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Corporate political donations and audit fees: Some evidence from Australian audit pricing

Ferdinand A. Gul

University of Sunshine Coast, Sippy Downs, Australia

Arifur Khan

Deakin University, Burwood, Australia

Karen Lai

Shenzhen Audencia Financial Technology Institute, Shenzhen University, Shenzhen, China

Dessalegn Getie Mihret

RMIT University, Melbourne, Australia

Mohammad Badrul Muttakin

Deakin University, Burwood, Australia

Correspondence:

Mohammad Badrul Muttakin,
Deakin Business School,
Department of Accounting,
Deakin University, 221 Burwood Highway, Burwood,
Victoria 3125, Australia.
Email: m.muttakin@deakin.edu.au

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Abstract

We examine whether corporate political donations (CPDs) are associated with audit fees in the Australian setting. Our baseline results based on observations of Australian top 500 non-financial companies show that, on average, firms with CPDs are associated with about 9% lower audit fees than firms without CPDs consistent with the strategic investment or resource dependency view. Using path analysis, we next show that high earnings quality resulting from strategic benefits of CPDs explains the association. Overall, these results confirm firms use CPDs as strategic investments that are associated with lower earnings management, which leads to lower audit risk and hence reduced audit fees.

Keywords Political donation, audit fees, audit risk, strategic investments, agency costs, government contracts

JEL Classification: D72; G34; M42

1. Introduction

Prior studies based largely on US data have shown that corporate political donations (CPDs) are associated with higher audit fees consistent with agency costs arguments (Gounopoulos, Kallias, Kalias, & Tzeremes, 2017; Gounopoulos, Loukopoulos, & Loukopoulos, 2019). In the U.S., corporations make CPDs through Political Action Committees (PACs) to political candidates running for either Presidential, Senate or House Offices (Wallace, 2013).¹ We extend prior studies by examining whether CPDs are associated with audit fees in the Australian setting, which is different from the U.S. (see discussion later). Auditors as independent assurers of financial statements are directly connected with firms' internal controls and financial reporting quality. As such, assessing their response will provide some insights into how assurers of financial statements view CPDs.²

We are motivated to examine the link between CPDs and audit fees in Australia for the following reasons. First, there are two opposing arguments regarding the links between political contributions and firm value (Hillman & Dalziel, 2003; Hillman, Withers, & Collins, 2009; Cooper, Gulen, & Ovtchinnikov, 2010; Boubakri, Guedhami, Mishra, & Saffar, 2012) with differing implications for audit pricing. Based on the premise that the impact of CPDs on corporate performance and the resulting implications on audit pricing depend on the institutional setting, we investigate the association between CPDs and audit fees in Australia. We are motivated to examine this issue for the following reasons. First, like other developed countries such as the U.S., the issue of CPDs in Australia has attracted much attention. For example, Butler (2016) discusses concerns surrounding CPDs in Australia. He draws attention to the fact that for the period 2014 to 2015, the Liberal Party received \$A10.418 million in donations, some of which are from the corporate sector like Village Roadshow Ltd, which donated \$A5 million in 2015 to both the Liberal and Labor parties (McGhee, 2016; Anderson, Tadros, Han, & Chenoweth, 2017).

Political donations, especially from the corporate sector, attract media and public attention partly because donating firms may use CPDs as a strategic investment to influence policy decisions in their favor or facilitate the donating firm's access to government contracts. Indeed, prior studies documented that interest in government contracts drives political donations (Witko, 2011; Zullo, 2006). This observation is consistent with the view that corporate political activity (CPA) enables companies to exploit political institutions to establish informal networks that produce benefits to companies engaged in such activity (Fung, Gul, & Radhakrishnan, 2015) as networks of social relations influence economic action (Granovetter, 1985). Given the importance of CPDs in the Australian corporate sector (Butler, 2016; Anderson et al., 2017), it is surprising that little is known about the effects of CPDs on corporate outcomes.

Second, the issue of CPDs has recently attracted the attention of the media, academics, and practitioners, especially since the U.S. Supreme Court decision in *Citizens United v. Federal Election Commission* in January 2010. The decision effectively approved unbridled corporate campaign donations in the U.S. CPDs have also become a common feature in many developed and developing countries, with some academics calling for a better understanding of whether CPDs have a positive or negative effect on corporate behavior and corporate outcomes in different countries (e.g., Torres-Spelliscy & Fogel, 2011; Chatterjee & Sahoo, 2014). Like in the U.S. and the UK, CPDs are commonplace in Australia, which gives businesses political access to further their interests and provide some benefits. Larger CPDs help Australian businesses to organize one-to-one meetings with the members of the cabinet at short notice, whereas smaller CPDs facilitate the opportunity to meet with politicians at dinners or receptions or attend a privileged advance presentation of upcoming policy initiatives (McMenamin, 2008). Given that CPDs are commonplace in the Australian

corporate landscape, a better understanding of how they might affect corporate outcomes is warranted.

Third, most of the prior studies are in the U.S. setting where litigation risk of auditors is relatively high. However, in many other jurisdictions, such as Australia auditor litigation risk is relatively lower (see for example, Khurana & Raman, 2004). As such, it is not clear whether auditors' response to CPDs in Australia would be similar to that of the U.S. If, indeed, auditors face significantly lower litigation risk, they may be less concerned about agency costs considerations in the determination of audit fees. In addition, unlike other Western countries such as the U.S., where some legislative restrictions are imposed on political donations (Prahbat, 2012), there are no caps on CPDs in Australia. Given these differences, it is unclear how Australian auditors would react to CPDs.

Finally, the limited prior studies, mainly in the U.S., reported a positive association between CPDs and audit fees in the U.S. (Gounopoulos et al., 2019), which supports the agency cost hypothesis. However, these studies have not considered some possible channels that could suggest situations that are a direct reflection of CPDs as a strategic investment. For example, Preuss and Konigsgruber (2021) point out that firms with CPDs improve their access to financial resources in terms of "procurement of contracts". Anecdotal evidence in Australia suggests that increased government contracts as a result of CPDs support the strategic investment explanation. One such outcome of strategic investment is higher profitability and a lower tendency for the firms to overstate earnings (see later for evidence).

Last but not least there are two competing theories that explain the motivation behind corporate decisions to make CPDs. On the one hand, following resource dependency theory³ (Gounopoulos et al., 2019), firms may use CPDs as a strategic spending channel to influence policies and regulation (Cooper et al., 2010; Duchin & Sosyura, 2012; Gordon & Hafer, 2005) or gain access to government contracts (Witko, 2011; Zullo, 2006) and improve firm

performance. For example, Cooper et al. (2010), in a U.S. study, find that firms participating in the political contributions process achieve “real economic benefits” and create “positive net present value investments” (p. 719). According to this theory, and based on Simunic’s (1980) argument regarding the association between an audit client’s risk factors and audit fees, it can be argued that firms with CPDs are more likely to be associated with lower audit risk and hence lower audit fees.

On the other hand, other studies based on agency theory argue that managers invest in CPDs to pursue private benefits at the expense of shareholders (Hadani, Dahan, & Doh, 2015; Gounopoulos et al., 2019). The private benefits obtained include exchanging favors (Claessens, Feijen, & Laeven, 2008), improving managers’ reputation (Hadani et al., 2015), and hoping to obtain political positions (Gama, Galilea, Bandeira-de-Mello, & Marcon, 2019). These private benefits favor the interests of directors and managers and could diverge from those of shareholders. Thus, CPDs could adversely affect firm outcomes by exacerbating agency costs and moral hazard problems (Stiglitz, 2012; Aggarwal, Meschke, & Wang, 2012; Kostovetsky, 2015). In line with the agency rent-seeking perspective, Gounopoulos et al. (2019), using U.S. data, find a positive association between CPDs and audit fees. However, given auditors’ litigation risk is much lower in non-US settings (see for example, Khurana & Raman, 2004), whether Australian auditors perceive CPDs as increasing or reducing audit risk is unknown.

Based on the supply-side argument for determining audit fees (Gul & Tsui, 1998; Morgan & Stocken, 1998), we argue that CPDs may lead to reduced audit fees to donating firms. That is, auditors assess client characteristics in making audit pricing decision such that auditor charge higher (lower) audit fees when client’s characteristics are likely to increase (reduce) audit risk (Simunic, 1980). The International Auditing and Assurance Standard (IAASB) 315 (IAASB, 2019) provides guidance to auditors for audit risk assessment using

the audit risk model. Using this model and the established association between audit risk factors and audit fees, we argue that CPDs are likely to reduce audit fees through (1) reduced inherent risk⁴ potentially originating from favorable political and regulatory treatment; and (2) government contracts facilitated by political donations (e.g., Cooper et al. 2010; Oliver & Holzinger, 2008). Furthermore, favorable government treatment may reduce the likelihood of earnings management as donating firms may perceive reduced regulatory scrutiny (Ramanna & Roychowdhury, 2010). Ramanna and Roychowdhury (2010) draw on Watts and Zimmerman's (1978) political cost hypothesis, which predicts that larger companies are more likely to attract higher taxes and costly regulatory oversight due to higher visibility and scrutiny. As a result, these companies choose accounting methods that defer reported earnings from current to future periods. Jones (1991), in a similar vein, extended the political cost hypothesis and showed that firms manage earnings downward during import relief investigations and when they obtain benefit from government-sponsored import relief attempts. Based on these ideas, we argue that as auditors employ a risk-based audit approach (Schultz Jr., Bierstaker, & O'Donnell, 2010; Knechel, 2007), reduced regulatory scrutiny resulting from strategic investment in political donations may lead to reduced pressure on the firm to manage earnings, thereby lowering audit risk and consequently reducing audit fees.

We undertake this empirical investigation using a dataset of the top 500 non-financial companies listed on the Australian Securities Exchange (ASX). Our findings indicate that donating firms pay significantly lower audit fees compared to their non-donating counterparts. We also perform path analysis to show that CPDs are associated with lower audit fees through lower earnings management. In support of our argument that CPDs are strategic investments, we show that firms with CPDs and government contracts are more likely to improve their firm performance, proxied by ROA, in the subsequent period.

In contrast to the findings of Chaney, Faccio and Parsley (2011) that there is a positive relationship between political connection and earnings management, our path analysis suggests a negative relation between CPDs and earnings management in Australia. This contrast supports the theoretical distinction we have outlined between the two forms of CPA, namely political connections used in the Chaney et al. (2011) study and CPDs. Overall, our results are consistent with Correia (2014), who documented that U.S. firms making political donations are related to lower risk of SEC enforcement actions and face lower penalties associated with such actions.

