well as all other model variables at their means. Refer to Appendix A for all variable definitions.

#### 4.3.4 Robustness Test

I also conduct a series of sensitivity tests. First, I limit my sample to Big 4 auditors only. Second, I limit my sample to the Post-SOX period only. In untabulated results, I find that my main conclusion does not alter under these two alternative samples. Third, rather than deleting observations, I include an indicator variable *SOX* (a dummy variable equal to 1 for fiscal year greater than 2002 and zero otherwise) and an indicator variable *CRISIS* (a dummy variable equal to 1 for fiscal years 2007-2008, and zero otherwise) to control for exogenous shocks on the association between political connection and the demand for industry specialist auditors. In untabulated results, I find that the tenor of my results does not change after including an indicator variable *SOX* and an indicator variable for *CRISIS*. Third, I conducted robustness test to define industry specialist at the national level based on market shares. Regardless I define the national industry specialist at the leading auditor or the leading two top auditor in a two-SIC code and year combination. I find that the coefficient on political contributions ( $PC^{PAC}$ ) and the political affiliation for board members ( $PC^{DIR}$ ) remains positive and significant at least at 5% level except for lobbying activities ( $PC^{LOB}$ ), the coefficient of which turns to negative and insignificant. Finally, following Abbott and Parker (2000) and Kang (2014), I include additional control variables such as percentage of independent board members (*BODIND*), duality for CEO and chairman for the board (*CEOCHR*), management ownership (*MgOWN*), and institutional ownership (*IOR*). I continue to find a positive coefficient for the political connection variables, although the results are weaker. Consistent with prior literature, I find a significant positive coefficient on *Family*, *BODIND* and an insignificant coefficient on *CEOChair*, *IOR*, and *MgOWN*. These results are broadly consistent with my main conclusion that political connected firms are more likely to demand industry specialist auditors.

## 5. Conclusion

The purpose of this study is to provide a better understanding of the impact of political connection on the demand for high quality auditors – industry specialists. Results from this study confirms that firms with political connection are more likely to retain an industry specialist auditor than non-connected firms. The results are robust to alternative measures of auditor industry specialization and controlling for endogeneity using an instrumental variable approach. Neither are the findings sensitive to the deletion of non-Big 4 firms and observations in the Pre-SOX period, nor are the results influenced by controlling for indicators for SOX period and financial crisis period. Further examination of the association among political connection, auditor industry specialization and auditor turnover reveal that both political connection and auditor industry specialization are associated with lower auditor changes. When I limit the sample to auditor switch firms only, I find that political connected firms are more likely to engage in a lateral and upward switches, corroborating the main conclusion that client firms demand high quality auditors in order to mitigate agency costs. This study extends the large body of literature on the economic consequences of political connection from the capital and debt market to the client-auditor contracting setting. While this study does provide initial insights that industry specialization is *perceived* to mitigate the agency costs of political connected firms, it does not provide direct evidence that the demand for auditor specialist *actually* improve the monitoring capabilities. Further research on the examination of audit outcomes introduced by political connection and its interaction with auditor specialization is warranted. Chin and Chi (2009) find that auditor specialization at both the firm-level and the partner-level reduces financial restatement, another avenue for further research is to incorporate partner-level data into the analysis.

## Acknowledgements

I gratefully acknowledge the excellent research assistance from Fangjun Xiao for part of the data collection. All errors are mine.



