Politically skilled audit committee directors and audit fees

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ABSTRACT

Provoking a cause for concern, a decline in audit fees–as a component of total revenue for audit firms from 2006 to 2011–was observed by former Public Company Accounting Oversight Board chairman James Doty. Prior research suggests that audit fees indicate the degree of audit effort exerted by an external auditor, and a decline in fees may suggest a decline in audit quality. In this study, the impact of corporate audit committee directors' political skill on audit fees is examined. Political skill is defined as a system of social competencies that enables an individual to understand others in work-applicable situations and utilize that knowledge to impact others' behavior in ways that heighten one's organizational and/or personal objectives. Prior research suggests that former political and government officials possess political skill, and over the past few decades, they have been appointed to corporate boards in large numbers. Utilizing a hybrid resource dependence theory and agency theory underpinning, arguments as to why differences in the amount of audit fees paid due to the presence of a politically skilled audit committee director are advanced. Archival data from a sample of 258 S&P SmallCap 600 Index firms with a December 31, 2012 fiscal year-end and ordinary least squares (OLS) are used to test the association between an audit committee director's political skill and the amount of audit fees. A marginally significant positive relationship is documented and suggests that a more comprehensive audit is demanded by audit committees with at least one politically skilled director.

Keywords: audit committee, political skill, audit fees

Portions of this manuscript were taken directly from the author's doctorial dissertation. The dissertation, including the portions herein, have not been previously journal published.

INTRODUCTION

Over the years, external audit fees of publicly traded corporations have been the subject of much scrutiny (Securities and Exchange Commission [SEC], 2000; Government Accountability Office [GAO], 2008) and research (Hay, 2013; Hay, Knechel, & Wong, 2006). Simunic and Stein (1996) and Carcello et al. (2002) argue that audit fees represent efficient auditors' economic costs which consist of resource costs (costs attributed to doing additional audit work) and expected future losses (attributed to legal liability). According to Simunic and Stein (1996), those costs are recognized to differ significantly with certain characteristics (e.g. size, riskiness, complexity) of the auditee. Carcello et al. (2002) argue that auditors look to minimize an audit's total cost by finding an optimal balance between resource costs and expected future losses resulting from legal liability. As additional audit effort is rendered, the probability of suffering a liability loss decreases (Carcello et al., 2002), and audit fees charged are likely to increase. The authors provide evidence that suggests that when an auditor faces a higher level of legal liability exposure, that auditor makes adjustments in audit fees nearly exclusively through rendering higher degrees of audit effort, as opposed to simply levying a price premium. Furthermore, Simunic and Stein (1996) argue that the audit committee can demand a significant quantity of audit effort. Given the aforementioned documented association between audit fees and audit effort, it is imperative that the audit committee engages in quality governance when selecting and retaining an external auditor capable of providing a quality, client-specific audit.

Levitt (1998), Blue Ribbon Commission (BRC, 1999), and White (2014) assert several personal characteristics that a good audit committee and audit committee director should possess for good governance. Some characteristics asserted included qualified and toughminded (Levitt, 1998), accountable (BRC, 1999), and conscientious (White, 2014). Such characteristics have often been associated with individuals who are politically skilled (i.e. former political and governmental officials). Furthermore, large numbers of politically skilled individuals have been appointed to corporate boards of directors over the last few decades (Lester, Hillman, Zardkoohi, & Cannella, 2008). Though considerable academic examination has been given to the topic of audit fees and has resulted in the discovery and understanding of several audit fee determinants, no study has investigated the impact of audit committee director political skill on audit fees. This study seeks to fill this gap by advancing arguments with respect to audit committee behavior differences expected as a result of the presence of audit committee directors that are politically skilled.

The motivation for this study arises from the concerns of former Public Company Accounting Oversight Board (PCAOB) Chairman James Doty regarding a decline in the audit fees component of an audit firm's total revenue from 2006 to 2011 (Doty, 2014). In a May 2014 address to attendees of Baruch College's Zicklin School of Business 13th Annual Financial Reporting Conference, Chairman Doty expresses his concerns about the impact that the decline in audit fees may have on audit quality.[1] Although the PCAOB does not regulate audit fees, Chairman Doty finds the trend alarming and questions whether the decline in audit fees suggests a decline in an external audit's scope. Given that auditor effort during an external audit is

[1] Analyzing statistics regarding changes in external auditors of 418 Russell 3000 firms from 2006 to 2011, Chairman Doty's concern was due to an 11.5% decrease in the audit fees those firms reported and 62% of those firms reported a reduction in fees during an engagement's first year (Doty, 2014). Also, the reduction in fees was more pronounced for sizable engagements of at least $3 million, of which 83% of those firms reported reduced audit fees in the external auditor's first year, a 15.7% median reduction (Doty, 2014).