We contribute to the debate on CPDs regarding the relationship between CPDs and firm outcomes (Ansolabehere, Snyder, & Ueda 2004; Werner, 2011; Aggarwal et al., 2012; Kostovetsky, 2015; Cooper et al., 2010) in the following ways. First, while CPDs produce direct economic benefit to the firm and bear implications for financial reporting, prior research largely focused on aggregate market-based measures of firm performance (e.g., Cooper et al., 2010) and SEC enforcement action and penalties (e.g., Gorden & Hafer, 2005). The findings of the present study demonstrate that previously documented association of CPDs with maximization of shareholder wealth and SEC enforcement need to be extended to shed light on the possible links between political donations, financial reporting and auditor judgement. Second, by exploring the association between CPDs and audit fees, our study extends the recent literature (e.g., Correia, 2014; Aggarwal et al., 2012) that demonstrates the link between political-economic factors and accounting numbers.

Finally, CPDs represent the “tip of the iceberg” of the whole business of corporate political activities in Australia (Wood & Griffiths, 2018) and thus understanding the links between CPDs and the audit process is a small step in understanding the audit implications of CPDs within this overall framework of corporate political activities. More generally, the study enriches the audit fee literature by demonstrating that CPD is an important audit risk

factor that influences audit fee determination in the Australian environment. The present study offers this new empirical evidence.

In the following section, we provide a background on CPDs in Australia, review related literature, and develop hypotheses. We outline the research design in Section 3. Section 4 reports and discusses the results, followed by further analysis in Section 5. The final section concludes the paper.

2. Background and hypothesis

2.1 Background: Corporate political donations in Australia

CPDs are commonplace in Australia, where no restrictions apply on such donations, except that donating firms are required to disclose the donations to the Australian Electoral Commission (AEC). A study of political finance in Australia (Tham & Young, 2006) documented that CPDs constitute a major source of funding for political parties. Australian law allows companies to donate directly to political parties (Australasian Centre for Corporate Responsibility, 2016), compared to the practice in the U.S., where companies are permitted to make political donations only through separate Political Action Committees (PACs) (Prabhat, 2012). Like the practice in the U.S. (Prabhat, 2012), Australian companies are not required to seek shareholder approval to make political donations, nor do they disclose political donations in annual reports. This contrasts with the practice in the United Kingdom, where corporations are required to secure shareholder approval (Torres-Spelliscy & Fogel, 2011) to make political donations and disclose the donations in annual reports (Chatterjee & Sahoo, 2014).

Unlike other Western countries such as the US, where some legislative restrictions are imposed on political donations (Prahbat, 2012), no such restrictions or caps apply to CPDs in Australia. Further, Australian companies that donate to political parties are not required to

disclose such donations in annual reports, stand-alone reports, or corporate websites. Donating companies are only required to submit returns by 17 November each year to the Australian Election Commission (AEC), disclosing the aggregate amounts of political donation exceeding a set annual threshold. The AEC releases on its website information about political donations, donors, associated entities, and political parties on the first working day in February every year. The AEC imposes A\$1,000 fine on companies that fail to submit their return disclosing necessary information on political donations by the due date. Yet, there are concerns regarding a lack of sufficient transparency in corporate political donations (Tham & Young, 2006).

2.2. Contrasting theories of corporate political donations

Theoretical arguments and prior research suggest that the link between CPDs and audit fees could be negative, thereby supporting the resource dependency (strategic investment) view or positive, which is consistent with the agency cost argument. CPDs can serve as a strategic investment through which firms develop relations with politicians to influence policymaking (Hillman & Hitt, 1999) and/or receive government contracts (Witko, 2011; Zullo, 2006). CPDs may serve as a form of investment in political capital. The resource dependency literature shows that firms can reduce environmental uncertainty by tapping into the resources of the political system (Hillman et al., 2009; Hillman, Keim, & Schuler, 2004; Pfeffer & Salancik, 1987). Prior studies (e.g., Mullery, Brenner, & Perrin, 1995) link CPDs with resource dependency arguments. Humphries (1991) argues that donating companies may exchange information with policymakers and can achieve greater success in the policy arena. Furthermore, CPDs could benefit the donating firms through direct subsidies (Stratmann, 1991), market protection (Lenway, Morck, & Yeung, 1996), lower taxes (Richter, Samphantharak, & Timmons, 2009; Bo, 2006), and access to

government contracts (Witko, 2011). Additionally, the industrial organization literature shows that CPAs such as CPDs can enhance corporate profitability through restricted competition and ease of entry into protected markets (Dean, Vryza, & Fryxell, 1998; Esty & Caves, 1983; Stigler, 1971).

Prior research also documented that political donations result in positive effects on firm outcomes. Cooper et al. (2010) use a comprehensive database of PAC donations in the U.S. and find a positive relationship between political donations and future stock returns of firms. They also documented that the relation is more pronounced when donations are weighted toward House candidates, Democrats, and candidates who reside in the same state in which the firm is headquartered. They conclude that political donations enhance firm value. Brown, Drake, and Wellman (2015) examine whether firms that invest in relationships with tax policymakers via campaign donations accrue greater future tax benefits. Their findings show that the most politically active firms enjoy both increased levels of future tax benefits and more-sustainable tax benefits over time.

CPDs may also lead to donating firms' receiving government contracts because of reciprocity between donating firms and politicians (Zullo, 2006). Government contracts require rigorous monitoring of different aspects of performance using a variety of monitoring tools and procedures, including inspections of work, complaints monitoring, performance goals and measures, and customer surveys (Witesman & Fernandez, 2012). Thus, rigorous monitoring of government contracts could help the donating firms to improve performance since it restricts managerial opportunistic behavior by increasing the chances that such behavior will be detected. Auditors of donating firms receiving government contracts would, therefore, reduce their assessed inherent risk.

It is also important to note that in contrast to the strategic investment argument, the agency theory literature suggests that CPAs tend to be driven by managerial self-interest, i.e.,

against the interest of shareholders. As Stiglitz (2012) points out: “It is generally recognized that providing money support conditional on a candidate providing a favor, is corruption” (p. 132). As a result, a lack of transparency tends to accompany the practice of political donations, enabling managers to use political donations as perquisite consumption (Aggarwal et al., 2012). Consistent with this argument, Aggarwal et al. (2012) find that donating firms have free cash flow problems, and donations are negatively correlated with returns. They argue that since donating firms have a greater amount of free cash flows, they engage in more acquisitions with significantly lower cumulative abnormal returns than non-donating firms. Similarly, Coates (2012) finds that in industries that are not regulated, political donation is associated with weaker shareholder power, greater signs of managerial agency costs, and lower corporate value.

The agency problem highlighted in the literature (Aggarwal et al., 2012; Coates, 2012) suggests that the legal and institutional context of companies may have implications for motivations and consequences of CPDs. Further, the legal contexts across countries may have a bearing on the motivation for and consequences of political donations. For example, cap and other restrictions apply to political donations in the U.S. (Prabhat, 2012), whereas no capping applies in Australia, where the disclosure requirements are less onerous. Such differences in institutional and legal contexts may shape the driving factors and consequences of political donations.

Consistent with the agency cost argument, prior studies show corporate political donations are positively associated with audit fees (Gounopoulos et al., 2019; Wallace, 2013). Wallace’s (2013) and Gounopoulos et al.’s (2019) studies suggest it is reasonable to argue that CPDs may lead to opaque financial reporting and possible agency costs, both of which imply higher audit risk and thus higher audit fees.

2.3 *CPDs and informal networks*

The political economy literature provides conceptual explanations on the drivers and impact of corporate political donations (Stigler, 1971; Grossman & Helpman, 1994; Peltzman, 1976). One possible premise briefly alluded to earlier in this paper, is that firms can exploit the political system to their advantage. According to this line of thinking, CPDs can be considered a strategic investment undertaken to establish access to politicians (McMenamin, 2008) and develop networks that generate economic benefits to donating companies (see Lester, Hillman, Zardkoohi, & Cannella Jr, 2008). This viewpoint is underpinned by the notion that politicians pursue self-interest rather than work to maximize the aggregate welfare of society (Stigler, 1971). For example, the revolving door argument suggests that past employment links or potential post-agency employment opportunities in industries may drive politicians' use of regulatory discretion in favor of these industries (Makkai & Braithwaite, 1992).

2.4 *Hypotheses*

As outlined earlier, the literature suggests that CPDs could be associated with better firm performance and less regulatory action in line with the “strategic investment” perspective, thus leading to lower audit risk and audit fees. On the other hand, CPDs could be associated with poorer firm performance and higher inherent risk and audit fees consistent with the agency argument. On balance, as we discussed earlier, the vast majority of the studies suggest that CPDs are strategic investments for the following reasons. First, based on the informal network argument and the need to establish links with politicians for strategic purposes, CPDs are likely to be associated with the strategic investment explanation thus leading to better firm performance and lower inherent risk, resulting in lower audit fees. Second, support for the strategic investment explanation for CPDs is provided by several studies. For example, Preuss and Konigsgruber (2021) point out that firms with CPDs

improve their access to financial resources in terms of “procurement of contracts”. Cooper et al. (2010) provide evidence that CPDs in the U.S. are associated with a firms’ future abnormal returns and future earnings consistent with the strategic investment argument. Third, anecdotal evidence in Australia suggests that there is increased government contracts as a result of CPDs, thus supporting the strategic investment explanation. Fourth, unlike studies in the U.S. setting where political donations are invariably linked to the firms’ CEOs political ideologies (Republican versus Democrats), and hence corporate policies (Elnahas & Kim, 2017), there is no evidence of such linkages in Australia. In addition, studies in the U.S. suggest that CPDs are designed to influence the U.S. Congress and federal agencies (Gounopolos et al., 2019). No such evidence along these lines is available in Australia. In fact, prior studies suggest that CPDs could facilitate government contracts to donating firms, thus improving firm performance. Following this line of thought, and the audit risk model (IAASB, 2019), it is reasonable to expect that CPDs could lead to lower inherent risk and audit fees. On balance, we argue that Australian firms are likely to use CPDs to improve strategic outcomes.

Based on the above reasoning, we set up the following hypothesis:

H1a: There is a negative association between CPDs and audit fees.

We next focus on whether misstatement risk is a significant path that explains the association between CPDs and audit fees. Our assumption is that CPDs can generate strategic benefits, such as government contracts, that generate income which reduces the need for earnings manipulation. Based on IAASB (2019) we expect that benefits arising from CPDs as a strategic investment will reduce an audit client’s inherent risk. This will, in turn, decrease the auditor’s business risk (through reduced financial misstatement risk), which ultimately reduces audit risk and audit fees. This reasoning leads to our second hypothesis:

H1b: CPDs are negatively associated with audit fees through lower risk of misstatements.