## References

- Abbott, L. J., & S. Parker. (2000). Auditor selection and audit committee characteristics. *Auditing: A Journal of Practice & Theory*, 19 (2), 47–66. <http://dx.doi.org/10.2308/aud.2000.19.2.47>
- Aggarwal, R., Meschke, F., Wang, T. (2012). Corporate political donations: investment or agency. *Business and Politics*, 14 (1), 1–40. <http://dx.doi.org/10.1515/1469-3569.1391>
- Ashbaugh, H., LaFond, R., & Mayhew, B. W. (2003). Do nonaudit services compromise auditor independence? Further evidence. *Accounting Review*, 78 (3), 611-639. <http://dx.doi.org/10.2308/accr.2003.78.3.611>
- Balsam, S., Krishnan, J., & Yang, J. S. (2003). Auditor industry specialization and earnings quality. *Auditing: A Journal of Practice & Theory*, 22 (2), 71-97. <http://dx.doi.org/10.2308/aud.2003.22.2.71>
- Beasley, M. S., & Petroni, K. R. (2001). Board independence and audit-firm type. *Auditing: A Journal of Practice & Theory*, 20 (1), 97. <http://dx.doi.org/10.2308/aud.2001.20.1.97>
- Bebchuk, L., Cohen A., & Ferrell, A. (2009). What matters in corporate governance? *Review of Financial Studies*, 22 (2), 783–827. <http://dx.doi.org/10.1093/rfs/hhn099>
- Bertrand, M., Kramarz, F., Schoar A., & Thesmar, D. (2008). Politicians, firms and the political business cycle: evidence from france. Working paper, University of Chicago.
- Boritz, J. Efrim, Kochetova-Kozloski, Natalia, & Robinson, Linda (2015). Are fraud specialists relatively more effective than auditors at modifying audit programs in the presence of fraud risk? *Accounting Review*, 90 (3), 881-915. <http://dx.doi.org/10.2308/accr-50911>
- Boubakri, Narjess, Guedhami, O., Mishra, Dev, & Saffar, Walid. (2012). Political connections and the cost of equity capital (January 2012). Working paper. American University of Sharjah.
- Boubakri, Nariess, Sattar Mansi, and Walid Saffar. (2013). Political institutions, connectedness, and corporate risk-taking. *International Business Studies*. <http://dx.doi.org/10.1057/jibs.2013.2>
- Brown, J. L., Drake, Katharine, & Wellman, Laura. (2015). The Benefits of a Relational Approach to Corporate Political Activity: Evidence from Political Contributions to Tax Policymakers. *Journal of the American Taxation Association*, 37 (1), 69-102. <http://dx.doi.org/10.2308/atax-50908>
- Cahan, Steven F., Jeter, Debra C., & Naiker, Vic. (2011). *Are all industry specialist auditors the same?* *Auditing: A Journal of Practice & Theory*, 30 (4), 191–222. <http://dx.doi.org/10.2308/ajpt-10181>
- Cairney, T. D. & Stewart, E. G. (2015). Audit fees and client industry homogeneity. *Auditing: A Journal of Practice & Theory*, 34 (4), 33-57. <http://dx.doi.org/10.2308/ajpt-51040>
- Carson, E. (2009). Industry specialization by global audit firm networks. *The Accounting Review*, 84 (2), 355-382. <http://dx.doi.org/10.2308/accr.2009.84.2.355>
- Caves, R. N. (1992). *American Industry: Structure, Conduct, Performance*. Englewood Cliffs, NJ: Prentice Hall.
- Chaney, P., Jeter D., & Shivakumar L. (2004). Self-Selection of auditors and audit pricing in private firms. *The Accounting Review*, 79 (1), 51-72. <http://dx.doi.org/10.2308/accr.2004.79.1.51>
- Chaney, P., Faccio, M., & Parsley, D. (2011). The quality of accounting information in politically connected firms. *Journal of Accounting and Economics*, 51 (1-2), 58-76. <http://dx.doi.org/10.1016/j.jacceco.2010.07.003>
- Chen, Chen, Martin, Xiumin, & Wang, Xin. (2013). Insider trading, litigation concerns, and auditor going-concern opinions. *The Accounting Review*, 88 (2), 365–393. <http://dx.doi.org/10.2308/accr-50347>
- Chung, H., & Kallapur, S. (2003). Client importance, nonaudit services, and abnormal accruals. *The Accounting Review*, 78 (4), 931–955. <http://dx.doi.org/10.2308/accr.2003.78.4.931>
- Chin, C.-L. & Chi, H.-Y. (2009). Reducing Restatements with Increased Industry Expertise. *Contemporary Accounting Research*, 26 (3), 729-765. <http://dx.doi.org/10.1506/car.26.3.4>
- Correia, M. (2014). Political connections and SEC enforcement. *Journal of Accounting and Economics*, 57 (2-3), 241-262. <http://dx.doi.org/10.1016/j.jacceco.2014.04.004>
- Craswell, A. T., Francis, J. R., & Taylor, S. L. (1995). Auditor brand name reputations and industry specializations. *Journal of Accounting & Economics*, 20 (3), 297-322. [http://dx.doi.org/10.1016/0165-4101\(95\)00403-3](http://dx.doi.org/10.1016/0165-4101(95)00403-3)