unobservable to investors, Chairman Doty believes such a trend in audit fees may not help to improve public confidence in the external audit, which has been adversely affected by The Great Recession.[2] He goes on to state "the need to understand the effect of these trends and pressures on audit quality" (Doty, 2014). Underpinned by a hybrid resource dependence theory and agency theory foundation, this study uses archival data to investigate whether audit fees paid are impacted by audit committee directors' political due to behavioral differences between audit committees of firms with a politically skilled directors compared to those of audit committees of firms without such a director. Audit fees paid in 2012 by a sample of 258 S&P SmallCap 600 Index firms with a December 31 fiscal year-end are examined using ordinary least squares (OLS) to ascertain whether audit fees are influenced by audit committee directors' political skill.

This study makes at least a few contributions. First, it answers a call for the use of a hybrid agency theory and resource dependence theory underpinning when investigating audit committee characteristics (Cohen et al., 2008). Second, it fills a gap in the auditing and accounting literature in that there appears no prior study has investigated this topic, and only one prior study (Seawright, 2017) has examined the audit committee director characteristic political skill. Lastly, this study contributes to the ongoing corporate governance debate as well as the ongoing 'revolving door' debate which focuses on political and government officials who enter the private sector upon leaving the public sector.

A review of related literature follows in the next section. Sections three and four present the theory development and hypothesis development, respectively. The research methodology is presented in the fifth section followed by the results of empirical tests. The paper concludes with a brief summary and conclusion.

RELATED LITERATURE

Determinants of Audit Fees

Several prior studies have investigated the impact of corporate board characteristics and audit committee characteristics on audit fees paid to the external auditor. Carcello et al. (2002) investigates the association between characteristics (independence, expertise, and diligence) of the board of directors and audit fees (Big Six) for a sample of Fortune 1000 firms. They find significant positive associations for all three board characteristics, but additional analyses document that similar audit committee characteristics of the firms are insignificant in the regression model while in the company of the board variables. Abbott, Parker, Peters, and Raghunandan (2003) investigate the association between audit fees and audit committee characteristics and find evidence that contradicts the findings of Carcello et al. (2002). Abbott et al. (2003) find evidence that in the presence of variables that represent board characteristics, audit committee independence and financial expertise are positively and significantly related to audit fees. Lee and Mande (2005) investigate the relation between audit fees and audit committee independence and diligence and provide evidence (both single equation and simultaneous equations) that both are positively related to audit fees. Using a sample of public Australian firms, Goodwin-Stewart and Kent (2006) investigate the relation between audit fees, audit committee characteristics (including independence and financial expertise, and number of meetings), and the internal audit function. They find that audit fees are positively and

[2] The period of economic turmoil world markets experienced from December 2007 through June 2009.

significantly associated with audit committee meeting frequency, but not significantly related to audit committee independence and financial expertise. Their finding contradicts Abbott et al. (2003) who provide evidence of a positive and significant association between audit fees and audit committee independence and financial expertise. Using a sample of Fortune 500 firms, Vafeas and Wagelein (2007) investigate the relationship between audit committee characteristics and audit fees and find that audit fee levels are positively associated with audit committee size, independence, and financial expertise. Rainsbury, Bradbury, and Cahan (2009) use a sample of unregulated New Zealand firms to investigate the association between audit committee quality (including audit committee independence and accounting expertise) and find no significance among all audit committee quality proxies used. Ittonen, Miettinen, and Vahamaa (2010) use a sample of S&P 500 Index firms to investigate the relation between audit fees and female representation on the audit committee and provide evidence that lower audit fees are likely when a female is the chair of the audit committee. Lastly, Zaman, Hudaib, and Haniffa (2011) use a sample of United Kingdom (UK) Financial Times Stock Exchange (FTSE) 350 firms to examine the association between audit committee effectiveness and audit and non-audit fees using a composite measure to capture audit committee size, independence, diligence, and financial expertise. They provide evidence of a positive relation between audit fees and their audit committee effectiveness composite measure only for clients that are larger.

THEORY DEVELOPMENT

Political Skill

Political skill, a system of social competencies, enables an individual to understand others in work-relevant circumstances and use that acquired knowledge to influence others' behavior in ways that enhances one's personal and/or organizational objectives (Ferris et al., 2005). Researchers believe it can be innate or developed considerably through training or socialization (Ferris et al., 2002). Also, many researchers believe that organizations are inherently political to some degree (Mintzberg, 1985) and that political skill is necessary to be successful in them (Pfeffer, 1981).

