

## **Politically skilled audit committee directors and audit committee diligence**

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### **ABSTRACT**

After many years of scrutiny, corporate audit committee diligence remains a grave concern to stakeholders. Generally, researchers use the number of audit committee meetings to proxy for audit committee diligence.

In this study, the influence of audit committee directors' political skill on the number of audit committee meetings is examined. Defined as a system of social competencies, political skill enables individuals to understand others in work-relevant situations and use that knowledge to influence others' actions in ways that heighten their personal and/or organizational objectives. Prior research indicates that former government and political officials possess political skill and have been appointed to corporate boards of directors in large numbers in the past four decades. Using a hybrid resource dependence theory and agency theory underpinning, arguments as to why differences in the behavior of the audit committee can be expected due to the presence of politically skilled audit committee directors are developed. Using archival data from a sample of 270 S&P SmallCap 600 Index firms with a fiscal-year end date of December 31, 2012, ordinary least squares (OLS) is used to test the association between audit committee directors' political skill and the number of audit committee meetings. A significant positive relationship between firms with a politically skilled audit committee director and the number of audit committee meetings is documented. This finding suggests that audit committees with a politically skilled director are likely to meet more frequently than audit committees without such a director. It also has implications for audit committee effectiveness.

Keywords: audit committee, diligence, meetings, political skill

## INTRODUCTION

Corporate audit committee diligence has been subject to tremendous scrutiny from key stakeholders over the years (Levitt, 1998; Blue Ribbon Committee [BRC], 1999; White, 2014). Generally, the number of audit committee meetings is used by researchers to proxy for audit committee diligence since it is the sole publicly available and quantifiable signal of diligence (DeZort, Hermanson, Archambeault, & Reed, 2002; Raghunandan & Rama, 2007). Given the important role the audit committee has, the opportunities regular audit committee meetings present for enhancing communication and relationships between the committee and a firm's management and external auditor (BRC, 1999; Public Oversight Board [POB], 1993) justifies the scrutiny audit committees have received. Furthermore, the documented associations between frequent audit committee meetings and positive financial reporting outcomes in the accounting and auditing literatures have also warranted scrutiny of audit committees. Much of the scrutiny led to the passage of the Sarbanes-Oxley Act of 2002 (SOX), one of the most comprehensive pieces of business reform legislation since the Securities Act of 1933 and the Securities Exchange Act of 1934. Much of it was also instrumental in the Securities and Exchange Commission (SEC) adopting rules and requirements related to an audit committee's composition and activities (SEC 1999a, 1999b, 2003a, 2003b). Though the SEC gave considerable attention to the independence and accounting/financial expertise of audit committee directors, no consideration was given to audit committee directors' political skill. This study helps to fill this gap by developing arguments as to why differences in the behavior of the audit committee can be expected due to the presence of politically skilled audit committee directors. And, empirical tests are conducted to ascertain whether there really are differences in behavior.

The motivation for this study stems from the perennial concerns of stakeholders regarding audit committee diligence. Levitt (1998), BRC (1999), and White (2014) all address audit committee diligence and assert that good, effective audit committee directors possess particular personal characteristics. While addressing the New York University Center for Law and Business in September 1998 on the adverse impact of earnings management on financial reporting quality and disclosure, SEC chairman Arthur Levitt (1998) asserts that audit committees that are "qualified, committed, independent and tough-minded" are "the most reliable guardians of the public interest" (p. 12). BRC (1999) asserts the following:

Good governance dictates that the board be comprised of individuals with certain personal characteristics, such as a recognition of the importance of the board's tasks, integrity, sense of accountability, a history of achievement, and the ability to ask tough questions. (p. 21)

And, more recently, current SEC chairwoman Mary Jo White (2014) echoed very similar sentiments regarding audit committee director attributes during a June 2014 speech given at Stanford University's Rock Center for Corporate Governance 20<sup>th</sup> Annual Stanford Directors' College. During her address, White (2014) asserts that directors are vital "gatekeepers" upon whom investors and the SEC rely, and should be "conscientious," "diligent," "engaged," "committed," as well as able "to ask difficult questions" and "insist on answers when questions arise."

Some of the characteristics asserted by Levitt (1998), BRC (1999), and White (2014) have been argued and/or documented in the political skill and organizational politics literatures to be associated with politically skilled individuals. Ferris et al. (2005) define political skill as a system of social competencies that enables individuals to understand others in work-relevant situations and use that knowledge to influence others' actions in ways that heighten their

personal and/or organizational objectives. Ferris et al. (2007) argue that politically skilled individuals are socially astute and accountable to others. Treadway, Hochwarter, Kacmar, and Ferris (2005) argue that politically skilled individuals are conscientious. Among other things, politically skilled individuals have been argued to be assertive (Ferris et al., 2007) and proactive (Thompson, 2005; Liu et al., 2007).

Former government and political officials are suggested to possess political skill due to the training (implicit and explicit) they receive upon occupying a public office (Parker, Parker, & Dabros, 2012), as well as due to the intricate environments they must navigate and the opposition they must overcome (Morrell & Hartley, 2006; Simpson, 2008). Over the last four decades, there has been a significant increase in the appointment of politically skilled individuals, in the form of former public officials, to corporate boards (Lester, Hillman, Zardkoohi, & Cannella, 2008). Some of those individuals have subsequently been assigned to board subcommittees, including the audit committee. Pfeffer (1981) suggests that political skill is essential for being successful in organizations, which Mintzberg (1985) characterizes as being inherently political. Due to the significant oversight role the audit committee has in corporate governance, identifying additional audit committee characteristics that are associated with audit committee diligence is imperative. In this study, a hybrid resource dependence theory and agency theory foundation is used to examine the association between audit committee directors' political skill and audit committee diligence as measured by the number of AC meetings held during the year. The audit committee meetings during 2012 for 270 S&P SmallCap 600 Index firms with a fiscal year-end of December 31 are analyzed to determine whether the number of audit committee meetings is impacted by audit committee composition.