3. Research design

3.1 Sample and data

This study utilizes top 500 non-financial firms (based on market capitalization) listed on the Australian Securities Exchange (ASX) during the period 2000 to 2016. The study period covers the tenure of both Labour and Liberal governments. Consistent with previous Australian study by Lu, Shailer, and Wilson (2015), we begin our study period in 2000 when the political contribution data was available but unlike Lu et al. (2015) we ended our study period in 2016 while Lu et al (2015) ended their study period in 2007. Furthermore, at the time we conducted the research project, the data were available in the same database up to 2016. The ASX 500 firms account for over three-quarters of the total market capitalization of all firms listed on the ASX (Jonson, McGuire, Rasel & Cooper, 2020). Lu et al. (2015) find that donations by top 100 firms account for over 90% of the donations made by the top 500 listed firms. The data are collected from various sources: corporate governance and audit-related information were collected from the SIRCA database; CPD data were hand-collected from the Australian Electoral Commission's webpage (<http://www.aec.gov.au>), and financial information was collected from the DatAnalysis database.

Table 1 presents the sample description. We started with an initial sample of 8,500 non-financial firm-year observations. However, we excluded 3,753 observations due to the unavailability of any information for some of our control variables. Thus, the final usable sample comprises 4,747 observations after removing firms with missing data.

<Table 1 about here>

3.2 Model

We employ the following base model using an OLS regression to examine the relation between CPDs and audit fees.

$$\begin{aligned}
Laf = & \beta_0 + \beta_1 Dondum(Ldon) + \beta_2 B4 + \beta_3 Bind + \beta_4 Femdir + \beta_5 Lnonaf + \beta_6 Lsub + \\
& \beta_7 Opinion_dum + \beta_8 Invta + \beta_9 Recta + \beta_{10} Loss + \beta_{11} Roa + \beta_{12} Lev + \beta_{13} Size + \beta_{14} Age + \\
& \beta_{15} Mbe + \beta_{16} Ceoten + \beta_{17} Stdroa + \beta_{18} Stdcf + \beta_{19} Stdsales + \beta_{20} Audten + \beta_{21} Audchg + \\
& \beta_{22} Busy + \beta_{23} Ndebt + \beta_{24} Nequity + \beta_{25} MA + \beta_{26} Exitem + \beta_{27} Specialist + \beta_{28} Lgcon \\
& + \sum \delta Industry + \sum \mu Year + \varepsilon
\end{aligned} \tag{1}$$

3.3 Dependent and independent variables

The dependent variable, audit fees (*Laf*), is measured by taking the natural log of audit fees. For our independent variable CPDs, we use two proxies. In our primary analysis, we use the dummy variable *Dondum* (equals 1 if a firm makes donations to a political party, and 0 otherwise). As an additional test, we examine the relation between donation size and audit fees, and the dummy variable is replaced by *Ldon*, which is the natural log of the donation amount (Aggarwal et al., 2012; Lu et al., 2015).⁵ We follow a previous Australian study by Lu et al. (2015) and concentrate on the donations made at the federal level, because there could be significant differences among states in terms of political issues, which could influence corporate political strategies. Furthermore, Lu et al. (2015) suggest that there are relatively low incidences of political donations at the state level, which could make the statistical analysis noisy if state-level data are used. Finally, to measure donations, we take total rather than individual donations (Lu et al., 2015).

3.4 Control variables

Following the audit fee literature, we include several control variables in equation (1): Big 4 auditor dummy (*B4*), board independence (*Bind*), the proportion of female directors on the board (*Femdir*), non-audit fees (*Lnonaf*), number of subsidiaries (*Lsub*), type of opinion

(*Opinion_dum*), inventory to total assets (*Invta*), receivables to total assets (*Recta*), loss dummy (*Loss*), profitability (*Roa*), leverage (*Lev*), firm size (*Size*), firm Age (*Age*), market-to-book ratio (*Mbe*), CEO tenure (*Ceoten*), the volatility of profitability (*Stdroa*), cash flow volatility (*Stdcf*), sales volatility (*Stdsales*), auditor tenure (*Audten*), auditor change (*Audchg*), auditor busyness (*Busy*), new debt issue (*Ndebt*), new equity issue (*Nequity*), mergers or acquisition (*MA*), extraordinary items (*Exitem*), audit firm industry specialization (*Specialist*), government contracts (*Lgcon*) and year and industry controls.

The Big 4 auditor dummy (*B4*) is a dummy variable that equals 1 if a company is audited by a Big 4 audit firm, and 0 otherwise (Carson, Simnett, Soo, & Wright, 2012). Board independence (*Bind*) is measured as the total number of independent directors scaled by the total number of directors on the board (Carcello, Hermanson, Neal, & Riley, 2002). The proportion of female directors on the board (*Femdir*) is measured as the total number of female directors scaled by the total number of directors on the board (Lai, Srinidhi, Gul, & Tsui, 2017). Consistent with prior research, we expect Big 4 auditor dummy (*B4*), board independence (*Bind*) and the proportion of female directors on the board (*Femdir*) to be positively related to audit fees. Non-audit fees (*Lnonaf*) are measured by taking the natural log of non-audit fees. Prior research indicates that non-audit fees positively influence audit fees (Palmrose, 1986). The number of subsidiaries (*Lsub*) is the natural log of the number of subsidiaries. Opinion (*Opinion_dum*) is a dummy variable that equals 1 if a company receives a going concern modified opinion, and 0 otherwise (Hogan & Wilkins, 2008). Inventory-to-total assets (*Invta*) is measured as the ratio of inventory to total assets. Receivables to total assets (*Recta*) is measured as the ratio of receivables to total assets. The loss dummy (*Loss*) is a dummy variable that equals 1 if a company reported a loss in the previous year, and 0 otherwise. Based on earlier audit fee models (see, for example, Simunic, 1984, Taylor, 2011, Stewart, Kent, & Routledge, 2016), we expect these variables to be positively related to audit

fees (*Laf*). Profitability (*Roa*) is measured as net profit after tax scaled by total assets. Findings of prior research suggest that profitable firms are charged lower audit fees (Hay, Knechel, & Wong, 2006). Leverage (*Lev*) is measured as total debt scaled by total assets. Firm size (*size*) is measured as the natural log of the book value of total assets. We control for leverage because firms with higher leverage ratios and larger size are charged higher audit fees (Simunic, 1980; Hay et al., 2006). Firm age (*Age*) is measured as the natural log of firm age since incorporation. Growth opportunities are proxied by the market-to-book (*Mbe*) ratio. *Mbe* is measured as the ratio of market value and the book value of equity. Auditors are likely to charge higher audit fees to high growth firms because of possible higher level of information asymmetry. CEO tenure (*Ceoten*) is proxied by the length of service. Audit risk might decrease with the length of CEO tenure (Kim, Li & Li, 2015) as CEOs with longer tenure are keen to protect the firm's reputation.

The volatility of profitability (*Stdroa*) is measured by taking the standard deviation of profitability of the previous five years. Firms with volatile profits are risky clients, and hence, auditors could charge higher audit fees. Cash flow volatility (*Stdcf*) is the standard deviation of operating cash flows over total assets of the previous five years (Ge & Kim, 2020). Cash flow volatility is a proxy for financial reporting quality and auditors are likely to charge higher audit fees for firms with more volatile cash flows. Sales volatility (*Stdsales*) is the standard deviation of sales over total assets of the previous five years. High sales volatility could indicate operational risk, and therefore, audit risk is likely to increase as sales volatility increases. Auditor tenure (*Audten*) is measured as the natural log of auditor tenure (Kim et al., 2015; Ghosh & Siriviriyakul, 2018). Auditors are expected to charge a fee premium as the length of their audit engagement increases (Ghosh & Siriviriyakul, 2018). Auditor change (*Audchg*) is a dummy variable that equals 1 if a company changes auditor, and 0 otherwise (Kim et al., 2015; Lu, Wu & Yu, 2017; Ge & Kim, 2020). Consistent with Kim et al. (2015),

auditor change is likely to be positively associated with audit fees. Auditor busyness (*Busy*) is a dummy variable that equals 1 for firms with fiscal year ending June 30, and 0 otherwise (Ettredge Sherwood, & Sun, 2018; Ge & Kim, 2020; Bronson, Ghosh, & Hogan, 2017). Auditors are expected to charge higher audit fees during busy seasons.

New debt issue (*Ndebt*) is a dummy variable that equals 1 if a company issues new debt, and 0 otherwise (Ettredge et al., 2018). New equity issue (*Nequity*) is a dummy variable that equals 1 if a company issues new equity, and 0 otherwise. Mergers or acquisition (*MA*) is a dummy variable that equals 1 if a company involves in mergers or acquisition transaction, and 0 otherwise (Ettredge et al., 2018; Ghosh & Siriviriyakul, 2018). Extraordinary items (*Exitem*) is a dummy variable that equals 1 if extraordinary items are present in the financial statements, and 0 otherwise (Bronson et al., 2017; Ettredge et al., 2018). Consistent with prior studies (Ghosh & Siriviriyakul, 2018), auditors are expected to charge higher audit fees when clients issue new securities, acquire new businesses and have discontinued operations. Audit firm industry specialist (*Specialist*) is a dummy variable that equals 1 if an audit firm is an industry specialist using market share measures, and 0 otherwise (Casterella, Francis, Lewis, & Walker, 2004). We also control for government contracts (*Lgcon*). *Lgcon* is the natural log of amount of government contract awarded to a firm.

4. Results

4.1 Univariate analysis

Univariate analysis of the variables used in the regression model is presented in Table 2. Panel A presents results for the whole sample. The average audit fee for the sample companies is A\$0.682 million. Approximately 7% of our sample companies made donations to political parties. The average amount of donation is 0.749 (logged value). Among the control variables, the natural logarithm of firm size (*Size*) is 19.714. The average profitability (*Roa*) of our sample companies is 2.5%. The average age (*Age*) of our sample firms is

around 2.816 (logged value). The average length of CEO tenure (*Ceoten*) is 6.8 years. Sixty-nine percent of the sample firms were audited during the auditors' busy season (*Busy*). Finally, the average board independence (*Bind*) and the average proportion of female directors (*Femdir*) are approximately 51% and 6.3%, respectively.

Panel B presents results for the sub-sample of firms that make political donations (do not make any political donation), i.e., sub-sample of donor (non-donor) firms. For our sub-sample with donors (non-donors), the average audit fee is 14.230 (13.500). These differences are without controlling for other variables. For the 320 firms that made political donations, the mean CPD is A\$137,000, and the maximum (untabulated) is A\$869,224.⁶ The average non-audit fees (logged value) for the sub-sample with donors (without donors) is 13.034 (11.583). Around 91% (81%) of sub-sample with donors (without donors) use Big 4 auditors. The natural logarithm of firm size (*Size*) is 21.913 (19.579) for the sub-sample with donors (without donors). The average profitability (*Roa*) is 5.5% (2.3%) for the sub-sample with donors (without donors). Around 7% (25%) of sub-sample with donors (without donors) are loss making firms. Leverage (*Lev*) has an average of 0.249 (0.183) for the sub-sample with donors (without donors). Board independence (*Bind*) has an average of 51.4% (43.7%) for the sub-sample with donors (without donors). The average proportion of female directors (*Femdir*) is 10% (6%) for the sub-sample with donors (without donors). The average CEO tenure (*Ceoten*) is 7.67 (6.78) for the sub-sample with donors (without donors). The average age (logged value) of the firms with donors (without donors) is 2.96 (2.77) years.