- Cull, R., Li, Wei, Sun, Bo, & Xu, Lixin Colin. (2015). Government connections and financial constraints: Evidence from a large representative sample of Chinese firms. *Journal of Corporate Finance*, 32, 271-294. <http://dx.doi.org/10.1016/j.jcorpfin.2014.10.012>
- D'Aveni, R. (1990). Top managerial prestige and organizational bankruptcy. *Organization Science*, 1 (2), 121-142. <http://dx.doi.org/10.1287/orsc.1.2.121>
- DeAngelo, L. (1981). Auditor size and audit quality. *Journal of Accounting and Economics*, 3 (3), 183-199. [http://dx.doi.org/10.1016/0165-4101\(81\)90002-1](http://dx.doi.org/10.1016/0165-4101(81)90002-1)
- Dopuch, N., & Simunic, D. A. (1982). Competition in audit research: An assessment. *The 4th Symposium on Audit Research, University of Illinois*.
- Duchin, R., & Sosyura, D. (2012). The politics of government investment. *Journal of Financial Economics*, 106 (1), 24-48. <http://dx.doi.org/10.1016/j.jfineco.2012.04.009>
- Dunn, K., & Mayhew, B. (2002). Auditor firm industry specialization and client disclosure quality. *Review of Accounting Studies*, 9 (1), 35-58. <http://dx.doi.org/10.1023/B:RAST.0000013628.49401.69>
- El Ghoul, Sadok, Guedhami, Omrane, & Pittman, Jeffrey, Cross-country evidence on the importance of big four auditors to equity pricing: The mediating role of legal institutions (December 1, 2014). <http://dx.doi.org/10.2139/ssrn.1567524>
- Engelberg, Joseph, & Sankaraguruswamy, Srinivasan. How to gather data using a web crawler: An application using SAS to search Edgar (2007). National University of Singapore.
- Faccio, M. (2006). Politically connected firms. *American Economic Review*, 96 (1), 369-386. <http://dx.doi.org/10.1257/000282806776157704>
- Faccio, M., Masulis, R., & McConnell, J. (2006). Political connections and corporate bailouts. *Journal of Finance*, 61 (6), 2597-2635. <http://dx.doi.org/10.1111/j.1540-6261.2006.01000.x>
- Faccio, M. (2007). The characteristics of politically connected firms. Working paper. Purdue University.
- Faccio, M. (2010). Differences between politically connected and nonconnected firms: A cross-country analysis. *Financial Management (Wiley-Blackwell)*, 39(3), 905-928. <http://dx.doi.org/10.1111/j.1755-053X.2010.01099.x>
- Fama, E. F., & Jensen, M. C. (1983). Separation of ownership and control. *Journal of Law and Economics*, 26 (June), 301-25. <http://dx.doi.org/10.1086/467037>
- Fan, J. P. H., Wong, T. J., & Zhang, Tianyu (2007). Politically connected CEOs, corporate governance, and Post-IPO performance of China's newly partially privatized firms. *Journal of Financial Economics*, 84 (2), 330-357. <http://dx.doi.org/10.1016/j.jfineco.2006.03.008>
- Francis, Jere R., Michas, Paul N., & Stein, Sarah E. (2013). Do auditors affect investment efficiency? Working paper (April 17, 2013). *University of Missouri-Columbia*.
- Francis, J. R., Stokes, D. J. Stokes, & Anderson, D. (1999). City markets as a unit of analysis in audit Research and the re-examination of Big 6 market shares. *Abacus*, 35 (2), 185-206. <http://dx.doi.org/10.1111/1467-6281.00040>
- Ferguson, A., Francis, J. R., & Stokes, D. J. (2003). The effects of firm-wide and office-level industry expertise on audit pricing. *The Accounting Review*, 78 (2), 429 - 448. <http://dx.doi.org/10.2308/accr.2003.78.2.429>
- Francis, J. R., Reichelt, K. J. & Wang, D. D. (2005). The pricing of national and city-specific reputations for industry expertise in the U.S. audit market. *The Accounting Review*, 80 (1), 113-136. <http://dx.doi.org/10.2308/accr.2005.80.1.113>
- Frankel, R. M., Johnson, M. F. & Nelson, K. K. (2002). The relation between auditors' fees for nonaudit services and earnings management. *Accounting Review*, 77 (Supplement), 71-105. <http://dx.doi.org/10.2308/accr.2002.77.s-1.71>
- General Accounting Office (GAO). (2003). Public accounting firms: mandated study on consolidation and competition. GAO Report 03-864. Washington, D.C.: Government Printing Office.
- General Accounting Office (GAO). (2008). Audits of public companies: continued concentration in audit market for large public companies does not call for immediate action. GAO Report 08-163. Washington, D.C.: Government Printing Office.