A survey of the political skill and organizational politics literature by Ferris et al. (2007) leads the authors to conceptualize political skill as being made up of four dimensions: (1) social astuteness, (2) interpersonal influence, (3) networking ability, and 94) apparent sincerity. The social astuteness dimension encompasses the ability of an individual to be a keen observer of others (Ferris et al., 2007). Socially astute individuals are viewed by others as having a high self-awareness and self-confidence, as well as being accountable to others (Ferris et al., 2007). The interpersonal influence dimension captures an individual's ability to influence others and adapt to different settings and situations (Ferris et al., 2007). Ferris et al. (2007) suggest that this influence enables politically skilled individuals to bring about desired behavior of others. The networking ability dimension encompasses an individual's ability to recognize, develop, and maintain networks that are diverse and extensive (Ferris et al., 2007). This dimension also captures an individual's ability to manage and resolve conflict, negotiate and make deals, as well as to form and maintain coalitions and alliances (Ferris et al., 2007). Lastly, the apparent sincerity dimension captures an individual's ability to seem to possess a high degree of integrity, as well as produce confidence and trust within others around them.

In short, politically skilled individuals are able to be very successful and effective in work-relevant situations. And, considering that divergent beliefs (Dye, 1991) and conflicting interests (Dey, 2008) are common among corporate governance participants, the appointment of politically skilled individuals to corporate boards may improve corporate governance quality.

Resource Dependence Theory and Agency Theory

The board of directors is said to serve a two-fold purpose of providing resources to the firm and monitoring management (Hillman & Dalziel, 2003). Hillman and Dalziel (2003) argue that the social and human capital directors possess impact the board's ability to provide resources and monitor a firm's management. Providing resources is central to resource dependence theory, whereas monitoring management is central to agency theory.

Scholars of resource dependence theory argue that firms depend upon external organizations that operate within the external environment (Pfeffer & Salancik, 1978). That dependency is argued to give rise to uncertainty and risk which impact the performance of firms (Hillman, 2005). In an effort to mitigate or protect against that uncertainty and risk, firms form linkages with those external organizations (Pfeffer & Salancik, 1978). Hillman (2005) argues that the board of directors is the primary method of extracting and absorbing essential components of environmental uncertainty and risk into the firm. Once on the board, those former affiliates and employees of the external organizations provide firms with resources (e.g. skills and competencies) that have been collected about and from the external environment.

Monitoring a firm's management in an effort to mitigate agency costs of the firm is central to agency theory (Jensen & Meckling, 1976). Such costs stem from the separation of ownership and management of a firm (Jensen & Meckling, 1976). Scholars of agency theory argue that, due to conflicting interests and information asymmetry, a firm's management is likely inclined to participate in behavior that maximizes its own utility at the expense of the firm's shareholders (Dey, 2008; Jensen & Meckling, 1976). To deter or minimize that behavior, corporate governance mechanisms are instituted to help mitigate or resolve conflicts of interests. And, the board of directors and its subcommittees are critical to effective corporate governance.

Hillman and Dalziel (2003) argue that studies investigating links between a firm's board of directors and firm performance warrants a hybrid resource dependence theory and agency theory underpinning because of the board's two-fold purpose of providing resources and monitoring management. They argue that using only one theory is inappropriate because doing so provides an incomplete understanding of how that two-fold purpose is carried out by the board. And, a call for a hybrid resource dependence theory and agency theory underpinning for studies examining audit committee characteristics (Cohen et al., 2008) lends credibility to that argument.

HYPOTHESIS DEVELOPMENT

One external organization that impacts corporate firms is the U.S. government. Whether through corporate taxation or industry regulation, the government's operations affect corporate firms. From a resource dependence perspective, such an impact creates a reliance on the government and gives rise to risk and uncertainty that affect a firm's performance and may lead to the formation of linkages (appointment of former public officials to the board of directors) with the government to reduce that risk and uncertainty (Hillman, 2005). Corporate boards have

experienced an influx of former government and political officials as directors over the last forty years (Goldman et al., 2009; Lester et al., 2008), and it is reasonable to believe that some of those officials are serving on the audit committee.

Due to the training they received after entering a public office or assuming a public capacity, political and government officials are argued to possess political skill (Parker et al., 2012). That training is believed to have provided those public officials with the opportunity to acquire and/or develop social and human capital such as extensive contacts and networks, policy expertise, and experience formulating as well as maneuvering legislation (Parker et al., 2012). Morrell and Hartley (2006) and Simpson (2008) argue that public officials must be persistent and self-motivated individuals due to opposition they must overcome and the intricate, ambiguous environments they have to navigate. Hibbing and Theiss-Morse (1995) suggest public officials are skillful at conflict resolution and compromise. Furthermore, public officials are argued to have a strong sense of duty to others and are likely to be ethical and conscientious (Mondak & Halperin, 2008).