<Table 2 about here>

A correlation matrix of sample observations for the dependent and independent variables is presented in Table 3. We find that audit fees (*Laf*) is significantly and positively correlated with both the likeliness of donation (*Dondum*) and the amount of political donations (*Ldon*). Furthermore, audit fees (*Laf*) is positively correlated with board

independence (*Bind*), the proportion of female directors (*Femdir*), non-audit fees (*Lnonaf*), the number of subsidiaries (*Lsub*), inventory-to-assets (*Invta*), receivables-to-assets (*Recta*), profitability (*Roa*), leverage (*Lev*), firm size (*Size*), firm age (*Age*), and is negatively correlated with loss (*Loss*) and likelihood of issuing a going concern opinion (*Opinion_dum*). In general, the correlations are quite low except for the correlations between *Size* and *Laf*, *Size* and *Lnonaf*, and *Size* and *Lsub*. To check for potential multicollinearity among the independent variables, we also calculate the variance inflation factors (VIFs) for the independent variables in each of the regression models.

<Table 3 about here>

4.2 CPDs and audit fees (Hypothesis 1a)

Table 4 presents the regression results for testing *H1a*. In our baseline model 1, our key variable of interest is *Dondum*. We examine whether firms donating to political parties incur higher/lower audit fees compared to firms that do not donate. We find a negative and significant coefficient for the *Dondum* variable at the 5% level, indicating that firms donating to political parties pay lower audit fees than firms that do not donate. The coefficient suggests that, on average, firms that make CPDs pay approximately 9% or A\$0.131 million⁷ lower audit fees than firms without CPDs. In model 2, consistent with the results reported in the first model, we find a negative and significant coefficient for the *Ldon* variable at the 5% level. This implies that firms paying higher amounts of donations incur lower audit fees, thus supporting *H1a*.⁸ Therefore, both tests provide support for the “strategic investment” interpretation role of CPDs. Our results suggest that the agency arguments and managerial self-dealing motives are not likely to drive political donations. Among the control variables, consistent with prior research (e.g., Carcello et al., 2002), we find that audit fees are significant and positively associated with the size of the audit firm (*B4*), board independence

(*Bind*), proportion of female directors (*Femdir*), non-audit fees (*Lnonaf*), number of subsidiaries (*Lsub*), inventory-to-total assets (*Invta*), receivables to total assets (*Recta*), firm size (*Size*) and firm age (*Age*), specialist auditor (*Specialist*) and government contract (*Lgcon*) and negatively associated with leverage (*Lev*), profitability (*Roa*), and CEO tenure (*Ceoten*). Consistent with previous research (for example, Stewart et al., 2016; Ge & Kim, 2020; Ghosh & Siriviriyakul, 2018), we fail to document any significant effect of going concern modified opinion (*Opinion_dum*), auditor change (*Audchg*), acquisition of new businesses (*MA*), auditor busy season (*Busy*), issuance of new securities (*Ndebt*, *Nequity*) on audit fees.⁹

<Table 4 about here>

4.3 *Endogeneity Issue*

Our analyses thus far may suffer from correlated omitted variables. Some observable or unobservable firm characteristics may simultaneously affect political donations and the audit bill. We address the endogeneity issue using three approaches: change analysis, instrumental variable approach, and propensity score matching procedure.

4.3.1 *Change Analysis*

To control for unobservable time-variant variables, we use change analysis. Our dependent variable is the change in audit fees (ΔLaf) between the years, t and $t-1$, and the treatment variable is the change in political donation ($\Delta Ldon$) between years, t and $t-1$. All other control variables are change variables with a lag except dummy variables. Table 5 presents the results of the change analysis, change in political donation ($\Delta Ldon$) shows a marginally significant effect on change in audit fees (ΔLaf) in the following year.

<Table 5 about here>

4.3.2 *Instrumental variable approach*

To further address the concern of omitted unobservable variables, we performed a two-stage analysis using an instrumental variable approach. In the first stage, we

estimate the probability that a firm will make political donations. Following Cooper et al. (2010), we include the firm's market share in the industry (*Mkt_sh*), and the Herfindahl sales concentration index (*Herfindahl*) apart from the control variables used in the audit fees model. In addition, this approach requires a condition that the instrumental variables have to be correlated with our endogenous variable *Dondum* (*Ldon*) but uncorrelated with the error term of the second-stage regression (See Larcker & Rusticus, 2010; Roberts & Whited, 2013 for details). Following Correia (2014), we choose the average level of donation for all the other firms in the same industry over the same period (*Don_avg*). We believe that they are important determinants of individual firms donating to political parties. However, it is unlikely that industry averages are associated with audit fees.

To test whether the instrumental variable is valid, we perform the Cragg–Donald Wald F statistic, the Kleibergen–Paap rk Wald F statistic, the F-statistics, the partial R², the Kleibergen–Paap rk LM statistic and the Sargan overidentification tests (Stock, & Yogo, 2005). Our results presented in Table 6 show that Cragg–Donald statistics are above the 10% critical values in *Dondum* and *Ldon* equations. Kleibergen–Paap Wald rk F statistics are above the 15% critical value in *Dondum* and *Ldon* equations. In addition, the F-statistics and partial R² are relatively high. Overall, these statistics provide us with confidence to reject the likelihood that the instruments are weak. We also reject the null hypothesis of under-identification using the Kleibergen–Paap rk LM statistic. Finally, we fail to reject the null hypothesis that the instrument is not correlated with the error term using the Sargan overidentification test (χ^2 is above 0.1). To the extent that the instrument is valid, the results of our second stage reported in Table 6 show a significantly negative relation between predicted *Dondum* (*P_Ldon*) and audit fees.

<Table 6 about here>

4.3.3 Propensity score matching

We further perform the propensity score matching procedure (Rosenbaum & Rubin, 1983) to address the endogeneity concern of observable omitted variables. We create a sample of firms with a set of similar characteristics that affect audit fees but differs in terms of whether they donate to political parties. We first estimate the probability that a firm will donate to political parties conditional on the observable firm and industry characteristics. Based on the coefficients from this model, we compute a propensity score for each observation. We match each observation with $Dondum=1$ to a unique observation with $Dondum=0$, without replacement. To ensure a close match, we require a caliper width of less than 0.005. This produces a sample of 317 matched-pairs, 634 firm-year observations.

Panel A of Table 7 illustrates the difference in the means of the treatment and control firms' covariates. Laf is significantly lower in the sub-sample with $Dondum=1$ than the sub-sample with $Dondum=0$. The means of the matched control variables are not significantly different for firms with and without political contribution except for the corporate governance variables such as board independence ($Bind$), the proportion of female directors ($Femdir$), leverage (Lev), volatility of profitability ($Stdproa$), auditor tenure ($Audten$), auditor change ($Audchg$), busy season ($Busy$), issuance of new debt ($Ndebt$), issuance of new equity ($Nequity$) indicating that the matching procedure has achieved covariate balance between treatment and control groups. We then report our regression results in Panel B of Table 7. Our key variable of interest is $Dondum$. The sign and significance level of $Dondum$ variable is consistent with our main findings reported in Table 4. Overall, our results remain unchanged.

<Table 7 about here>

4.4 Decile rank of political donations

In this section, we focus on only firms that make CPDs. This is a relatively small

sample (N=320) and provides some insights on whether the *amount* of the donation has an impact on the auditors' risk assessment. To test for robustness, we restrict our sample to firms that donate. To perform the test, we convert the political donation variable (*Ldon*) into a decile rank variable and then rerun our baseline regression using the converted variable (*Ldon_rank*). The results are presented in Table 8. We document a negative and significant coefficient for the *Ldon_rank* variable at the 1% level. This is consistent with our findings reported in Table 4 and suggests once again that firms making higher amounts of political donations pay lower audit fees consistent with hypothesis 1.

<Table 8 about here>

4.5 Path analysis (Hypothesis 1b)

Following DeFond, Lim and Zang (2016), we use path analysis to test the hypothesis that CPDs are associated with lower audit risks as a result of lower earnings management. Like Baron and Kenny (1986), we decompose the correlation between causal variable (corporate political donation in our context) and an outcome variable, audit fees, into direct and indirect paths. We conjecture that CPDs affect auditors' responses directly through inherent risk and indirectly mediated by the risk of misstatements proxied by earnings management measures. A direct path contains one path coefficient, while a mediated path contains a coefficient between the source variable and the mediating variable and a coefficient between the mediating variable and the outcome variable. The total magnitude of the mediated path is the product of the individual path coefficients for each segment of that path. Figure 1 shows the direct and indirect paths for the above model, along with their coefficients.

< Figure 1 about here>

To perform the path analysis, we adopt the following model based on prior studies (DeFond et al., 2016):

$$Laf_{i,t} = \gamma_0 + \gamma_1 CPDs_{i,t} + \gamma_2 EM_{i,t} + \sum \gamma_n Controls_{i,t} + \varepsilon_{i,t} \quad (2)$$

$$EM_{i,t} = \omega_0 + \omega_1 CPDs_{i,t} + \varepsilon_{i,t} \quad (3)$$

The first equation includes the control variables from the audit fee model. The path coefficient γ_1 represents the magnitude of the direct path from CPDs to auditor responses and the path coefficient $\gamma_2 * \omega_1$ represents the magnitude of the indirect path mediated through earnings management (*EM*). We measure earnings *EM* using three proxies.

First, following Kothari, Leone, and Wasley (2005) and Stubben (2010), we employ the performance-matched modified Jones model to estimate discretionary accruals (*Dac*):

$$Dac = AC_{it} - \alpha_0(1/TA_{t-1}) + \beta_1((\Delta Rev_t - \Delta AR_t)/TA_{t-1}) + \beta_2(PPE_t/TA_{t-1}) + \beta_3Roa_{t-1}, \quad (4)$$

where *AC* is the current annual accruals, *TA* is total assets in *t-1*, ΔRev is the change in net sales revenue, ΔAR is the change in net accounts receivable, *PPE* is net property, plant and equipment, and *Roa* is the return on assets in period *t-1*.