This study makes several contributions. First, though there have been several studies to examine the impact of audit committee director characteristics such as independence (Klein 2002), accounting/financial expertise (Dhaliwal, Naiker, and Navissi 2010) and gender (Thiruvadi and Huang 2011; Thiruvadi 2012) on audit committee quality and effectiveness, there appears to be no prior studies examining this topic; therefore, it fills a void in the literature. Second, this study contributes to the accounting and auditing literature by investigating an unexplored, non-accounting audit committee characteristic that has been added to the audit committee voluntarily, unlike the financial expert characteristic which is a requirement of SOX. Third, this study answers the call for studies to use a hybrid resource dependence theory and agency theory underpinning when examining audit committee characteristics (Cohen et al. 2008). Lastly, this study has the potential to contribute to two ongoing debates, the corporate governance debate as well as the 'revolving door' debate which centers on government and political officials who leave the public sector for the private sector.

A literature review follows in the next section. This is followed by theory development, then a hypothesis development section. The fifth section presents the research methodology, while the sixth section presents the results of empirical tests and a sensitivity analysis. This paper ends with a brief summary and conclusion.

## **RELATED LITERATURE**

### **Audit Committee Diligence and Positive Financial Reporting Outcomes**

Audit committee diligence, as proxied by the number of audit committee meetings, has been documented in prior studies as being associated with several positive financial reporting outcomes. Menon and Williams (1994) investigate whether voluntarily formed audit committees

are relied upon for monitoring as indicated by the number of audit committee meetings held and audit committee composition. They find that many audit committees either meet once or not at all and that as the proportion of outside directors increases, the probability of the audit committee meeting more also increases. McMullen and Raghunandan (1996) use a sample of firms with and without financial reporting issues (SEC enforcement actions and restatements of earnings) to examine differences in audit committee composition and meeting habits of such firms in an effort to discover clues about audit committee effectiveness. They find that the audit committee of firms with a financial reporting issue is less likely to meet regularly, be comprised solely of outside directors, or have a certified public accountant as a director. Scarbrough, Rama, and Raghunandan (1998) use a sample of Canadian manufacturing firms to investigate the association between audit committee composition and communication with the internal audit function. They find that frequent meetings of the audit committee with the internal audit chief are more likely when the audit committee is comprised solely of independent directors. Beasley, Carcello, and Hermanson (1999) provide a comprehensive analysis of incidences of fraudulent financial reporting since the report issued by the Treadway Commission in 1987. With a threefold objective of (1) identifying SEC alleged incidences of fraudulent financial reporting, (2) examining certain firm and management attributes of a sample of firms identified as having an alleged SEC incidence of fraudulent reporting, and (3) providing recommendations for corporate financial reporting improvements, the authors find that the audit committees of firms that comprise their sample appear weak, rarely meet, lack a director with accounting or finance expertise, and the boards of those firms have a heavy presence of inside directors, on average. Xie, Davidson, and DaDalt (2003) investigate the role of corporate governance mechanisms (board of directors, audit committee, and executive committee) in restraining earnings management and find smaller levels of discretionary accruals are associated with boards and audit committees that meet regularly. Using a matched-pairs sample of firms with and without a non-fraud restatement of financials, Abbott, Parker, and Peters (2004) examine the association between audit committee characteristics and the likelihood of restatement and find a significant, negative relationship between the number of audit committee meetings and restatements and between restatements and audit committees with at least one director with financial expertise. Using a sample of firms with and without an occurrence of fraud as determined by the SEC, Farber (2005) investigates the association between the quality of a firm's corporate governance mechanisms and the integrity of its financial reporting system and finds that firms not identified by the SEC as having fraudulently manipulated their financial statements have more frequent audit committee meetings compared to similar firms with a fraud occurrence.

### **Audit Committee Diligence Determinants**

Although audit committee diligence has been associated with positive financial reporting outcomes, studies on the determinants of audit committee diligence are scarce. To add to the scant literature on the matter, Raghunandan and Rama (2007) examine the association between the number of audit committee meetings and characteristics of the firm, and Thiruvadi (2012) investigates the impact of audit committee director gender on audit committee diligence.

Using a sample of S&P SmallCap 600 firms with a fiscal year-end of December 31, 2003, Raghunandan and Rama (2007) find that firms that are larger, have a higher level of blockholders, are in industries prone to litigation, and have more board meetings are more likely to have a higher audit committee meetings frequency. They also document a significant positive

relationship between audit committee meetings frequency and the proportion of directors considered accounting experts.

Using a sample of S&P SmallCap 600 firms with a fiscal year-end of December 31, 2003, Thiruvadi (2012) investigates the impact of behavioral differences due to audit committee director gender on audit committee diligence. She argues and posits that gender differences should be expected to lead to differences in the behavior (meeting frequency) of audit committees with and without a female director. She finds marginally significant evidence to support her hypothesis that audit committees with at least one female director are likely to meet more often than audit committees comprised of all males.

## **THEORY DEVELOPMENT**

### **Political Skill**

Political skill is defined as a system of social competencies that enables an individual to understand others in work-relevant situations and use that knowledge to influence others' actions in ways that heighten one's organizational and/or personal objectives (Ferris et al., 2005). Researchers view political skill as a social competency that can be innate or significantly developed or shaped through socialization or training (Ferris et al., 2002). Many researchers agree that organizations are inherently political to some degree (Mintzberg, 1985). Moreover, some researchers argue that political skill is necessary for success in organizations (Pfeffer, 1981).