Providing effective oversight over the external audit process and the management-auditor relationship is critical to the integrity of the financial reporting and disclosure function of a firm and is the primary responsibility of the audit committee. However, the effectiveness of the audit committee is a function of the quality of its directors (Turley & Zaman, 2007). Turley and Zaman (2007) argue that an audit committee's ability to influence the relationship between management and the external auditor depends on the quality of audit committee directors. BRC (1999), Levitt (1998), and White (2014) assert that accountable, tough-minded, committed individuals who are able to ask difficult questions make good audit committee directors. Similar personal characteristics are associated with politically skilled (public officials) individuals. Public officials have been argued to possess a strong sense of duty and accountability to others (Mondak & Halperin, 2008) and are skilled at conflict resolution and compromise (Hibbing & Theiss-Morse, 1995). Politically skilled audit committee members may communicate with management prior to negotiating the external audit engagement contract with the firm's audit firm. It is plausible that the politically skilled audit committee uses that information provided by management during those communications to demand a more comprehensive (quality) external audit during the audit engagement contract negotiations. So, it is likely such a demand may impact the amount of audit fees levied by the external auditor. Therefore, I put forth the following research question:

H1: Audit committees with at least one politically skilled director will pay more in audit fees than audit committees without such a director.

METHODOLOGY

Multivariate Regression Model

Following prior literature on audit fees (Hay, 2013; Hay et al., 2006), audit fees in this study are modeled as a function of audit client attributes, auditor attributes, and audit engagement attributes. To examine the impact of politically skilled audit committee members, a proxy for the presence of a politically skilled audit committee member (PSKILL) is included in the model to test the association between it and audit fees, while controlling for other associations. The model is as follows:

$$LNAFEES = \beta_0 + \beta_1 LNAT + \beta_2 SUBS + \beta_3 INVTA + \beta_4 ROA + \beta_5 LEV + \beta_6 ICMW + \beta_7 BIG4 + \beta_8 NEWAUD + \beta_9 ARL + \beta_{10} PSKILL + \varepsilon$$

Where:

LNAFEES=	The natural log of audit fees.
LNAT=	The natural log of total assets as of 12/31/2012.
SUBS=	The number of subsidiaries.
INVTA=	The ratio of inventory to total assets.
ROA=	Return on assets measured as earnings before interest and taxes divided by total assets.
LEV=	The ratio of long-term debt to total assets as of 12/31/2012.
ICMW=	1 if an internal control material weakness reported, otherwise 0.
BIG4=	1 if external auditor a Big Four firm (Deloitte, PricewaterhouseCoopers, Ernst & Young, or KPMG), otherwise 0.
NEWAUD=	1 if external auditor tenure equal to 3 or less years, otherwise 0.
ARL=	The number of calendar days between the firm's fiscal year-end and audit report date.
PSKILL=	1 if at least one politically skilled director on the audit committee, otherwise 0.

The dependent variable, LNAFEES, is the natural log of audit fees paid in fiscal year 2012. Audit fee data were extracted from Audit Analytics. The independent variable particular interest, PSKILL, was hand-collected from 2012 proxy statements filed with the SEC. The data hand-collection process involved identifying audit committee directors after reading the audit committee report, reviewing those directors' background information found in the proxy statements, then assessing whether they possessed political skill by using a modified version of the Goldman et al. (2009) political connection classification measurement.[3] Audit committee directors who previously served in an international or federal governmental or political office, or as governor of a state or mayor of a city, were determined politically skilled.

Audit Client Attributes. Several control variables that proxy for audit client attributes are used in the model. Audit client size (LNAT) is a commonly used control variable that proxies for the complexity of the audit client as well as monitoring demands. Audit client size is measured as the natural log of total assets. Larger audit clients are expected to pay more in audit fees than smaller audit clients. The number of subsidiaries (SUBS) a parent company has is a commonly used control variable that also proxies for complexity. Audit firm clients with more subsidiaries are expected to pay more in audit fees. The inventory of audit clients has been documented as being challenging to audit due to complexity or the degree of judgement involved in valuing inventory (Simunic, 1980; Newton & Ashton, 1989). This leads to greater inherent risk which is proxied in this study by the ratio of inventory to total assets (INVTA). Audit clients with larger amounts of inventory are expected to pay more in audit fees than clients with smaller amounts. The profitability of an audit client poses a risk to auditor and such a risk is likely to lead to higher audit fees. Return on assets (ROA) is used proxy for profitability. A

[3] Goldman et al. (2009) develops a classification scheme that determines if a member of a board of directors is politically connected. The classification scheme determined a board member as being politically connected if he/she served in a governmental or political office at the international, federal, state, or local level of government or politics. See Goldman et al. (2009) for additional information.

positive association is expected between negative ROA and audit fees, and a negative association is expected when ROA is positive. An audit client's leverage poses a risk to the auditor as since it may indicate a client's likelihood of failing (Simunic, 1980). Measured as the ratio of long-term debt to total assets (LEV), a positive association between leverage and audit fees is expected. The presence of an internal control material weakness (ICMW) is likely to result in higher audit fees paid due to higher risk and the need for additional audit work. A positive association is expected between the presence of an internal control material weakness and audit fees.