- Goldman, E., Rocholl, J., & So, J. (2009). Do politically connected boards affect firm value? *Review of Financial Studies*, 22 (6), 2331–2360. <http://dx.doi.org/10.1093/rfs/hhn088>
- Green, W. (2008). Are industry specialists more efficient and effective in performing analytical procedures? A multi-stage analysis. *International Journal of Auditing*, 12(3), 243-260. <http://dx.doi.org/10.1111/j.1099-1123.2008.00383.x>
- Guedhami, Omrane, & Pittman, Jeffrey A. (2006). Ownership concentration in privatized firms: The role of disclosure standards, auditor choice, and auditing infrastructure. *Journal of Accounting Research*, 44 (5), 889–929. <http://dx.doi.org/10.1111/j.1475-679X.2006.00219.x>
- Guedhami, Omrane, Pittman, Jeffrey A. & Saffa, Walid. (2014). Auditor choice in politically connected firms. *Journal of Accounting Research*, 52 (1), 107-162. <http://dx.doi.org/10.1111/1475-679X.12032>
- Gul, F. A., Fung S. Y. K., & Jaggi B. (2009). Earnings quality: Some evidence on the role of auditor tenure and auditors' industry expertise. *Journal of Accounting and Economics*, 47 (3), 265-287. <http://dx.doi.org/10.1016/j.jacceco.2009.03.001>
- Hall, Richard L., & Wayman, Frank W. (1990). Buying time: Moneyed interests and the mobilization of bias in congressional committees. *American Political Science Review*, 84 (3), 797-820. <http://dx.doi.org/10.2307/1962767>
- Hogan, C. E., & Jeter, D. C. (1999). Industry specialization by auditors. *Auditing: A Journal of Practice & Theory*, 18 (1), 1–17. <http://dx.doi.org/10.2308/aud.1999.18.1.1>
- Hosmer, D., & Lemeshow, S. (2000). *Applied logistic regression*. 2nd edition. Hoboken, NJ: John Wiley & Sons, Inc. <http://dx.doi.org/10.1002/0471722146>
- Houston, J., Jiang, L., Lin, C., & Ma, Y. (2014). Political connections and the cost of bank loans. *Journal of Accounting Research*, 52(1), 193-243. <http://dx.doi.org/10.1111/1475-679X.12038>
- Hunter, W.J., & Nelson, M. A. (1995). Tax enforcement: A public choice perspective. *Public Choice*, 82 (1–2), 53–67. <http://dx.doi.org/10.1007/BF01047729>
- Infante, L. and M. Piazza. (2014). Political connections and preferential lending at local level: Some evidence from the Italian credit market. *Journal of Corporate Finance*, 29 (December), 246-262. <http://dx.doi.org/10.1016/j.jcorpfin.2014.06.003>
- Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, 3 (4), 305-360. [http://dx.doi.org/10.1016/0304-405X\(76\)90026-X](http://dx.doi.org/10.1016/0304-405X(76)90026-X)
- Johnson, P., Jamal K., & Berryman, R. (1991). Effects of framing on auditor decisions. *Organization Behavior and Human Decision Processes*, 50 (1), 75-105. [http://dx.doi.org/10.1016/0749-5978\(91\)90035-R](http://dx.doi.org/10.1016/0749-5978(91)90035-R)
- Kang, Fei. (2014). Founding Family Ownership and the Selection of Industry Specialist Auditors. *Accounting Horizons*, 28 (2), 261-276. <http://dx.doi.org/10.2308/acch-50714>
- Kim, Chansog (Francis), & Zhang, Liandong. (2015). Corporate political connections and tax aggressiveness (Online version on July 1, 2015). *Contemporary Accounting Research*, Forthcoming. <http://dx.doi.org/10.1111/1911-3846.12150>
- Kim, Yongtae, & Park, Myung Seok. (2014). Real Activities Manipulation and Auditors' Client-Retention Decisions. *The Accounting Review*, 89 (1), 367–401. <http://dx.doi.org/10.2308/accr-50586>
- Knechel, W. Robert, Naiker, Vic, & Pacheco, Gail. (2007). Does Auditor Industry Specialization Matter? Evidence from market reaction to auditor switches. *Auditing: A Journal of Practice & Theory*, 26 (1), 19-45. <http://dx.doi.org/10.2308/aud.2007.26.1.19>
- Kothari, S. P., Andrew, J. Leone, & Wasley, Charles E. 2005. Performance-matched discretionary accruals. *Journal of Accounting and Economics*, 39 (1), 163–197. <http://dx.doi.org/10.1016/j.jacceco.2004.11.002>
- Krishnan, G. V. (2003). Does Big 6 Auditor industry expertise constrain earnings management? *Accounting Horizons*, 17, 1-16. <http://dx.doi.org/10.2308/acch.2003.17.s-1.1>
- Landsman, W. R., Nelson K. K., Rountree, B. R. (2009). 'Auditor switches in the pre- and post-Enron eras: Risk or realignment?' *Accounting Review*, 84 (2), 531-558. <http://dx.doi.org/10.2308/accr.2009.84.2.531>