After conducting a survey of the political skill and organizational politics literatures, Ferris et al. (2007) conceptualize political skill as being comprised of four dimensions: (1) social astuteness, (2) interpersonal influence, (3) networking ability, and (4) apparent sincerity. Socially astute individuals are considered keen observers of others (Ferris et al., 2007). They are viewed as possessing high self-awareness and self-confidence, though not self-centered. They are also argued to be accountable to others, and Treadway et al. (2005) suggest politically skilled individuals are conscientious. The interpersonal dimension of political skill encompasses the influence ability and adaptability of politically skilled individuals (Ferris et al., 2007). Such individuals are able to exert compelling influence on others, and that influence allows them to adapt to different environments and situations to bring about responses desired of others. Liu et al. (2007) and Thompson (2005) provide evidence on significant positive relationships between the interpersonal dimension of political skill and proactive personality. The networking ability dimension of political skill captures a politically skilled individual's ability to identify, develop, and maintain diverse and extensive contacts and networks (Ferris et al., 2007). It also captures a politically skilled individual's ability to build and maintain beneficial coalitions and alliances. The authors argue that due to politically skilled individuals' ability to develop and maintain diverse and extensive contacts and networks, they are more likely to be assertive. Lastly, the apparent sincerity dimension of political skill captures the ability of a politically skilled individual to appear genuine and sincere (Ferris et al., 2007). It also captures a politically skilled individual's ability to appear to possess a high degree of integrity and to produce confidence and trust within others around them.

### **Resource Dependence Theory and Agency Theory**

Hillman and Dalziel (2003) argue that because the purpose of the board of directors is to

provide resources to the firm and to monitor management, this two-fold purpose warrants the use of a hybrid resource dependence theory and agency theory underpinning when exploring links between a firm's board of directors and firm performance. They also argue that the human and social capital directors bring to the board affect the board's ability to provide resources as well as effectively monitor management. The authors go on to state that too many prior studies have used only one perspective (primarily agency theory), and such use yields an incomplete understanding of how a board executes its two-fold purpose and that a hybrid theoretical underpinning is more appropriate. Support for the authors' argument is reflected by a call for such a hybrid theoretical framework for future studies investigating audit committee characteristics (Cohen et al., 2008).

Providing resources or access to resources is central to the resource dependence perspective in which researchers argue that firms are dependent upon outside organizations that operate within the external environment (Pfeffer & Salancik, 1978). Such a dependency gives rise to uncertainty and risk which affect the performance of firms (Hillman, 2005). To protect against or minimize that uncertainty and risk, firms form linkages with those external organizations (Pfeffer & Salancik, 1978), oftentimes by using the board of directors as its primary means of extracting and absorbing crucial components of environmental uncertainty and risk into the firm (Hillman, 2005). Once appointed to corporate boards, those former affiliates or employees of external organizations provide firms with resources (human and social capital) that have been accumulated from and about the external environment.

Monitoring management is central to agency theory which seeks to minimize agency costs of a firm (Jensen & Meckling, 1976). Such costs arise due to the separation of a firm's ownership and management. Such a separation leads to information asymmetry and conflicting interests between a firm's shareholders and management (Jensen & Meckling, 1976; Dey, 2008). Because of that information asymmetry and conflicting interests, agency scholars argue that managers of the firm are likely inclined to engage in activities that maximize their own utility at the expense of maximizing the wealth of shareholders. So, to deter or minimize those activities by resolving or mitigating conflicts of interests, corporate governance mechanisms and controls are established (Dey, 2008).

## **HYPOTHESIS DEVELOPMENT**

The U.S. government is one external organization that impacts corporate firms in some way or another. Whether through the promulgation of corporate tax policy or regulating certain industries, the government's role as a policy maker, regulator, and enforcer impacts corporate firms. From a resource dependence perspective, such an impact creates a dependence on the government and gives rise to uncertainty and risk which affect the performance of firms and lead to the forming of linkages with the government in an effort to protect against or minimize that uncertainty and risk (Hillman, 2005). The appointment of former political and government officials to corporate boards is one way those linkages can be formed, and over the last four decades, corporate boards have seen an influx of former political and government officials (Lester et al., 2008; Goldman et al., 2009). Lester et al. (2008) document former federal government cabinet members and senators comprise a large number of outside corporate directorships. Since subcommittees are subsets of the full board, it is likely that some of those former public officials have been appointed to the audit committee. Moreover, it is also plausible that those individuals may be using the resources (human and social capital) acquired

and developed while in the public sector, to carry out their director duties while board members in the private sector.

Prior research indicates that former political and government officials possess political skill because of the training, both implicit and explicit, they receive upon occupying their respective public office or capacity (Parker et al., 2012). Such training enables those officials to develop policy expertise, extensive contacts and networks, and experience formulating and maneuvering legislation. Morrell and Hartley (2006) and Simpson (2008) suggest public officials are self-motivated and persistent individuals because of the ambiguous, intricate environments they must navigate and opposition they must overcome. Mondak and Halperin (2008) suggest public officials possess a strong sense of duty which is often associated with individuals being ethical, accountable, and conscientious. Furthermore, due to public officials developing and maintaining extensive networks and contacts (Kotter, 1982; Lester et al., 2008), such activities suggest those individuals must be assertive (Ferris et al., 2007).

Given the importance of audit committee diligence to stakeholders and the integrity of financial reporting and disclosure, identifying factors that are associated with audit committee diligence is essential. Since politically skilled individuals (i.e. former public officials) are argued and suggested to possess personal characteristics similar to those of a good audit committee director as asserted by Levitt (1998), BRC (1999), and White (2014), it is plausible that the presence of at least one politically skilled audit committee director may lead to differences in the behavior of the audit committee and may impact audit committee diligence. Therefore, the following hypothesis is posited:

H1: Audit committees with at least one politically skilled director will meet more frequently than audit committees without such a director.