Auditor Attributes. Two control variables that proxy for external auditor attributes are used in the model. Auditor size (e.g. Big Four) is commonly used as a control variable to proxy for auditor quality. The higher the quality of auditor, the more in audit fees the auditee is expected to pay. BIG4 proxies for auditor quality in the model, and a positive association is expected between it and audit fees. External auditors with relatively short tenures (e.g. less than 3 years) auditing a client have been suggested as being associated with pricing an audit for an amount less than the cost (lowballing). NEWAUD proxies for auditor tenure in the model, and a negative association is expected between it and audit fees.

Engagement Attributes. One control variable that proxy for an audit engagement attribute is used in the model. Audit report lag represents the time that has passed since balance sheet date and up to the audit report being issued. Longer audit report lags have been documented to be associated with higher audit fees (Hay et al., 2006). ARL proxies for audit report lag in the model. A positive association between it and audit fees is expected.

Data and Sample

A few factors influenced the sample selection for this essay. First, due to having to hand-collect data from proxy statements (DEF 14A) filed with the SEC, a manageable sample size was desired. Second, due to their size, smaller firms tend to have less alternative monitoring mechanisms (e.g. analysts) than larger firms; therefore, the significance of the audit committee should be greater for smaller firms. Lastly, due to changes in regulations, the analysis of this study is limited to firms having a fiscal year-end of December 31. And, using the sample selection criteria outlined above, the analysis in this study is limited to S&P SmallCap 600 Index firms with a fiscal year-end of December 31, 2012.

Table 1 (Appendix) presents sample selection information and information pertaining to the industry distribution of the firms that comprise the sample. Compustat's Execucomp database was utilized to identify the initial sample of S&P SmallCap 600 Index firms. Firms with a fiscal year-end other than December 31, 2012 were excluded. Using the ticker symbols of the remaining firms, financial data for the firms were extracted from the Compustat Industrial Annual database and Audit Analytics, then merged. Firms with missing COMPUSTAT and Audit Analytics data were excluded, followed by the exclusion of firms with missing proxy statements, firms with military-only politically skilled audit committee directors, and firms having politically skilled audit committee directors having previously held state and local government positions lower than governor or mayor. The proxy statements provided background descriptions of the audit committee directors, and those descriptions were used to determine if an audit committee director possessed political skill. Such a determination was made using a modified version of the political connection classification scheme developed in Goldman et al. (2009). Adhering to that modified version, an audit committee director is

considered politically skilled if he or she previously held a government or political position at the international or federal level, or as a state governor or city mayor. Audit committee directors that did not meet that criteria were excluded from the sample in line with prior literature that investigated political connections on corporate boards.

The final sample is comprised of 258 firms, of which 202 have at least one politically skilled audit committee director.

RESULTS

Descriptive Statistics

Table 2 (Appendix) presents descriptive statistics for the study's full sample while Table 3 provides descriptive statistics on subsamples created based on groupings regarding whether a firm has a politically skilled audit committee director (PSKILL=1) or not (PSKILL=0). The mean (median) amount of audit fees for the full sample is $1.42 ($1.25) million, whereas mean (median) audit fees for firms with a politically skilled audit committee director and those with such a director are $1.57 ($1.44) million and $1.28 ($1.06) million, respectively. Firms with a politically skilled director, on average, are larger than firms without such a director as reflected by mean (median) total assets of $1.47 ($1.02) billion and $996.27 ($700.76) million, respectively. On average, firms with a politically skilled director are more complex than firms without such a director as reflected by the mean (median) number of subsidiaries of 38.89 (27.00) and 29.38 (15.00), respectively. Also, firms with a politically skilled audit committee director are more leveraged than firms without such a director as reflected by mean (median) leverage ratios of 0.24 (0.25) and 0.16 (0.11), respectively.

Univariate Analysis

Table 4 (Appendix) presents univariate analysis information according to groupings regarding whether a firm has at least one politically skill audit committee director (PSKILL=1) or not (PSKILL=0). An assessment of the p-values of the variables indicates a highly statistically significant difference in means for the dependent variable, the natural log of audit fees and two control variables, the natural log of total assets and leverage. Analysis of the natural log of audit fees indicates a highly statistically significant (p-value = <.01) difference in means for the subsamples. This finding suggests that firms with audit committees that have at least one politically skilled director pay more in audit fees likely due to demanding a more thorough, quality audit which would involve more audit work and lead to higher fees. Analysis of the natural log of total assets indicates a highly statistically significant (p-value = <.01) difference in means for the two subsamples. This finding suggests that politically skilled directors are more likely to be found on the audit committee of large firms. Lastly, analysis of firm leverage indicates a highly statistically significant (p-value = <.01) difference in means for the subsamples. This finding may suggest that easy or preferential access to credit markets is more likely to be afforded to firms with a politically skilled individual on the audit committee.