- Larcker, David F., & Rusticus, Tjomme O. (2007). Endogeneity and empirical accounting research. *European Accounting Review*, 16 (1), 207-215. <http://dx.doi.org/10.1080/09638180701269905>
- Libby, R., & Tan, H.-T. (1994). Modeling the determinants of audit expertise. *Accounting, Organizations and Society*, 19 (8), 701-716. [http://dx.doi.org/10.1016/0361-3682\(94\)90030-2](http://dx.doi.org/10.1016/0361-3682(94)90030-2)
- Lim, C., & Tan, H. (2008). Non-audit service fees and audit quality: The impact of auditor specialization. *Journal of Accounting Research*, 46 (1), 199–246. <http://dx.doi.org/10.1111/j.1475-679X.2007.00266.x>
- Long, J. S., & Freese, J. (2006). *Regression models for categorical dependent variables using Stata*. 2nd ed. College Station, TX: Stata Press.
- Mayhew, Brian W., & Wilkins, Michael S. (2003). Audit firm industry specialization as a differentiation strategy: Evidence from fees charged to firms going public. *Auditing: A Journal of Practice & Theory*, 22 (2), 33-52. <http://dx.doi.org/10.2308/aud.2003.22.2.33>
- Mills, L.F., Nutter, S. E., & Schwab, C. M. (2013). The effect of political sensitivity and bargaining power on taxes: Evidence from federal contractors. *The Accounting Review*, 88 (3), 977–1005. <http://dx.doi.org/10.2308/accr-50368>
- Milyo, Jeffrey, Primo, David M. & Groseclose, Timothy J. (2010). Corporate PAC contributions in perspective. *Business Politics*, 2 (1), 75-88.
- Moroney, Robyn. (2007). Does industry expertise improve the efficiency of audit judgment? *Auditing: A Journal of Practice & Theory*, 26 (2), 69-94. <http://dx.doi.org/10.2308/aud.2007.26.2.69>
- Neal, Terry L., & Riley, Jr. Richard R. (2004). Auditor industry specialist research design. *Auditing: A Journal of Practice & Theory*, 23 (2), 169–177. <http://dx.doi.org/10.2308/aud.2004.23.2.169>
- O'Keefe, T. B., Simunic, D. A. & Steini, M. T. (1994). The production of audit services: Evidence from a major public accounting firm. *Journal of Accounting Research*, 32 (2), 241-261. <http://dx.doi.org/10.2307/2491284>
- Owhoso, V. E., Messier, J. W. F. & J Lynch, J. J. G. (2002). Error detection by industry-specialized teams during sequential audit review. *Journal of Accounting Research*, 40 (3), 883-900. <http://dx.doi.org/10.1111/1475-679X.00075>
- Reichelt, K. J., & Wang, D. (2010). National and office-specific measures of auditor industry expertise and effects on audit quality. *Journal of Accounting Research*, 48 (3), 647-686. <http://dx.doi.org/10.1111/j.1475-679X.2009.00363.x>
- Solomon, I., Shields, M. D. & Whittington, O. R. (1999). What do industry-specialist auditors know? *Journal of Accounting Research*, 37 (1), 191-208. <http://dx.doi.org/10.2307/2491403>
- Srinidhi, B. N., He, Shaohua, Firth, Michael (2014). The effect of governance on specialist auditor choice and audit fees in U.S. family firms. *Accounting Review*, 89 (6), 2297-2329. <http://dx.doi.org/10.2308/accr-50840>
- Watts, R. L., & Zimmerman, J. L. (1986). *Positive accounting theory*. 1st ed. Upper Saddle City, NJ: Prentice Hall.
- Whitworth, J. D., & Lambert, T. A. Lambert (2014). Office-Level Characteristics of the Big 4 and Audit Report Timeliness. *Auditing: A Journal of Practice & Theory*, 33 (3), 129-152. <http://dx.doi.org/10.2308/ajpt-50697>
- Young, M., Reksulak, M. & Shughart, W. F. (2001). The political economy of the IRS. *Economics & Politics*, 13 (2), 201–220. <http://dx.doi.org/10.1111/1468-0343.00090>
- Yu, F., & Yu, X. (2011). Corporate lobbying and fraud detection. *Journal of Financial and Quantitative Analysis*, 46 (6), 1865-1891. <http://dx.doi.org/10.1017/S0022109011000457>