## METHODOLOGY

### Multivariate Regression Model

The model<sup>1</sup> employed to test the association between audit committee directors' political skill and the number of audit committee meetings is as follows:

$$\begin{aligned} \text{LNACMTGS} = & \beta_0 + \beta_1\text{LNAT} + \beta_2\text{INSIDER} + \beta_3\text{BLOCK} + \beta_4\text{LEV} + \beta_5\text{ROA} + \beta_6\text{MTB} \\ & + \beta_7\text{LTGN} + \beta_8\text{ACSIZE} + \beta_9\text{ACCEXP} + \beta_{10}\text{OTH} + \beta_{11}\text{FEM} \\ & + \beta_{12}\text{CHRCEO} + \beta_{13}\text{LNBDSIZE} + \beta_{14}\text{BDIND} + \beta_{15}\text{BDMTGS} + \beta_{16}\text{BIG4} \\ & + \beta_{17}\text{PSKILL} + \varepsilon \end{aligned}$$

Where:

LNACMTGS =The natural log of the number of audit committee meetings held in fiscal year 2012.

LNAT =The natural log of total assets as of December 31, 2012.

INSIDER =The percent of common shares held by officers and directors.

<sup>1</sup> The regression model used in this study is a modified version of that employed by in Thiruvadi (2012). Audit committee director political skill is added as an additional explanatory variable.

BLOCK	=The percent of common shares held by outside block-holders of 5% or more of shares outstanding.
LEV	=The ratio of long-term debt to assets as of December 31, 2012.
ROA	=The earnings before interest and taxes (EBIT) divided by total assets.
MTB	=The ratio of market value to book value as of December 31, 2012.
LTGN	=1 if firm is in litigious sectors Pharmaceuticals (SIC 2833-2836), Computers (3570-3577), Electronics (3600-3674), Retail (5200-5961), or Software (7370), otherwise 0.
ACSIZE	=The number of audit committee directors.
ACCEXP	=The proportion of audit committee directors who are accounting experts (e.g. CPA, auditor, CAO, CFO, or controller).
OTH	=The proportion of audit committee directors who are designated as audit committee financial experts, but are not accounting experts as defined by ACCEXP.
FEM	=1 if at least one female audit committee director, otherwise 0.
CHRCEO	=1 if CEO is also the board chairman, otherwise 0.
LNBDSIZE	=The natural log of the number of directors on the board.
BDIND	=The proportion of independent directors on the board.
BDMTGS	=The number of board meetings held in 2012.
BIG4	=1 if external auditor a Big Four <sup>2</sup> firm, otherwise 0.
PSKILL	=1 if at least one politically skilled audit committee director, otherwise 0.

The dependent variable, LNACMTGS, measures the number of audit committee meetings held in fiscal year 2012. The log transformation of the number of audit committee meetings is used to improve. Data regarding the number of audit committee meetings was hand-collected from proxy statements filed with the SEC in 2012.

The independent variable of interest is PSKILL and was hand-collected from proxy statements filed with the SEC in 2012. The process of collecting that data included reading the audit committee report to identify audit committee directors. Then, the background description of audit committee directors found in the proxy statements was reviewed to determine whether an audit committee director possessed political skill. A determination was made using a modified version of the political connection classification scheme developed by Goldman et al.,

<sup>2</sup> In accordance with prior literature, PricewaterhouseCoopers, Deloitte, Ernst & Young, and KPMG are considered Big Four audit firms.



(2009).<sup>3</sup> Audit committee directors who held former positions at any international or federal level of government or politics, or as state governors or city mayors, were deemed politically skilled.

The selection of control variables is guided by the critical monitoring role the audit committee carries out as well as prior research (Raghunandan & Rama, 2007; Thiruvadi, 2012) investigating factors that could impact the number of audit committee meetings.

Firm size, in the accounting and auditing literature, is commonly used as a control variable to proxy for factors such as the firm complexity and monitoring demands. Firm size is measured as the natural log of total assets. A higher frequency of meetings, as compared to smaller firms, is expected for larger firms.

Due to the separation of ownership and control of firms, there may be agency costs due to conflicting interests between owners and managers (Jensen & Meckling, 1976). Jensen and Meckling (1976) suggest a decrease in such costs as managerial ownership increases since managerial ownership can act as an alternative monitoring mechanism. A negative association between audit committee meetings frequency and insider stock ownership is expected.

Outside shareholders who own a large percentage of a firm's shares (block-holders) also may act as an alternative monitoring mechanism (Shleifer & Vishny, 1997). Shleifer and Vishny suggest that, due to their large investment, outside block-holders are incentivized to monitor the behavior of a firm's management. Therefore, a higher frequency of AC meetings for firms in which the level of block-holders is higher is expected.

Collier and Gregory (2000) document a positive association between leverage and audit committee activity. A positive association between leverage and the number of audit committee meetings is expected.

During periods of financial stress, audit committees may use regular meetings a mechanism to assure external stakeholders about the integrity of financial reporting (Raghunandan & Rama, 2007). Also, financially stressed firms may perform poorly due to weak internal controls (Carcello, Hermanson, & Raghunandan, 2005). Return on assets (ROA) is used to proxy for profitability. A positive relation is expected between the presence of a negative (ROA) and the number of audit committee meetings.

During periods of rapid growth, firms may outgrow their existing infrastructure, including its system of internal control (Stice, 1991). Such growth warrants the need of the audit committee to increase monitoring. The market-to-book ratio is used to proxy for growth. A positive association between it and the number of audit committee meetings is expected.