Second, following previous research (e.g., Burgstahler & Dichev, 1997), we examine whether firms with CPDs are associated with lower audit fees through a higher tendency for firms to manipulate earnings to avoid losses measured by the higher-than-expected frequency of firms reporting slightly positive earnings. This tendency of focusing on thresholds is termed as “threshold mentality” by Degeorge, Patel, and Zeckhauser (1999). Other studies (e.g., Leuz, Nanda, & Wysocki, 2003; Gunny, Jacob, & Jorgensen, 2013) show that firms obfuscate their performance by smoothing their income. Accordingly, for this study, we use these alternative proxies for earnings management – reporting i) small profit and ii) income smoothing. Our dependent variable small profit is a dummy variable which equals 1 if $(NI - NI_{t-1}) / TA$ is within the interval (0.00 and 0.02) and otherwise 0. Our dependent variable for income smoothing is the five-year volatility of earnings scaled by the five-year volatility of operating cash flows following previous studies (e.g., Francis, La Fond, Olsson, & Schipper, 2004; McInnis, 2010; Gunny et al., 2013).

Table 9 presents the results for path analysis. The direct path coefficients between *Dondum* (*Ldon*) and audit fees are negative and significant, consistent with our conjecture that CPDs directly reduce audit fees because of lower inherent risk. The path coefficients between *Dondum* (*Ldon*) and earnings management proxies are negative and significant, suggesting that firms are likely to be associated with lower earnings management when firms have higher corporate political donations. In addition, the path coefficients between earnings management and audit fees are significantly positive, indicating that more earnings manipulation leads to higher fees. Column (1) reports the total mediator path for discretionary accruals [$p(Dondum, Dac) \times p(Dac, Laf)$]. The coefficient of $\hat{\omega}_1 * \hat{\gamma}_2$ is 0.005, which is 5.3% [$= -0.005 / (-0.005 - 0.088)$] of the total effect of political donation on audit fees. In Column (3), the total mediated path through small profit is 0.002, which is 2% [$= -0.002 / (-0.002 - 0.088)$] of the total effect of political donation on audit fees. In Column (5), the total mediated path through income smoothing is 0.022, which is about 20% of the total effect of political donation on audit fees [$= -0.022 / (-0.022 - 0.088)$]. Columns (2), (4), and (6) report the results when the dependent variable is *Ldon*. They also provide similar findings. Overall, our findings imply that CPDs decrease auditors' risk assessment through reduced financial misstatement risk which ultimately influence them to charge lower audit fees to their clients, thus supporting *H1b*.

<Table 9 about here>

5 Additional test: Political donations, government contracts and lead year firm performance

As discussed earlier, we posit that one of the ways firms with CPDs can improve firm performance and, therefore, lower incentives to manipulate earnings is through government contracts (Zardkoohi, 1985). Both early works on corporate political investment (e.g., Zardkoohi, 1985; Pittman, 1977) and more contemporary studies present interest to gain access to government contracts as a primary driver of CPDs (Witko, 2011; Zullo, 2006). We

believe that firms with government contracts as a result of CPDs are more profitable, and in this section, we provide some evidence to test this conjecture. We use $t+1$ profitability (*Roa_lead1*) as our dependent variable. We control for firm characteristics which include board independence (*Bind*), the percentage of female directors on board (*Femdir*), size of the firm (*Size*), leverage (*Lev*), capital expenditure (*Capex*), cash-to-total assets ratio (*Cashta*), cumulative sales growth (*Cum_salesgrth*), the volatility of profitability (*Stdroa*) and the length of service by CEO (*ceoten*). The results are reported in Table 10. In model 1, we document a negative and significant coefficient for *Dondum* variable at the 10% level implying firms making more donations experience lower profitability in the subsequent year. In model 2, we examine the effect of government contract on firm performance in $t+1$ and document a positive but significant coefficient for the *Lgcon_Lead1* variable at the 5% level. Finally, in model 3, we use an interaction term between *Dondum* and *Lgcon_Lead1* (*Dondum*Lgcon_Lead1*) variables to explore the impact of donation on subsequent firm performance (*Roa* in $t+1$) when firms receive government contracts in $t+1$. We document a positive and significant coefficient for the interaction term *Dondum*Lgcon_Lead1* at the 1% level. It implies that firms with government contracts become more profitable in the subsequent period. These results provide support for the conjecture that the procurement of government contracts by CPD firms in Australia are likely to be one of the reasons for the lower incentives to manage earnings.

<Table 10 about here>

6. Conclusion

In this study, we present empirical evidence on the links between CPDs, earnings management and audit fees. We conducted our empirical test using a dataset of Australian companies between 2000 and 2016. Our results show that firms donating to political parties

pay lower audit fees compared to non-donating firms. Using path analysis, we demonstrate that CPDs have a negative effect on audit fees. Further, we find that misstatement risk captured by three proxies of earnings management are significant mediating paths that explain the relationship between CPDs and audit fees. Our additional analysis also shows a positive relation between CPDs and firm performance in the subsequent period. This finding reinforces our conclusion on the inverse relationship between political donations and audit fees because better firm performance and higher quality earnings in donating firms suggest that the auditor is likely to assess lower inherent risk for firms that donate to political parties.

Our results provide evidence to refine the understanding of the impact of CPA on firm value. While political connections tended to be manifestations of agency problems and thus associated with lower earnings quality (Chaney et al., 2011) and higher audit fees (Gul, 2006), the evidence in the present Australian study shows that CPDs serve as a strategic investment that would lead to reduced audit risk and audit fees. The reduction in audit fees is shown to be through lower earnings management as a result of the improved firm performance derived from the strategic benefits of CPDs. Overall, our results support the argument that CPDs serve as a strategic investment compared to the short-term, mostly issue-based nature of lobbying.

The findings of the study have important implications for investors, auditors, and regulators. For instance, the findings may inform shareholders about the potential benefits of political donations from a financial reporting and audit perspective. The results also suggest that auditors can factor political donations into audit risk assessment and audit pricing. This is an important implication as audit fees are closely linked to audit quality (Ettredge et al., 2014). However, the findings of this study should be interpreted with caution for several reasons. First, the economic significance of the results, while relatively small, is qualitatively important in terms of improving our understanding of whether auditors

recognize CPDs. Second, the results are based on the Australian setting and should not be generalized to other contexts with different institutional settings. Third, our sample is restricted to large, publicly listed companies that are more likely to make CPDs and should not be generalizable to smaller listed firms. Fourth, we were unable to collect data on business opportunities that arise out of CPDs except for government contracts but the number of observations were limited. As a result our path analytical model is somewhat limited since we did not include a path for business opportunities; instead we use the lower risk of misstatements to capture the advantages of business opportunities. However, we run a separate tests to show that CPD firms with government contracts are associated with superior performance, in future years, thus providing a rationale why CPD firms may generate lower earnings management. Fifth, while we attempt to control for endogeneity in our tests, we are still unable to completely rule out the endogeneity concerns that could affect our results. Finally, while in this study, we use two proxies for corporate governance, as controls, it is not clear whether other proxies may produce the same results. We leave these and other issues to future research.

Endnotes

1. The PAC is formed by a firm and makes donations to political candidates the firm chooses.
2. CPD is often identified as part of corporate political activity (CPA). Political connection is another form of CPA, which occur when major shareholders, corporate directors and/ or executives are current or former government officials (Fung, Gul, & Radhakrishnan, 2015; Faccio, 2006; Johnson & Mitton, 2003) or when the government controls the ownership of firms (Bliss, Gul, & Majid, 2011). CPA also includes lobbying, which shows corporate effort focused on specific issues and tends to be a defensive move.
3. We use the terms resource dependency and strategic investment interchangeably – both these terms are used in the CPD literature.
4. Inherent risk is a component of audit risk (International Auditing and Assurance Standards Board, 2019). Audit risk is the product of the likelihood that environmental and client factors will produce a material error (inherent risk), the likelihood that internal controls will not detect or prevent a material error (control risk) and the likelihood that audit procedures will not detect the material error (detection risk).
5. We set the donation amount to one dollar to allow for the log transformation.
6. After winsorized at 1% the maximum CPD was A\$247,610.
7. To confirm that CPD is negatively correlated with Laf, we perform lasso and elastic net regressions. The results of the standardized coefficients of CPD remain negative.
8. As the mean audit fee of our sample is A\$1.248 million, therefore, $-0.105 \times \text{A\$}1.248 \text{ million} = \text{A\$}0.131 \text{ million}$.
9. We use directors' turnover (hand collected data) to control for weak management. We find that the association between political donation and audit fee is still negative and significant.

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Table 1: Sample Selection

	No of observations
ASX 500 2000-2016	8,500
Less missing controls	
Total assets, inv & rec	649
Long term and short term debt	702
Subsidiaries and age	1,451
Non-audit fees	626
CEO tenure	207
Auditor tenure	118
Final number of observations	4,747

Table 2: Univariate Analysis

Panel A Full sample

Variables	N	Mean	Std Dev	25%	Median	75%
<i>Laf</i>	4,747	13.575	1.235	12.725	13.484	14.311
<i>Audit Fees (in millions)</i>	4,747	0.682	1.308	0.124	0.264	0.604
<i>Ldon</i>	4,747	0.749	2.754	0	0	0
<i>Dondum</i>	4,747	0.070	0.255	0	0	0
<i>B4</i>	4,747	0.818	0.386	1	1	1
<i>Bind</i>	4,747	0.505	0.286	0.200	0.500	0.667
<i>Femdir</i>	4,747	0.063	0.094	0	0	0.125
<i>Lnonaf</i>	4,747	11.669	1.670	10.551	11.687	12.826
<i>Lsub</i>	4,747	2.633	1.220	1.792	2.564	3.951
<i>Opinion dum</i>	4,747	0.002	0	0	0	0
<i>Invta</i>	4,747	0.086	0.112	0.004	0.037	0.129
<i>Recta</i>	4,747	0.132	0.122	0.036	0.099	0.191
<i>Loss</i>	4,747	0.235	0.424	0	0	0
<i>Roa</i>	4,747	0.025	0.151	0.006	0.050	0.089
<i>Lev</i>	4,747	0.188	0.161	0.028	0.179	0.295
<i>Size</i>	4,747	19.714	1.693	18.505	19.541	20.792
<i>Age</i>	4,747	2.816	2.624	1.946	2.565	3.091
<i>Mbe</i>	4,747	2.834	3.195	1.105	1.859	3.191
<i>Ceoten</i>	4,747	6.842	4.050	4	6	10
<i>Stdroa</i>	4,747	0.046	0.078	0.005	0.017	0.048
<i>Stdcf</i>	4,747	0.137	0.241	0.010	0.054	0.148
<i>Stdsales</i>	4,747	0.618	1.256	0.018	0.170	0.580
<i>Audten</i>	4,747	6.284	4.341	3.000	5.000	9.000
<i>Audchg</i>	4,747	0.241	0.428	0	0	0
<i>Busy</i>	4,747	0.694	0.461	0	1	1
<i>Ndebt</i>	4,747	0.628	0.483	0	1	1
<i>Nequity</i>	4,747	0.647	0.478	0	1	1
<i>MA</i>	4,747	0.043	0.203	0	0	0
<i>Exitem</i>	4,747	0.128	0.334	0	0	1
<i>Specialist</i>	4,747	0.272	0.445	0	0	1
<i>Lgcon</i>	4,747	1.227	4.081	0	0	0

The donations are winzorized at 1% to remove outliers.