## Notes

Note 1. These (former) positions include: president, presidential candidate, member of the House of Representatives, Senator, (deputy/under/assistant) Secretary of State/Treasury/Defense/ the interior/ Agriculture/ Commerce/Labor/ Health and Human Services/Housing and Urban Development/ Transportation/ Energy/ Education/ Veterans' Affairs/ Homeland Security or Attorney General, Governor, representative to the United Nations, Ambassador, Mayor, staff (White House, president, presidential campaign), chairman of the Party Caucus, chairman or staff of the presidential election campaign and chairman or member of the president's committee/council, director/ deputy director/ commissioner of the Federal Departments and Agencies (e.g. CIA, FEMA, OMB, IRS, NRC, SSA, NRC, FDA, SEC, etc.).

Note 2. Results are very similar when I define SPEC as 1 for the top three industry leaders in the audit market.

Note 3. See Engelberg and Sankaraguruswamy (2007) for details about the SAS-based web crawling program.

## APPENDIX A VARIABLE DEFINITIONS

Dependent variable		
<i>SPEC</i>	=	Industry specialist auditors, measured as an indicator variable equal to 1 if the auditor is the city-level leading two largest auditors based on market-share in an 2 digit SIC code and year combination, and zero otherwise, following [adapted from Cheng, Martin, & Wang (2013)];
Variables of interest		
<i>PC</i>		One of our three proxies of political connections: 1) Lobby expenses ( $PC^{LOB}$ ) an indicator that takes the value of one if the client firm has non-zero lobby expenses, zero otherwise, following Yu & Yu (2011); 2) corporate campaign contributions ( $PC^{PAC}$ ), an indicator that takes the value of one if the client firm has non-zero campaign contributions, zero otherwise), following Cooper et al. (2010); 3) the employment of former politicians as corporate directors ( $PC^{DIR}$ ), an indicator that takes the value of one if the firm has at least one former politician on board, zero otherwise, following Kim & Zhang (2015);
$PC^{LOB}$	=	An indicator that takes the value of one if the firm has non-zero lobby expenses, zero otherwise;
$PC^{PAC}$	=	An indicator that takes the value of one if the client firm has non-zero campaign contributions, zero otherwise;
$PC^{DIR}$	=	An indicator that takes the value of one if the firm has at least one former politician on board, zero otherwise;
Control variables		
<i>SIZE</i>	=	Natural logarithm of total assets;
<i>LSEG</i>	=	Natural logarithm of the number of unique business segments;
<i>DForeign</i>	=	An indicator variable equal to 1 if the client firm engage in foreign operations, and 0 otherwise;
<i>ROA</i>	=	Return-on-assets, computed as the ratio of earnings before extraordinary items, scaled by total assets;
<i>LEV</i>	=	Leverage, calculated as total long-term liabilities divided by total assets.
<i>LOSS</i>	=	An indicator variable equal to 1 if there is a loss in the current fiscal year, and 0 otherwise;
<i>INVREC</i>	=	The sum of inventory and accounts receivable at the beginning of the year <i>t</i> for firm <i>i</i> , scaled by total assets;
<i>LIT</i>	=	Indicator variable that takes the value of 1 if the firm operates in a high-litigation industry, and 0 otherwise. High-litigation industries are industries with sic codes 2833-2836, 3570-3577, 3600-3674, 5200-5961, and 7370-7374 (Frankel et al., 2002; Ashbaugh et al., 2003);
<i>AGE</i>	=	Firm age, measured as the natural log of the number of years the firm has appeared in Compustat;