Previous research suggests that certain industries are prone to shareholder litigation (Francis, Philbrick, & Schipper, 1994). The audit committee of firms within those industries may use frequent meetings to signal vigilant monitoring (Raghunandan & Rama, 2007). Following Raghunandan and Rama (2007) and Thiruvadi (2012), litigious industries are classified by SIC code as follows: Pharmaceuticals (2833-2836), Computers (3570-3577), Electronics (3600-3674), Retail (5200-5961), and Software (7370). This study uses a dichotomous dummy variable (1 if the SIC code is one of the aforementioned industries, 0

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<sup>3</sup> Goldman et al. (2009) use an extensive classification scheme to classify a board member as being politically connected. That scheme includes some of the following positions: U.S. president, presidential candidate, senator, representative; presidential cabinet secretary or assistant, deputy, deputy assistant, or undersecretary; ambassador; representative to the United Nations; state governor; and city mayor. See Goldman et al. (2009) for the complete list.

otherwise) to indicate firms in litigious industries. A positive association between the number of audit committee meetings and firms in litigious industries is expected.

When audit committees are relatively large, more (human) resources are used to assist in improving the quality of financial reporting (DeFond & Francis, 2005). A large number of directors may lead to an increase in the number of items or issues that warrant attention (Raghunandan & Rama, 2007). A positive association between the number of audit committee directors and audit committee meetings is expected.

Costs (e.g. reputational) associated with a financial reporting failure may be higher for audit committee directors who are considered accounting experts (Raghunandan & Rama, 2007). Audit committee accounting expertise is defined as one who is a certified public accountant (CPA) or possesses experience with a commercial enterprise as an auditor, chief accounting officer (CAO), chief financial officer (CFO), or controller. A positive association between the presence of an accounting expert and the number of audit committee meetings is expected.

DeFond, Hann, and Hu (2005) document a positive market reaction to the appointment of audit committee directors with accounting expertise, but no reaction for those simply designated as an audit committee financial expert according to SOX. These non-accounting experts are those designated as an audit committee financial expert, but is not a CPA or lacks experience with a commercial enterprise as an auditor, CAO, CFO, or controller. A negative association between non-accounting experts and the number of audit committee meetings is expected.

Thiruvadi (2012) compares the meetings frequency of all-male audit committees to those with at least one female audit committee director and documents a positive association between the presence of a female director and the number of audit committee meetings. This study uses a dichotomous dummy variable (1 if at least one female audit committee director, 0 otherwise) to proxy for gender. A positive association between the presence of a female audit committee director and the number of audit committee meetings is expected.

Concerned about possibly increasing agency costs and impairing the independence between management and the board of directors, separating the CEO and chairman of the board (COB) functions is encouraged by governance activists (Brickely, Coles, & Jarrell, 1997). A dichotomous dummy variable (1 if CEO is also the COB, 0 otherwise) is used in this study to proxy for CEO duality. A negative association between CEO duality and the number of audit committee meetings is expected.

Raheja (2005) documents that an optimal size of a firm's board of directors could be small or large depending on certain characteristics of the firm. Therefore, regarding the effect of board size, no directional prediction is made.

Prior research (Beasley et al., 1999; Farber, 2005) indicates negative financial reporting consequences result when there is a small proportion of independent directors on the board. A positive association is expected between the proportion of independent directors and the number of audit committee meetings.

Often, subcommittees of the board of directors hold meetings directly after or right before meetings of the full board (Raghunandan & Rama, 2007). A positive association between the number of board meetings and audit committee meetings is expected.

Collier and Gregory (2000) document a positive association between high quality external auditors and audit committee activity. A dichotomous dummy variable (1 if external auditor is a Big Four firm, 0 otherwise) is used in this study to capture whether a firm employs a Big Four audit firm. A positive association between external auditor quality and the number of audit committee meetings is expected.

## Data and Sample

Several factors influenced the sample selection of this study. First, due to the necessity of hand-collecting audit committee data from proxy statements (DEF 14A) filed with the SEC, a manageable sample size was desired. Second, attention was directed on firms where other monitoring mechanisms would be reduced in strength so that the significance of the audit committee would be greater. Since large firms are more likely to have alternative monitoring mechanisms (e.g. securities analysts), this study focuses on smaller firms. Third, due to changes in regulations, the analysis of this study is limited to firms having the same fiscal year-end, that of December 31. Using the aforementioned criteria, this study's analysis is limited to all S&P SmallCap 600 firms with a fiscal year-end of December 31, 2012.

Sample selection information is presented in Table 1 (Appendix). The initial sample of S&P 600 SmallCap firms was identified from the Compustat Execucomp database. The tickers of those firms were then used to search for and extract Compustat financial data on those firms. Firms with missing Compustat data were excluded, followed by the exclusion of financial firms (SIC codes 6000-6999), firms missing proxy statements, and firms with a fiscal year-end other than December 31, 2012. Then, the background description of audit committee directors found in the proxy statements was reviewed to determine whether an audit committee director possessed political skill as determined by a modified version of the political connection classification scheme developed by Goldman et al. (2009). Those audit committee directors not meeting the modified political connection classification criteria were excluded from the sample.<sup>4</sup>

The final sample includes 270 firms, of which 213 have at least one politically skilled audit committee director.

## RESULTS

### Descriptive Statistics

Table 2 (Appendix) presents descriptive statistics for this study's sample. The mean (median) of total assets of the sample's firm is \$1,061 (\$706) million. An average of 10 percent of firms' common shares are held by firms' officers and directors and an average of 36 percent by block-holders. The average leverage ratio is 17 percent. The average return-on-assets is 10 percent, while the average market-to-book ratio is 2.43. And, on average, 24 percent of the firms operate within litigious industries.