Regression Results

Table 5 (Appendix) presents results from estimating the OLS regression model for this essay. The overall regression model is significant (F=24.57, p<.01), and the adjusted r-squared (Adj. R^2) value is .48. An assessment of those values appears to indicate the model has a good fit and explains much of the variation in the dependent variable. Of the control variables which proxy for audit client attributes, two (LNAT and SUBS), are highly significant with positive coefficients, one (LEV) is highly significant with a negative coefficient, and the remaining two (INVTA, ROA) are not significant. Regarding firm size and complexity, these findings suggest that larger and more complex firms require a more thorough audit and are more likely to pay higher audit fees. Regarding leverage, this finding suggests that more leveraged firms are less likely to pay higher audit fees. As for control variables that proxy for auditor attributes, both BIG4 and NEWAUD are highly significant, though the coefficients are positive and negative, respectively. These findings suggest that higher quality audit firms are more likely to charge more in fees for conducting an external audit, whereas auditors with less tenure (3 or less years with the auditee) are more likely to charge less fees (lowballing possible) for conducting the audit. As for the engagement attribute proxy ARL, it highly significant with a positive coefficient which suggests that firms that experience a longer audit report lag are more likely to incur higher audit fees. The control variable ICMW is found to be insignificant. Lastly, the coefficient (0.12) for the primary variable of interest (PSKILL) is positive and marginally significant. This finding suggests, on average, that firms with at least one politically skilled audit committee director pay audit fees that are 12 percent higher than firms without such a director.

Sensitivity analysis was performed on three control variables: LNAT, ROA, and LEV. According to Hay et al. (2006), more than twenty prior studies on audit fees found positive and significant results using sales to proxy for firm size, so the natural log of sales was substituted for the natural log of total assets in the model. Though the sales proxy is found to be positive and highly significant after estimating the model, the fit of the model declines from an adjusted r-squared (Adj. R^2) of .48 to .44. Also, the natural log of the market value of equity is substituted in the model for the natural log of total assets, and it is found be positive and highly significant, but model fit diminishes further (from Adj. R^2 of .48 to .39). Both variables are excluded from the model. The substitution of a dichotomous dummy earnings loss variable to assess the sensitivity of ROA yields insignificance after estimating the model. And, using a different leverage proxy (total debt to total assets) to assess the sensitivity of LEV results in insignificance after estimating the model.

SUMMARY & CONCLUSION

The amount of audit fees paid to the external auditor has garnered much attention and scrutiny over the years. A recent trend of declining audit fees as a segment of the total revenues of an audit firm presented a cause for alarm for former PCAOB chairman James Doty (2014) who questioned whether a decrease in audit fees suggests a decrease in audit scope. Audit fees represent the economic costs (resource costs and expected future legal liability) of efficient external auditors, and those auditors look to find a balance between those costs in an effort to minimize the total cost of conducting an external audit (Simunic & Stein, 1996). Although those economic costs can differ greatly due to certain auditee characteristics (e.g. size and complexity), the trend noticed by chairman Doty (2014) leads him to inquire if such a trend impacts audit quality. He also suggests the need to understand such a trend. Given the importance of the role of the audit committee in selecting and retaining the external auditor and the importance of

responding to suggestions of key stakeholders like PCAOB, it is important and useful to examine possible undiscovered determinants of audit fees such as audit committee directors' political skill.

This study examines and empirically tests the association between audit fees and audit committee directors' political skill. Arguments for a positive association between the presence of a politically skilled audit committee director and the amount of audit fees paid to the external auditor are advanced. The sample in this study is comprised of 258 S&P SmallCap 600 Index firms having a December 31, 2012 fiscal year-end. Highly statistically significant univariate evidence and marginally significant evidence from estimating the OLS regression model are documented. These findings suggest that audit committees with at least one politically skilled director demand a more comprehensive external audit. A more comprehensive audit should lead to additional audit work which should lead to higher audit fees.

This study's findings make several contributions. First, though there have been several studies to examine audit committee characteristics, there appears to be a dearth of studies that have examined audit committee directors' political skill. Second, this study contributes to the accounting and auditing literature by investigating a non-accounting audit committee characteristic that has been voluntarily added to the audit committee. Third, this study answers the call for studies to use a hybrid resource dependence theory and agency theory underpinning when investigating audit committee characteristics (Cohen et al., 2008). Lastly, this study contributes to the ongoing 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.