Panel B: Sub Sample donors and without donors

Variables	With Donors (<i>Dondum=1</i>)						Without Donors (<i>Dondum=0</i>)					
	N	Mean	Std Dev	25%	Median	75%	N	Mean	Std Dev	25%	Median	75%
<i>Laf</i>	320	14.230	0.963	13.244	13.930	14.487	4,427	13.500	1.205	12.686	13.419	14.185
<i>Audit Fees (in millions)</i>	320	1.514	1.386	0.564	1.121	1.957	4,427	0.627	1.278	0.119	0.248	0.532
<i>Ldon</i>	320	11.419	1.170	10.316	11.002	11.827	4,427					
<i>Total Donation (in millions)</i>	320	0.091	0.102	0.030	0.060	0.137	4,427					
<i>B4</i>	320	0.913	0.283	1.000	1.000	1.000	4,427	0.813	0.390	1.000	1.000	1.000
<i>Bind</i>	320	0.514	0.271	0.348	0.563	0.714	4,427	0.437	0.286	0.200	0.500	0.667
<i>Femdir</i>	320	0.104	0.098	0.000	0.111	0.167	4,427	0.061	0.093	0.000	0.000	0.125
<i>Lnonaf</i>	320	13.034	1.548	11.971	13.285	14.122	4,427	11.583	1.638	10.491	11.615	12.702
<i>Lsub</i>	320	3.893	1.106	3.511	4.043	4.700	4,427	2.552	1.180	1.609	2.485	3.332
<i>Opinion dum</i>	320	0.000	0.000	0.000	0.000	0.000	4,427	0.003	0.050	0.000	0.000	0.000
<i>Invta</i>	320	0.070	0.082	0.008	0.029	0.108	4,427	0.086	0.114	0.003	0.037	0.129
<i>Recta</i>	320	0.105	0.091	0.039	0.084	0.136	4,427	0.133	0.123	0.036	0.100	0.193
<i>Loss</i>	320	0.069	0.253	0.000	0.000	0.000	4,427	0.247	0.431	0.000	0.000	0.000
<i>Roa</i>	320	0.055	0.060	0.033	0.055	0.081	4,427	0.023	0.155	0.001	0.049	0.091
<i>Lev</i>	320	0.249	0.131	0.166	0.241	0.333	4,427	0.183	0.162	0.022	0.172	0.290
<i>Size</i>	320	21.913	1.245	21.104	22.082	22.731	4,427	19.579	1.623	18.434	19.432	20.609
<i>Age</i>	320	2.957	0.914	2.398	3.068	3.714	4,427	2.772	2.583	1.792	2.485	3.044
<i>Mbe</i>	320	2.191	1.667	1.150	1.740	2.664	4,427	2.882	3.276	1.104	1.874	3.235
<i>Ceoten</i>	320	7.672	4.083	4.000	7.000	10.000	4,427	6.779	4.040	4.000	6.000	9.000
<i>Stdroa</i>	320	0.020	0.035	0.004	0.011	0.022	4,427	0.048	0.080	0.005	0.018	0.050
<i>Stdcf</i>	320	0.245	0.313	0.047	0.125	0.297	4,427	0.129	0.232	0.009	0.050	0.138
<i>Stdsales</i>	320	1.260	1.865	0.106	0.403	1.571	4,427	0.570	1.184	0.015	0.155	0.534
<i>Audten</i>	320	2.137	1.567	1.386	2.079	2.485	4,427	1.812	1.450	1.099	1.609	2.197
<i>Audchg</i>	320	0.757	0.429	1.000	1.000	1.000	4,427	0.202	0.402	0.000	0.000	0.000
<i>Busy</i>	320	0.624	0.485	0.000	1.000	1.000	4,427	0.700	0.459	0.000	1.000	1.000
<i>Ndebt</i>	320	0.795	0.404	1.000	1.000	1.000	4,427	0.615	0.487	0.000	1.000	1.000
<i>Nequity</i>	320	0.700	0.459	0.000	1.000	1.000	4,427	0.643	0.479	0.000	1.000	1.000
<i>MA</i>	320	0.033	0.179	0.000	0.000	0.000	4,427	0.044	0.204	0.000	0.000	0.000
<i>Exitem</i>	320	0.234	0.424	0.000	0.000	1.000	4,427	0.120	0.325	0.000	0.000	0.000
<i>Specialist</i>	320	0.367	0.483	0.000	0.000	1.000	4,427	0.265	0.403	0.000	0.000	1.000
<i>Lgcon</i>	320	1.202	5.930	0.000	0.000	1.000	4,427	1.189	4.734	0.000	0.000	0.000

Panel A reports the descriptive statistics for the full sample, and Panel B reports the subsample for donors and without donors. The variable definitions are presented in Appendix 1.

Table 3: Correlation Matrix (n=4747)

Variables	<i>Ldon</i>	<i>Dondum</i>	<i>B4</i>	<i>Bind</i>	<i>Femdir</i>	<i>Lnonaf</i>	<i>Lsub</i>	<i>Opinion_dum</i>	<i>Invta</i>	<i>Recta</i>	<i>Loss</i>	<i>Roa</i>	<i>Lev</i>	<i>Size</i>	<i>Age</i>	<i>Mbe</i>
<i>Laf</i>	0.238	0.227	0.351	0.365	0.283	0.655	0.754	-0.080	0.099	0.142	-0.341	0.206	0.346	0.830	0.308	-0.162
<i>Ldon</i>		0.994	0.060	0.022	0.083	0.197	0.252	-0.020	-0.011	-0.038	-0.103	0.053	0.100	0.301	0.193	-0.054
<i>Dondum</i>			0.056	0.012	0.080	0.188	0.242	-0.020	-0.007	-0.034	-0.100	0.051	0.101	0.290	0.190	-0.055
<i>B4</i>				0.103	0.118	0.338	0.241	0.001	0.014	0.028	-0.076	0.021	0.160	0.277	0.131	-0.070
<i>Bind</i>					0.245	0.160	0.275	-0.034	-0.017	-0.051	-0.108	0.084	0.050	0.353	0.172	-0.023
<i>Femdir</i>						0.151	0.208	-0.021	0.091	0.034	-0.119	0.059	0.082	0.249	0.106	0.020
<i>Lnonaf</i>							0.513	-0.024	0.020	0.061	-0.212	0.135	0.257	0.591	0.167	-0.096
<i>Lsub</i>								-0.050	0.042	0.143	-0.322	0.179	0.321	0.705	0.272	-0.164
<i>Opinion_dum</i>									-0.030	-0.009	0.019	-0.032	-0.046	-0.037	0.049	0.011
<i>Invta</i>										0.192	-0.218	0.152	0.096	0.022	0.109	-0.064
<i>Recta</i>											-0.282	0.212	0.015	-0.064	-0.018	0.002
<i>Loss</i>												-0.703	-0.153	-0.341	-0.137	0.099
<i>Roa</i>													0.035	0.244	0.090	-0.044
<i>Lev</i>														0.377	0.061	-0.081
<i>Size</i>															0.324	-0.239
<i>Age</i>																-0.107

Variables	<i>Ceoten</i>	<i>Stdroa</i>	<i>Stdcf</i>	<i>Stdsales</i>	<i>Audten</i>	<i>Audchg</i>	<i>Busy</i>	<i>Ndebt</i>	<i>Nequity</i>	<i>MA</i>	<i>Exitem</i>	<i>Specialist</i>	<i>Lamt</i>
<i>Laf</i>	0.024	-0.174	0.317	0.334	0.270	-0.123	-0.045	0.354	-0.027	-0.001	0.094	0.220	0.326
<i>Ldon</i>	0.063	-0.081	0.126	0.141	0.115	0.322	-0.046	0.100	0.032	-0.015	-0.089	0.068	0.093
<i>Don dum</i>	0.057	-0.080	0.123	0.140	0.108	0.330	-0.042	0.096	0.030	-0.014	0.088	0.058	0.089
<i>B4</i>	-0.009	0.004	0.097	0.076	0.092	-0.106	-0.097	0.121	-0.052	0.005	0.049	0.288	0.097
<i>Bind</i>	0.181	0.008	0.181	0.145	0.277	-0.280	0.014	0.095	0.022	-0.005	0.028	0.060	0.206
<i>Femdir</i>	-0.063	-0.106	0.021	0.042	0.140	-0.043	0.009	0.107	-0.073	-0.015	-0.002	0.038	0.177
<i>Lnonaf</i>	-0.026	-0.127	0.190	0.223	0.094	-0.005	-0.046	0.257	0.045	-0.002	0.094	0.191	0.211
<i>Lsub</i>	0.092	-0.196	0.226	0.281	0.237	-0.057	-0.037	0.313	-0.013	-0.021	0.122	0.186	0.303
<i>Opinion_dum</i>	0.093	0.029	-0.031	-0.021	0.018	-0.004	-0.090	-0.063	-0.060	0.000	-0.019	0.061	-0.022
<i>Invta</i>	0.006	-0.137	0.102	0.185	0.010	-0.017	-0.017	0.120	-0.104	-0.017	-0.052	0.015	-0.018
<i>Recta</i>	0.041	-0.126	0.091	0.185	-0.014	-0.022	0.033	0.059	-0.081	-0.034	-0.051	0.018	0.096
<i>Loss</i>	-0.094	0.323	-0.182	-0.173	-0.076	0.041	-0.016	-0.191	0.111	0.009	-0.029	-0.062	-0.143
<i>Roa</i>	0.095	-0.358	0.156	0.129	0.089	-0.062	-0.001	0.107	-0.080	0.008	0.008	0.018	0.088
<i>Lev</i>	-0.034	-0.150	0.079	0.076	0.049	0.004	0.004	0.454	0.020	0.023	-0.003	0.078	0.102
<i>Size</i>	0.009	-0.248	0.354	0.331	0.253	-0.081	-0.099	0.369	-0.008	-0.006	0.139	0.202	0.294
<i>Age</i>	0.117	-0.061	0.256	0.202	0.293	-0.068	-0.187	0.110	-0.042	-0.024	0.120	0.106	0.058
<i>Mbe</i>	0.035	0.124	-0.032	-0.041	-0.040	0.023	0.061	-0.099	0.114	0.015	-0.035	-0.055	-0.031
<i>Ceoten</i>		-0.034	0.072	0.075	0.171	-0.108	0.023	-0.001	0.023	-0.128	0.011	0.049	0.055
<i>Stdroa</i>			-0.006	-0.078	0.023	-0.188	-0.027	-0.171	0.041	-0.001	0.008	-0.030	-0.090
<i>Stdcf</i>				0.610	0.181	-0.120	-0.121	0.106	-0.044	-0.002	0.069	0.089	0.076
<i>Stdsales</i>					0.149	-0.075	-0.069	0.118	-0.021	-0.022	0.050	0.102	0.143
<i>Audten</i>						-0.272	-0.015	0.040	-0.061	0.017	0.036	0.080	0.158
<i>Audchg</i>							0.001	-0.011	0.061	-0.014	-0.012	-0.059	-0.051
<i>Busy</i>								0.020	0.055	0.002	-0.088	-0.025	0.081
<i>Ndebt</i>									0.041	-0.014	0.010	0.061	0.126
<i>Nequity</i>										0.009	0.016	-0.056	-0.018
<i>MA</i>											0.009	-0.010	-0.041
<i>Exitem</i>												0.035	0.003
<i>Specialist</i>													0.100

Table 3 reports the Pearson correlations for the dependent and key independent variables. Correlation coefficients in bold are significant at the 5 percent level or better, two-tailed test. The variable definitions are presented in Appendix 1.