On average, the audit committee of the sample's firms is comprised of 3.65 directors. The proportion of audit committee directors who are accounting experts is, on average, 34 percent, whereas the proportion of directors who are not accounting experts, but are designated as audit committee financial experts is 53 percent. And, 101 of the 270 (on average, 37 percent) firms report having at least one female audit committee director.

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<sup>4</sup> This study's sample includes audit committee directors who held previous positions at the international and federal levels of government/politics, as well as those who were governors and mayors. Audit committee directors who meet that criteria are deemed being 'politically skilled.' Observations in which the audit committee director was a military service member only, or held a position at the state or local level of government or politics lower than governor or mayor, were excluded in accordance with prior literature investigating political connections on corporate boards. Such observations were excluded due to the lower public visibility, smaller constituency served, and/or less influence of military personnel and lower-level state and city public officials when compared to public officials having held higher offices such as U.S. senators and representatives.

Table 3 (Appendix) provides descriptive data about audit committee meetings frequency. BRC (1999) recommends that corporate audit committees meet at least four times annually. The mean (median) number of audit committee meetings is 7.03 (7.00) for this study's sample. Those numbers are in line with the mean (median) number of meetings documented in Raghunandan and Rama (2007) and Thiruvadi (2012)<sup>5</sup>. Moreover, all audit committees in this study's sample meet at least four times annually, and approximately 44 percent of those committees meet at least double the recommended four times annually.

Firms in which the CEO is also the chairman of the board comprise, on average, 43 percent of the sample's firms. On average, the board of directors is comprised of 8.12 directors of which 80 percent, on average, are considered independent. And, the mean (median) number of board meetings is 7.79 (7.00).

On average, 84 percent of this study's sample is audited by one of the Big Four accounting firm.

Of the 270 firms in this study's sample, only 57 have a politically skilled audit committee director. Table 4 (Appendix) provides comparative descriptive data on the audit committee meetings frequency of firms that have and have not a politically skilled audit committee director. The mean number of audit committee meetings of firms with and without a politically skilled audit committee director is 7.67 and 6.87, respectively. Moreover, univariate analysis of the data documents a statistically significant ( $p$ -value= .04) difference in the means.

## Regression Results

Table 5 presents the results from estimating the multiple regression model of this study. The overall regression model is significant ( $F=3.33$ ,  $p < .01$ ) and appears to have good fit. The model's adjusted  $r$ -squared (Adj.  $R^2$ ) value is .13. This value falls within the Adj.  $R^2$  values range of that for Raghunandan and Rama (2007) and Thiruvadi (2012).<sup>6</sup> Only two variables capturing characteristics of the firms, LEV and ROA, are at least marginally significant, and both have negative coefficients. This indicates that audit committees of firms that are more leveraged (long-term debt-to-assets) and experience higher levels of profitability (return-on-assets) are likely to meet less. Of the variables capturing audit committee characteristics, only non-accounting experts designated as audit committee financial experts (OTH) is at least marginally significant, and it has a positive coefficient. This indicates suggests that as the proportion of non-accounting audit committee directors increases, the number of audit committee meetings increases. The audit committee accounting expert variable (ACCEXP), however, is insignificant and indicates that the proportion of audit committee directors who are accounting experts is not associated with audit committee meetings frequency. Of the variables capturing board characteristics and type of external auditor, BDMTGS, BDIND, and BIG4 have positive coefficients and are at least marginally significant. This indicates that as the number of board meetings increases, the proportion of independent board directors increases, and the firm employs a high-quality external auditor, the number of audit committee meetings increases. Lastly, the variable of primary interest, PSKILL, has a positive coefficient (0.10) and is statistically significant at the 5 percent significance level. This indicates that, on average, having

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<sup>5</sup> Raghunandan and Rama (2007) and Thiruvadi (2012) document a mean (median) number of audit committee meetings of 7.2 (7.0) and 7.06 (7.0), respectively.

<sup>6</sup> The Adj.  $R^2$  for the models used in Raghunandan and Rama (2007) and Thiruvadi (2012) are .08 and .15, respectively.

at least one politically skilled audit committee director leads to an increase of 10 percent in audit committee's meetings.

A few variables capturing characteristics relating to the firms comprising this study's sample were assessed for sensitivity. Regarding firm size, the natural log of market value of equity was substituted for the natural log of total assets (LNAT) in the model. The result yields insignificance. To assess sensitivity of the leverage variable (LEV), another leverage proxy was substituted in the model. The LEV variable in the model is measured as the ratio of long-term debt-to-assets, whereas the substitute leverage model is measured as the ratio of total debt-to-assets. The result of estimating the model with the substitute leverage proxy yields insignificance. Lastly, return on assets (ROA) is replaced with a dichotomous dummy profitability variable (1 if negative earnings, 0 otherwise) to proxy for an earnings loss. The variable is insignificant.

## **SUMMARY & CONCLUSION**

The need for diligent audit committees has been of grave concern to several stakeholders including the SEC and private sector bodies and commission, leading some stakeholders to suggest certain personal characteristics that make for a quality audit committee director. Generally, researchers utilize the number of audit committee meetings to proxy for audit committee diligence since it the sole publicly available and quantifiable signal of it (DeZoort et al., 2002). Prior research has found the number of audit committee meetings to be associated with many positive financial reporting outcomes and some determinants of audit committee diligence have been documented as well. Given the potential benefits of regular audit committee meetings (e.g. enhanced communication and relationships with corporate internal and external stakeholders, as well as positive financial reporting outcomes), scrutiny that corporate audit committees have received from stakeholders over the years has been warranted. It also necessitates that audit committee composition receive additional attention from stakeholders, including accounting/auditing researchers. Audit committee director political skill is a competency that warrants attention, and no study to date has investigated its impact on audit committee meetings frequency.