This study is not absent of limitations. The audit fees proxy used is an imperfect proxy when attempting to capture the quality of the external audit. Using audit fees also does not provide the ability to determine the actual scope of the audit or the effort put forth by the external auditor during the audit. Future research could possibly examine this study's topic by obtaining (via interviews, questionnaires, and/or surveys) and using audit firm proprietary data that document the scope of the audit and the number of hours rendered by the external auditor while conducting the audit. Lastly, the political skill proxy used is an imperfect proxy as well. Using prior experience in a high-level political or government position as a proxy may not best capture an audit committee director's political skill. Future research on this study's topic could possibly obtain better political skill data through the use of a well-developed questionnaire or survey instrument.

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APPENDIX

TABLE 1:
Sample Selection

S&P SmallCap 600 Index firms in 2012 per Compustat Execucomp	600
Less: Firms with fiscal year-end other than 12/31/2012	-170
Less: Financial industry firms (SIC codes 6000-6999)	-113
Less: Firms missing Compustat data	-10
Less: Firms missing Audit Analytics data	-7
Less: Firms missing proxy statements (DEF 14A)	-14
Less: Firms with military-only politically skilled audit committee directors	-15
Less: Firms with politically skilled audit committee directors from state and local governmental/political levels lower than governor or mayor	-13
Final Sample	258

TABLE 2:
Descriptive Statistics

Variable	n	Mean	Std. Dev.	25th Percentile	Median	75th Percentile
AFEES (millions)	258	1.42	0.87	0.88	1.25	1.77
AT (millions)	258	1234.44	1164.56	0.47	862.07	1.73
SUBS	258	34.14	45.05	10.50	21.00	38.25
INVTA	258	0.10	0.11	0.00	0.08	0.15
ROA	258	0.09	0.08	0.05	0.08	0.12
LEV	258	0.20	0.18	0.05	0.18	0.30
ICMW	258	0.05	0.22	0.00	0.00	0.00
BIG4	258	0.85	0.36	1.00	1.00	1.00
NEWAUD	258	0.07	0.25	0.00	0.00	0.00
ARL	258	61.47	15.67	55.25	59.00	66.50
PSKILL	258	0.22	0.41	0.00	0.00	0.00

The sample includes 258 observations from non-financial S&P SmallCap 600 Index firms with a December 31, 2012 fiscal year end. Refer to Table 1 for sample selection information. Definitions of variables are as follows: PSKILL – 1 if at least one former politically skilled director on the AC; AFEES – total amount of audit fees; AT – total assets as of 12/31/2012; SUBS – number of subsidiaries; INVTA – ratio of inventory to total assets; ROA – EBIT divided by total assets; LEV – ratio of long-term debt to total assets as of 12/31/2012; BIG4 – 1 if external auditor a Big 4 firm, otherwise 0; NEWAUD – 1 if external auditor tenure equal to 3 or less years, otherwise 0; ARL – number of calendar days between the firm's fiscal year end and audit report date; and, ICMW – 1 if an internal control material weakness reported, otherwise 0.

TABLE 3:
Descriptive Statistics by Political Skill

	Firms without Audit Committee Political Skill (PSKILL=0)						Firms with Audit Committee Political Skill (PSKILL=1)					
Variable	n	Mean	Std. Dev.	25th PCTL	Median	75th PCTL	n	Mean	Std. Dev.	25th PCTL	Median	75th PCTL
AFEES (millions)	202	1.28	0.92	0.66	1.06	1.62	56	1.57	0.82	1.10	1.44	1.93
AT (millions)	202	996.27	1081.54	394.468	700.76	1163.79	56	1472.61	1247.58	540.81	1023.38	2294.35
SUBS	202	29.38	46.99	7.00	15.00	32.00	56	38.89	43.10	14.00	27.00	44.50
INVTA	202	0.10	0.12	0.00	0.07	0.15	56	0.11	0.11	0.01	0.10	0.15
ROA	202	0.09	0.10	0.05	0.08	0.13	56	0.08	0.07	0.04	0.08	0.11
LEV	202	0.16	0.18	0.00	0.11	0.27	56	0.24	0.18	0.10	0.25	0.33
BIG4	202	0.83	0.38	1.00	1.00	1.00	56	0.88	0.33	1.00	1.00	1.00
NEWAUD	202	0.08	0.27	0.00	0.00	0.00	56	0.05	0.23	0.00	0.00	0.00
ARL	202	62.61	22.51	56.00	59.00	67.00	56	60.32	8.83	54.50	59.00	66.00
ICMW	202	0.06	0.25	0.00	0.00	0.00	56	0.04	0.19	0.00	0.00	0.00

The full sample includes 258 observations from non-financial S&P SmallCap 600 Index firms with a December 31, 2012 fiscal year end. Refer to Table 1 for sample selection information. Definitions of variables are as follows: PSKILL – 1 if at least one former politically skilled director on the AC; AFEES – total amount of audit fees; AT – total assets as of 12/31/2012; SUBS – number of subsidiaries; INVTA – ratio of inventory to total assets; ROA – EBIT divided by total assets; LEV – ratio of long-term debt to total assets as of 12/31/2012; BIG4 – 1 if external auditor a Big 4 firm, otherwise 0; NEWAUD – 1 if external auditor tenure equal to 3 or less years, otherwise 0; ARL – number of calendar days between the firm's fiscal year end and audit report date; and, ICMW – 1 if an internal control material weakness reported, otherwise 0.