Table 4: Multivariate analysis: Effect CPDs on audit fees

Variables	<i>Dependent variable = Laf</i>	
	<i>Model 1</i>	<i>Model 2</i>
<i>Intercept</i>	13.755*** (11.57)	13.770*** (11.60)
<i>Dondum</i>	-0.088** (-2.02)	
<i>Ldon</i>		-0.008** (-2.04)
<i>B4</i>	0.232*** (7.24)	0.232*** (7.24)
<i>Bind</i>	0.084* (1.72)	0.084* (1.73)
<i>Femdir</i>	0.271** (2.53)	0.271** (2.52)
<i>Lnonaf</i>	0.137*** (10.73)	0.138*** (10.75)
<i>Lsub</i>	0.209*** (16.37)	0.209*** (16.36)
<i>Opinion_dum</i>	-0.011 (-0.07)	-0.011 (-0.06)
<i>Invta</i>	0.604*** (5.75)	0.603*** (5.76)
<i>Recta</i>	1.189*** (12.01)	1.188*** (11.99)
<i>Loss</i>	-0.066* (-1.71)	-0.066* (-1.71)
<i>Roa</i>	-0.280*** (-2.71)	-0.279*** (-2.71)
<i>Lev</i>	0.079 (1.11)	0.078 (1.10)
<i>Size</i>	0.674*** (5.84)	0.676*** (5.86)
<i>Age</i>	0.042*** (3.48)	0.042*** (3.48)
<i>Mbe</i>	0.000 (0.03)	0.000 (0.03)
<i>Ceoten</i>	-0.007*** (-2.88)	-0.007*** (-2.88)
<i>Stdroa</i>	0.599*** (4.08)	0.599*** (4.09)
<i>Stdcf</i>	-0.045 (-0.89)	-0.045 (-0.89)
<i>Stdsales</i>	0.002 (0.19)	0.002 (0.18)
<i>Audten</i>	-0.025 (-1.27)	-0.024 (-1.26)
<i>Audchg</i>	-0.008 (-0.26)	-0.009 (-0.27)
<i>Busy</i>	0.008 (0.51)	0.008 (0.51)
<i>Ndebt</i>	0.032 (1.55)	0.032 (1.56)
<i>Nequity</i>	-0.027 (-1.45)	-0.027 (-1.44)
<i>MA</i>	0.055 (1.10)	0.054 (1.10)
<i>Exitem</i>	-0.051	-0.051

	(-1.58)	(-1.58)
<i>Specialist</i>	0.050**	0.050**
	(2.21)	(2.22)
<i>Lgcon</i>	0.003*	0.003*
	(1.95)	(1.96)
<i>N</i>	4,747	4,747
<i>Industry</i>	Yes	Yes
<i>Year</i>	Yes	Yes
<i>R</i> ²	0.8270	0.8270

t-stats in parentheses are adjusted for two-way clustering by firms and year. *, **, *** = statistically significant at less than 0.10, 0.05 and 0.01, respectively. The variable definitions are presented in Appendix 1.

Table 5: Change Analysis: Effect of change in CPDs on audit fees

	<i>Dependent variable =ΔLaf</i>
Variables	
<i>Intercept</i>	0.011 (0.63)
<i>ΔLdon</i>	-0.005* (-1.87)
<i>B4</i>	-0.004 (-0.51)
<i>Bind</i>	0.001 (0.06)
<i>Femdir</i>	-0.050 (-0.99)
<i>ΔLnonaf</i>	0.310** (2.73)
<i>ΔLsub</i>	0.039 (0.87)
<i>ΔInvta</i>	0.001 (0.48)
<i>ΔRecta</i>	-0.004 (-0.41)
<i>Loss</i>	-0.034* (-1.83)
<i>ΔRoa</i>	-0.001** (-2.33)
<i>ΔLev</i>	0.004 (0.89)
<i>ΔSize</i>	0.360 (0.99)
<i>ΔAge</i>	-0.013 (-0.96)
<i>ΔMbe</i>	0.001 (0.05)
<i>ΔCeoten</i>	0.002 (0.09)
<i>ΔStdroa</i>	0.001 (0.80)
<i>ΔStdcf</i>	-0.003 (-0.55)
<i>ΔStdsales</i>	0.0037 (1.65)
<i>Audten</i>	-0.003 (-0.04)
<i>Busy</i>	0.004 (0.70)
<i>Ndebt</i>	0.001 (0.12)

<i>Nequity</i>	0.001
<i>MA</i>	-0.020 (-1.63)
<i>Exitem</i>	0.002 (0.44)
<i>Specialist</i>	0.007 (0.61)
<i>ΔLgcon</i>	-0.090** (-2.21)
<i>N</i>	230
<i>Industry</i>	Yes
<i>Year</i>	Yes
<i>Adj R²</i>	0.5239

t-stats in parentheses are adjusted for two-way clustering by firms and year. *, **, *** = statistically significant at less than 0.10, 0.05 and 0.01, respectively. The variable definitions are presented in Appendix 1.

Table 6: Instrumental Variable Approach: Effect of CPDs on audit fees

Variables	First Stage	Second Stage	First Stage	Second Stage
Intercept	0.879 (0.07)	1.804*** (16.42)	-1.174 (-1.35)	2.940*** (15.91)
<i>P_Dondum</i>		-0.535* (-1.87)		
<i>P_Ldon</i>				-0.449*** (-2.88)
<i>B4</i>	-0.820 (-0.69)	0.217*** (8.66)	0.012 (0.75)	0.190*** (7.42)
<i>Bind</i>	5.263*** (3.37)	0.070* (1.80)	-0.111*** (-2.92)	0.021 (0.49)
<i>Femdir</i>	-5.266 (-1.48)	0.201** (2.08)	0.085 (0.95)	0.380*** (3.83)
<i>Lnonaf</i>	-0.279 (-1.04)	0.135*** (21.22)	0.011* (1.66)	0.144*** (21.49)
<i>Lsub</i>	-0.361 (-1.04)	0.200*** (19.88)	0.006 (0.59)	0.200*** (19.34)
<i>Opinion_dum</i>	-0.950*** (-6.71)	-0.215 (-0.92)	-0.051 (-1.25)	-0.185 (-0.78)
<i>Invta</i>	-0.658 (-0.26)	0.296*** (3.39)	-0.072 (-0.87)	0.209** (2.33)
<i>Recta</i>	0.324 (0.11)	0.942*** (10.57)	-0.009 (-0.12)	0.924*** (10.14)
<i>Loss</i>	1.084 (0.55)	0.049 (1.53)	-0.023 (-0.70)	0.034 (1.04)
<i>Roa</i>	2.214 (0.87)	-0.328*** (-3.77)	-0.255 (-1.52)	-0.595*** (-6.25)
<i>Lev</i>	-2.609* (-1.80)	0.016 (0.25)	0.086 (1.37)	-0.050 (-0.78)
<i>Size</i>	0.110*** (3.13)	0.999*** (9.72)	0.154* (1.67)	0.392*** (4.07)
<i>Age</i>	0.001 (0.02)	0.004*** (5.37)	0.001 (0.98)	0.005*** (6.89)
<i>Mbe</i>	0.187 (1.03)	-0.003 (-0.12)	-0.001 (-0.76)	0.006* (1.95)
<i>Ceoten</i>	-0.015 (-0.31)	-0.008*** (-3.57)	0.001 (0.33)	-0.006*** (-2.83)
<i>Stdroa</i>	3.932 (0.77)	0.590*** (4.64)	-0.002 (-0.03)	0.650*** (5.01)
<i>Stdcf</i>	-5.210*** (-4.62)	-0.169*** (-3.63)	0.066** (2.00)	-0.072 (-1.48)
<i>Stdsales</i>	0.955*** (2.98)	-0.001 (-0.12)	-0.014** (-2.37)	-0.003 (-0.34)
<i>Audten</i>	-1.481* (-1.75)	-0.025 (-1.27)	0.037 (1.45)	-0.013 (-0.64)
<i>Audchg</i>	-4.594*** (-3.54)	-0.012 (-0.46)	0.179*** (3.39)	0.097*** (2.78)
<i>Busy</i>	-0.615 (-0.82)	-0.010 (-0.46)	0.022 (1.14)	0.025 (1.27)
<i>Ndebt</i>	1.226** (2.00)	0.048** (2.40)	-0.056** (-2.09)	0.016 (0.71)
<i>Nequity</i>	0.9212 (1.21)	-0.016 (-0.88)	-0.015 (-0.78)	-0.022 (-1.19)
<i>MA</i>	-0.753 (-0.58)	0.048 (1.15)	0.017 (0.34)	0.032 (0.76)
<i>Exitem</i>	1.145*** (7.59)	-0.075*** (-2.94)	-0.044*** (-3.53)	-0.106*** (-3.92)

<i>Specialist</i>	0.049 (0.08)	0.035* (1.77)	-0.004 (-0.17)	0.052*** (2.61)
<i>Lgcon</i>	0.903*** (8.35)	0.002 (0.93)	-0.013 (-1.04)	0.004* (1.73)
<i>Mkt_sh</i>	1.333*** (3.31)		-0.001 (-1.34)	
<i>Herfindahl</i>	0.001 (0.45)		-0.001* (-1.70)	
<i>Don_avg</i>	1.297** (2.19)		0.080*** (3.57)	
<i>N</i>	3,973	3,973	3,973	3,973
<i>Industry</i>	Yes	Yes	Yes	Yes
<i>Year</i>	Yes	Yes	Yes	Yes
<i>R²</i>		0.8289	0.0436	0.8210
<i>Maximum Likelihood</i>	103.833 (<0.0001)			
<i>Cragg–Donald Wald F statistic</i>	28.115††		37.413††	
<i>Kleibergen–Paap rk Wald F statistic</i>	13.386†		14.679†	
<i>Partial R²</i>	0.021		0.022	
<i>Partial F stats</i>	3.82 (0.0283)		10.13 (<0.0001)	
<i>Kleibergen–Paap rk LM statistic</i>	p<0.000		p<0.000	
<i>Hansen J statistics for over-identifying restrictions</i>	p>0.1		p>0.1	

Z- statistics and t-statistics, reported in brackets below each coefficient, are calculated based on standard error clustered by firms and year. *, **, *** = statistically significant at less than 0.10, 0.05 and 0.01, respectively. Stock–Yogo critical values for weak identification tests (used for Cragg–Donald Wald and are Kleibergen–Paap rk Wald F statistics) are 19.93 for 10% and 11.59 for 15% maximal relative bias. †† denotes significance at 10% and † denotes significance at 15% according to Stock–Yogo critical values. The variable definitions are presented in Appendix 1.