In this study, the association between the number of audit committee meetings and audit committee directors' political skill is examined. A positive association between the presence of a politically skilled director on the audit committee and the number of audit committee meetings is posited. This study's sample is comprised of 270 S&P SmallCap Index firms that have a fiscal year-end of December 31, 2012. In the sample, the mean (median) number of audit committee meetings for firms with at least one politically skilled director is 7.67 (8.00) and 6.87 (6.00) for firms without such a director. Also 51 percent (29 of 57) of firms with at least one politically skilled audit committee director have audit committees that held 8 to 12 meetings compared to only 38 percent (80 of 213) of firms without such an audit committee director. Audit committees of firms that experience higher levels of profitability and are more leverage are found to meet less. Regarding, accounting/financial expertise, the proportion of audit committee directors deemed accounting experts is found not to be associated with the number of audit committee meetings, whereas the proportion of non-accounting experts is found to be associated. This finding appears to contradict that of Raghunandan and Rama (2007) who find evidence of a positive association between the proportion of accounting experts and audit committee frequency. The number of board meetings, board independence, and high quality external audit firms are found to be positively associated with the number of audit committee meetings.

Moreover, evidence that firms with audit committees with at least one politically skilled audit committee director are likely to meet more than firms without a politically skilled director is documented.

The findings of this study contribute to the ongoing corporate governance debate and the “revolving door” debate in politics. It also contributes to the accounting and auditing literature by using a hybrid resource dependence theory and agency theory underpinning to examine the impact of an unexplored, voluntarily-added, non-accounting audit committee director characteristic on audit committee diligence, a measure of audit committee quality and effectiveness. This study presents at least one possible implication for corporate governance, the appointment of politically skilled directors to the audit committee. Moreover, given its findings, such appointments may warrant further attention given that audit committee diligence is critical to audit committee quality and effectiveness.

This study is not without limitations. First, the audit committee diligence proxy (number of audit committee meetings) used is a rough one; however, it is generally used by researchers. Second, this study’s sample is comprised of U.S. firms, and its findings may not be generalizable to other settings, especially countries in which government-owned firms are prevalent. Future research could investigate differences in how audit committees function across countries. Lastly, the time period of my study is only one year and uses cross-sectional regression analysis which impedes the ability to determine causation. Future research could possibly examine this or a similar topic over a span of years using a different research design and methodology (e.g. difference in difference(s)) technique in an effort to determine causation.

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## APPENDIX

**TABLE 1:**  
Sample Selection

S&P 600 firms in 2012 per Compustat Execucomp	600
Less: Firms with fiscal year-end other than 12/31/2012	-159
Less: Firms missing Compustat data	-121
Less: Financial industry firms (SIC codes 6000-6999)	-15
Less: Firms with military-only politically skilled audit committee directors	-15
Less: Firms with missing proxy statements (DEF 14A)	-13
Less: Firms with politically skilled audit committee directors with lower-level governmental/political experience	-7
Final Sample	270

**TABLE 2:**  
Descriptive Statistics

Variable	n	Mean	Std. Dev.	25 <sup>th</sup> Percentile	Median	75 <sup>th</sup> Percentile
<i>AT</i> (millions)	270	1061.13	1112.83	388.06	705.87	1262.29
<i>INSIDER</i>	270	0.10	0.12	0.03	0.06	0.12
<i>BLOCK</i>	270	0.36	0.14	0.26	0.35	0.46
<i>LEV</i>	270	0.17	0.18	0.00	0.14	0.29
<i>ROA</i>	270	0.10	0.12	0.05	0.09	0.13
<i>MTB</i>	270	2.43	3.34	1.26	1.75	2.77
<i>LTGN</i>	270	0.24	0.43	0.00	0.00	0.00
<i>ACSIZE</i>	270	3.65	0.94	3.00	3.00	4.00
<i>ACCEXP</i>	270	0.34	0.23	0.20	0.33	0.50
<i>OTH</i>	270	0.53	0.35	0.33	0.33	0.67
<i>FEM</i>	270	0.37	0.48	0.00	0.00	1.00
<i>CHRCEO</i>	270	0.43	0.50	0.00	0.00	1.00
<i>BDSIZE</i>	270	8.12	1.63	7.00	8.00	9.00
<i>BDIND</i>	270	0.80	0.09	0.75	0.83	0.88
<i>BDMTGS</i>	270	7.79	3.40	5.00	7.00	9.00
<i>BIG4</i>	270	0.84	0.37	1.00	1.00	1.00
<i>PSKILL</i>	270	0.21	0.41	0.00	0.00	0.00

The sample includes 270 observations from non-financial S&P 600 firms with a December 31, 2012 fiscal year-end. Refer to Table 1 for sample selection information. Definitions of variables are as follows: *AT* – total assets (in millions) as of 12/31/2012; *INSIDER* – percent of common shares held by officers and directors; *BLOCK* – percent of common shares held by outside block-holders of 5% or more of shares outstanding; *LEV* – ratio of long-term debt-to-assets as of 12/31/2012; *ROA* – EBIT divided by total assets; *MTB* – ratio of market value to book value as of 12/31/2012; *LTGN* – 1 if firm is in litigious sectors Pharmaceuticals (SIC 2833-2836), Computers (3570-3577), Electronics (3600-3674), Retail (5200-5961), or Software (7370), otherwise 0; *ACSIZE* – number of AC directors; *ACCEXP* – proportion of directors who are accounting experts (e.g., CPA, auditor, CAO, CFO, or controller); *OTH* – proportion of directors who are designated AC financial experts, but are not accounting experts as defined for *ACCEXP*; *FEM* – 1 if at least one female AC director, otherwise 0; *CHRCEO* – 1 if CEO is also the board

chairman, otherwise 0; *BDSIZE* – number of directors on the board; *BDIND* – proportion of independent directors on the board; *BDMTGS* – number of board meetings held in 2012; and, *BIG4* – 1 if external auditor a Big Four firm, otherwise 0; *PSKILL* – 1 if at least one politically skilled AC director, otherwise 0.