TABLE 4:
Univariate Analysis

	Firms without Audit Committee Political Skill (PSKILL=0; n=202)			versus	Firms with Audit Committee Political Skill (PSKILL=1; n=56)					
Variable	Mean	Std. Dev.	Median		Mean	Std. Dev.	Median	Diff. in Means	t-statistic	Pr>|t|
LNAFEES	13.87	0.61	13.88		14.12	0.58	14.18	-0.25	-2.77	.01
LNAT	6.53	0.85	6.55		6.92	0.93	6.93	-0.39	-2.97	.00
SUBS	29.38	46.99	15.00		38.89	43.10	27.00	9.51	-1.36	.17
INVTA	0.10	0.12	0.07		0.11	0.11	0.10	-0.01	-0.48	.63
ROA	0.09	0.10	0.08		0.08	0.07	0.08	0.01	0.67	.51
LEV	0.16	0.18	0.11		0.24	0.18	0.25	-0.08	-3.03	.00
ICMW	0.06	0.25	0.00		0.04	0.19	0.00	0.03	0.94	.35
BIG4	0.83	0.38	1.00		0.88	0.33	1.00	-0.05	-0.86	.39
NEWAUD	0.08	0.27	0.00		0.05	0.23	0.00	0.03	0.64	.52
ARL	62.61	22.51	59.00		60.32	8.83	59.00	2.29	1.16	.25

The t-test of means uses the pooled method when the underlying variances are equal and the Satterthwaite method when they are unequal. The full sample includes 258 observations from non-financial S&P SmallCap 600 Index firms with a December 31, 2012 fiscal year end. Refer to Table 1 for sample selection information. Definitions of variables are as follows: PSKILL – 1 if at least one former politically skilled director on the AC; LNAFEES – natural log of audit fees; LNAT – natural log of total assets as of 12/31/2012; SUBS – number of subsidiaries; INVTA – ratio of inventory to total assets; ROA – EBIT divided by total assets; LEV – ratio of long-term debt to total assets as of 12/31/2012; BIG4 – 1 if external auditor a Big 4 firm, otherwise 0; NEWAUD – 1 if external auditor tenure equal to 3 or less years, otherwise 0; ARL – number of calendar days between the firm's fiscal year end and audit report date; and, ICMW – 1 if an internal control material weakness reported, otherwise 0.

TABLE 5:
Regression Results

PANEL A: Regression Model

$$LNAFEES = \beta_0 + \beta_1 LNAT + \beta_2 SUBS + \beta_3 INVTA + \beta_4 ROA + \beta_5 LEV + \beta_6 BIG4 + \beta_7 NEWAUD + \beta_8 ARL + \beta_9 ICMW + \beta_{10} PSKILL + \varepsilon$$

PANEL B: Estimation of Regression Model ($F=24.57$, $p < .01$, $R^2 = .50$, Adjusted $R^2 = .48$)

Variable	Coefficient	t-statistic	p-value
Intercept	10.85	36.27	.00
LNAT	0.39	8.70	.00
SUBS	0.00	4.41	.00
INVTA	0.33	1.34	.18
ROA	-0.40	-1.25	.21
LEV	-0.63	-3.17	.00
ICMW	0.08	0.70	.48
BIG4	0.22	2.73	.01
NEWAUD	-0.27	-2.51	.01
ARL	0.01	3.46	.00
PSKILL	0.12	1.68	.09

Refer to Table 1 for sample selection information. Definitions of variables are as follows: LNAFEES – natural log of audit fees; LNAT – natural log of total assets as of 12/31/2012; SUBS – number of subsidiaries; INVTA – ratio of inventory to total assets; ROA – EBIT divided by total assets; LEV – ratio of long-term debt to total assets as of 12/31/2012; BIG4 – 1 if external auditor a Big 4 firm, otherwise 0; NEWAUD – 1 if external auditor tenure equal to 3 or less years, otherwise 0; ARL – number of calendar days between the firm's fiscal year end and audit report date; ICMW – 1 if an internal control material weakness reported, otherwise 0; and, PSKILL – 1 if at least one politically skilled director on the audit committee.