<i>ICW</i>	=	An indicator variable equal to 1 if the client firm has at least one material internal control weakness, and 0 otherwise;
<i>absACC</i>	=	Absolute value of discretionary accruals, calculated as the absolute value of the residual from performance-adjusted modified Jones model (Kothari et al., 2005);
<i>BigN</i>	=	Big 4/5 auditors, an indicator variable equal to 1 if the client firm is audited by one of the Big 4/5 auditors, and zero otherwise;
<i>GOV</i>	=	Governance index, calculated as (-1)*Entrenchment index, following Bebchuk et al. (2009). Bebchuk et al. (2009) create an entrenchment index ( <i>Eindex</i> ) based on six provisions – four constitutional provisions that prevent a majority of shareholders from having control (e.g., staggered boards, limits to shareholder bylaw amendments, supermajority requirements for mergers, and supermajority requirements for charter amendments), and two takeover-readiness provisions - poison pills and golden parachutes. (Note 1) This <i>Eindex</i> ranges from 0 to 6, with a higher value indicating stronger managerial entrenchment. I negate <i>Eindex</i> to generate <i>GOV</i> so that higher value of <i>GOV</i> refers to higher corporate governance. Observation with missing values are coded as zero to reduce data attrition;
<i>ISSUE</i>	=	An indicator variable equal to 1 if the sum of long-term debt and equity issued during the past three years is more than 5% of total assets, and 0 otherwise;
<i>BtM</i>	=	Book-to-Market, calculated as total assets to market value plus debt;
<i>IMR</i>	=	The inverse Mills ratio;
<b>Alternative measures for industry specialist</b>		
<i>SPEC2</i>	=	An indicator variable equal to 1 if the external auditor is the leading city-level industry specialist auditors and zero otherwise;
<i>SPEC3</i>	=	An indicator variable equal to 1 if the external auditor is a city-level industry specialist auditor with minimum 50% market share and zero otherwise;
<b>Variable unique to the auditor switching model</b>		
<i>AC</i>	=	Auditor switches, an indicator variable equal to 1 if client firm <i>i</i> switches auditors in year <i>t</i> , and zero otherwise;
<b>Variables unique to the auditor-client realignment model</b>		
<i>AC<sup>UPLATERAL</sup></i>	=	Up and lateral auditor switches, an indicator variable equal to 1 if client switches from a non-specialist auditor to a specialist auditor or from one specialist auditor to another specialist auditor during current fiscal year, and zero otherwise;
<i>LNAF</i>	=	The natural logarithm of non-audit fees;
<i>GC</i>	=	An indicator variable equal to one if the auditor issues a going-concern opinion;
<i>Restate</i>	=	An indicator variable equal to one if the client firm restate their current-year financial statement;
<i>Beta</i>	=	The company's beta estimate using a market model over the fiscal year;
<i>RVOL</i>	=	Return volatility.
<b>Additional control variables for robustness test</b>		
<i>IOR</i>	=	Institutional ownership, measured as the fraction of a firm's outstanding shares owned by institutional investors;
<i>CEOCHR</i>	=	1 if the CEO is also chairman of the board, and 0 otherwise;
<i>BODIND</i>	=	Percentage of member in the board of directors who are independent;
<i>MgOWN</i>	=	percentage of shares held by top management;
<i>FAMILY</i>	=	1 if the firm is classified as a family firm, and 0 otherwise.