**TABLE 3:**  
FY 2012 Audit Committee (AC) Meetings Frequency Descriptive Data

No. of AC Meetings	No. of Firms (%) [Full Sample; n=270]
Less than 4	0(0.0)
4	39 (14.4)
5	57 (21.1)
6	35 (13.0)
7	21 (7.8)
8	50 (18.5)
9	32 (11.8)
10	15 (5.6)
11	8 (3.0)
12	4 (1.5)
> 12	9 (3.3)
	270 (100)

**TABLE 4:**  
FY 2012 Audit Committee (AC) Meetings Frequency Descriptive Data: with and without Politically Skilled Director

No. of AC Meetings	No. of Firms (%) [Full Sample; n=270]	No. of Firms (%) [ <i>PSKILL</i> =0; n=213]	No. of Firms [ <i>PSKILL</i> =1; n=57]
Less than 4	0(0.0)	0 (0.0)	0 (0.0)
4	39 (14.4)	32 (15.0)	7 (12.3)
5	57 (21.1)	49 (23.0)	8 (14.0)
6	35 (13.0)	27 (12.7)	8 (14.0)
7	21 (7.8)	18 (8.5)	3 (5.3)
8	50 (18.5)	40 (18.8)	10 (17.6)
9	32 (11.8)	23 (10.8)	9 (15.8)
10	15 (5.6)	13 (6.1)	2 (3.5)
11	8 (3.0)	2 (0.9)	6 (10.5)
12	4 (1.5)	2 (0.9)	2 (3.5)
> 12	9 (3.3)	7 (3.3)	2 (3.5)
	270 (100)	213 (100)	57 (100)

The sample includes 270 observations from non-financial S&P 600 firms with a December 31, 2012 fiscal year-end. AC data were hand-collected from SEC proxy statement filings. Refer to Table 1 for sample selection information. Refer to Table 2 for definition of variables.

**TABLE 5:**  
Regression Results

PANEL A: Regression Model			
$LNACMTGS = \beta_0 + \beta_1 LNAT + \beta_2 INSIDER + \beta_3 BLOCK + \beta_4 LEV + \beta_5 ROA + \beta_6 MTB + \beta_7 LTGN$ $+ \beta_8 ACSIZE + \beta_9 ACCEXP + \beta_{10} OTH + \beta_{11} FEM + \beta_{12} CHRCEO + \beta_{13} LNBDSIZE$ $+ \beta_{14} BDIND + \beta_{15} BDMTGS + \beta_{16} BIG4 + \beta_{17} PSKILL + \varepsilon$			
PANEL B: Estimation of Regression Model (F=3.33, p < .01, R <sup>2</sup> = .18, Adj. R <sup>2</sup> = .13)			
Variable	Coefficient	t-statistic	p-value
Intercept	0.65	2.07	.04
<i>LNAT</i>	0.03	1.02	.31
<i>INSIDER</i>	0.21	1.18	.24
<i>BLOCK</i>	-0.02	-0.13	.89
<i>LEV</i>	-0.25	-1.68	.09
<i>ROA</i>	-0.38	-1.97	.05
<i>MTB</i>	0.01	0.81	.42
<i>LTGN</i>	-0.03	-0.66	.51
<i>ACSIZE</i>	-0.01	-0.26	.79
<i>ACCEXP</i>	0.06	0.62	.53
<i>OTH</i>	0.11	1.90	.06
<i>FEM</i>	-0.04	-0.84	.40
<i>CHRCEO</i>	-0.03	-0.70	.48
<i>LNBDSIZE</i>	0.13	1.15	.25
<i>BDIND</i>	0.66	2.89	.00
<i>BDMTGS</i>	0.01	1.89	.06
<i>BIG4</i>	0.18	3.11	.00
<i>PSKILL</i>	0.10	1.99	.05
<p>Refer to Table 1 for sample selection information. Definitions of variables are as follows:  <i>LNACMTGS</i> – natural log of the number of AC meetings held in fiscal year 2012; <i>LNAT</i> – natural log of total assets as of 12/31/2012; <i>INSIDER</i> – percent of common shares held by officers and directors; <i>BLOCK</i> – percent of common shares held by outside block-holders of 5% or more of shares outstanding; <i>LEV</i> – ratio of long-term debt-to-assets as of 12/31/2012; <i>ROA</i> – EBIT divided by total assets, otherwise 0; <i>MTB</i> – ratio of market value to book value as of 12/31/2012; <i>LTGN</i> – 1 if firm is in litigious sectors Pharmaceuticals (SIC 2833-2836), Computers (3570-3577), Electronics (3600-3674), Retail (5200-5961), or Software (7370), otherwise 0; <i>ACSIZE</i> – number of AC directors; <i>ACCEXP</i> – proportion of directors who are accounting experts (e.g., CPA, auditor, CAO, CFO, or controller); <i>OTH</i> – proportion of directors who are designated AC financial experts, but are not accounting experts as defined for <i>ACCEXP</i>; <i>FEM</i> – 1 if at least one female AC director, otherwise 0; <i>CHRCEO</i> – 1 if CEO is also the board chairman, otherwise 0; <i>LNBDSIZE</i> – natural log of the number of directors on the board; <i>BDIND</i> – proportion of independent directors on the board; <i>BDMTGS</i> – number of board meetings held in 2012; <i>BIG4</i> – 1 if external auditor a Big Four firm, otherwise 0; and, <i>PSKILL</i> – 1 if at least one politically skilled AC director, otherwise 0.</p>			