Table 7: Propensity Matching Samples: Effect of political donations on audit fees

Panel A: Covariate Analysis

	<i>Dondum=0</i>	<i>Dondum =1</i>		
Variables	n=243	n=243	Diff	t-stats
<i>Laf</i>	14.199	13.911	0.288	2.60**
<i>B4</i>	0.858	0.791	0.067	1.34
<i>Bind</i>	0.592	0.484	0.108	3.09***
<i>Femdir</i>	0.158	0.106	0.052	3.43***
<i>Lnonaf</i>	12.720	12.939	-0.219	-1.37
<i>Lsub</i>	2.828	3.038	-0.210	-1.29
<i>Invta</i>	0.083	0.073	0.010	0.73
<i>Recta</i>	0.115	0.109	0.006	0.68
<i>Loss</i>	0.118	0.112	0.006	0.40
<i>Roa</i>	0.019	0.053	-0.034	-1.61
<i>Lev</i>	0.187	0.250	-0.063	-3.16***
<i>Size</i>	20.409	20.631	-0.222	-0.90
<i>Age</i>	2.794	2.616	0.178	1.54
<i>Mbe</i>	3.189	2.534	0.655	1.48
<i>Ceoten</i>	5.561	6.707	-1.146	-1.34
<i>Stdroa</i>	0.064	0.033	0.031	2.32**
<i>Stdcf</i>	0.146	0.188	-0.042	-1.11
<i>Stdsales</i>	0.631	0.967	-0.336	-1.51
<i>Audten</i>	0.002	0.164	-0.162	-3.56***
<i>Audchg</i>	0.182	0.582	-0.4	-6.55***
<i>Busy</i>	0.693	0.812	-0.119	-2.83***
<i>Ndebt</i>	0.590	0.803	-0.213	-4.35***
<i>Nequity</i>	0.368	0.603	-0.235	-3.93***
<i>MA</i>	0.037	0.064	-0.027	-0.84
<i>Exitem</i>	0.103	0.079	0.024	-0.68
<i>Specalist</i>	0.245	0.294	-0.049	-1.23
<i>Lgcon</i>	1.290	1.593	-0.303	-0.46

Panel B: Multivariate Regression (Dependent variable: *Laf*)

Variables	<i>Laf</i>
<i>Intercept</i>	6.703*** (8.05)
<i>Dondum</i>	-0.224*** (-2.66)
<i>B4</i>	0.187 (1.35)
<i>Bind</i>	0.648*** (3.71)
<i>Femdir</i>	0.859* (1.76)
<i>Lnonaf</i>	0.165*** (4.54)

<i>Lsub</i>	0.428*** (8.30)
<i>Invta</i>	0.016 (0.03)
<i>Recta</i>	0.787 (1.65)
<i>Loss</i>	-0.043 (-0.21)
<i>Roa</i>	-0.998 (-1.52)
<i>Lev</i>	-0.091 (-0.28)
<i>Size</i>	0.173*** (3.74)
<i>Age</i>	0.102* (1.71)
<i>Mbe</i>	-0.003 (-0.08)
<i>Ceoten</i>	-0.019 (-1.60)
<i>Stdroa</i>	0.102 (0.12)
<i>Stdcf</i>	0.406 (1.58)
<i>Stdsales</i>	0.018 (0.37)
<i>Audten</i>	-0.121 (-1.46)
<i>Audchg</i>	0.250** (2.11)
<i>Busy</i>	-0.33 (-0.32)
<i>Ndebt</i>	-0.047 (-0.43)
<i>Nequity</i>	0.018 (0.17)
<i>MA</i>	-0.242 (-1.41)
<i>Exitem</i>	-0.236 (-1.56)
<i>Specialist</i>	0.012 (0.13)
<i>Lgcon</i>	0.011* (1.94)
<i>N</i>	634
<i>Industry</i>	Yes
<i>Year</i>	Yes
<i>R²</i>	0.9287

t-stats in parentheses are adjusted for two-way clustering by firms and year.
*, **, *** = statistically significant at less than 0.10, 0.05 and 0.01,
respectively. The variable definitions are presented in Appendix 1.

Table 8: Multivariate analysis for Donor Sample: The relation between CPDs and audit fees

Variables	<i>Laf</i>
<i>Intercept</i>	4.217** (2.28)
<i>Ldon_rank</i>	-0.033*** (-3.10)
<i>B4</i>	0.216* (1.85)
<i>Bind</i>	0.327** (2.06)
<i>Femdir</i>	0.504 (1.15)
<i>Lnonaf</i>	0.001*** (3.67)
<i>Lsub</i>	0.260*** (6.72)
<i>Invta</i>	1.258** (2.59)
<i>Recta</i>	1.840*** (4.46)
<i>Loss</i>	-0.129 (-0.81)
<i>Roa</i>	-1.070* (-1.75)
<i>Lev</i>	0.332 (1.14)
<i>Size</i>	0.396*** (6.66)
<i>Age</i>	-0.118** (2.52)
<i>Mbe</i>	0.030* (1.69)
<i>Ceoten</i>	-0.016 (-1.44)
<i>Stdroa</i>	0.042 (0.06)
<i>Stdcf</i>	-0.082 (-0.66)
<i>Stdsales</i>	0.034 (1.26)
<i>Audten</i>	0.036*** (3.96)
<i>Audchg</i>	-0.044 (-0.73)
<i>Busy</i>	-0.163** (-2.50)
<i>Ndebt</i>	0.034 (0.46)
<i>Nequity</i>	0.068 (0.91)
<i>MA</i>	-0.40 (-0.20)
<i>Exitem</i>	0.036 (0.42)
<i>Specialist</i>	-0.004 (-0.03)
<i>Lgcon</i>	0.005* (1.93)

<i>N</i>	320
<i>Industry</i>	Yes
<i>Year</i>	Yes
<i>R</i> ²	0.8468

t-stats in parentheses are adjusted for two-way clustering by firms and year. *, **, *** = statistically significant at less than 0.10, 0.05 and 0.01, respectively. The variable definitions are presented in Appendix 1.

Figure 1

Paths between CPDs and Auditor Fees

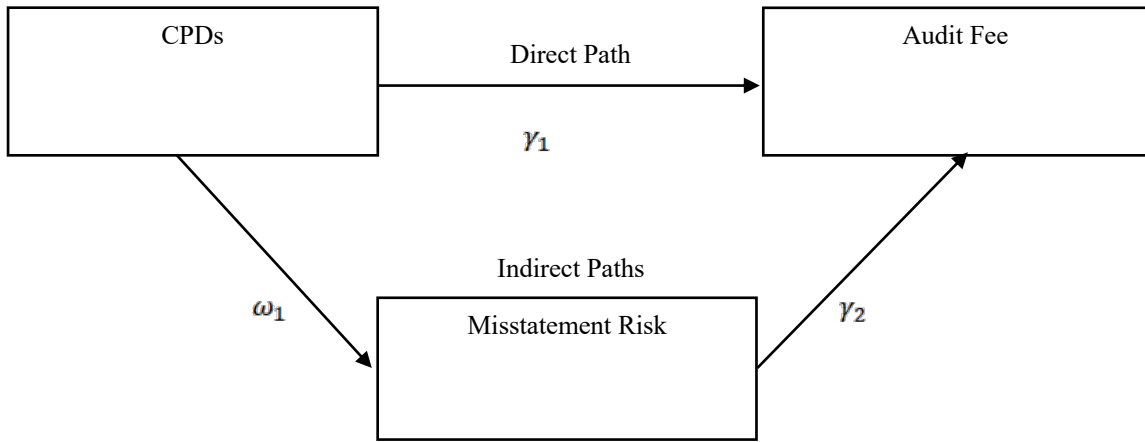


Table 9. Path Analysis: Corporate Political Donation, misstatement risk, and Audit Fees

	<i>Dac</i>		<i>Small Profit</i>		<i>Income Smoothing</i>	
	<i>Dondum</i>	<i>Ldon</i>	<i>Dondum</i>	<i>Ldon</i>	<i>Dondum</i>	<i>Ldon</i>
Direct path $p(CPD, Laf) \gamma_1$	-0.088** (-2.02)	-0.008** (-2.04)	-0.088** (-2.02)	-0.008** (-2.04)	-0.088** (-2.02)	-0.008** (-2.04)
Mediated path for misstatement risk $p(CPD, EM) \omega_1$	-0.019** (-2.21)	-0.002** (-2.20)	-0.034** (-2.16)	-0.003*** (-2.05)	-0.663** (-2.22)	-0.064** (-2.30)
$p(EM, Laf) \gamma_2$	0.159** (2.18)	0.159** (2.18)	0.054* (1.90)	0.058* (1.90)	0.033* (1.85)	0.033* (1.85)
Total mediated path for misstatement risk $\gamma_2 * \omega_1$	-0.005	-<0.001	-0.002	-<0.001	-0.022	-0.002
Percentage of effect mediated	5%	4%	2%	2%	20%	21%
Controls	Included	Included	Included	Included	Included	Included
Industry and Year FE	Included	Included	Included	Included	Included	Included
N.	4,380	4,380	4,722	4,722	4,087	4,087
Equation (2) Adj (Pseudo) R ²	0.1738	0.1745	(0.0538)	(0.0537)	(0.0617)	(0.0706)
Equation (3) Adj R ²	0.8082	0.8082	0.8179	0.8163	0.7804	0.7804

Notes. This table reports the results from a path analysis that examines the effect of corporate political donations on audit fees through misstatement risk. z and t -statistics, reported in parentheses below each coefficient, are calculated based on standard errors clustered by firm. *, **, *** denote significance at the 10%, 5%, and 1% levels, respectively. All variables are defined in Appendix A.

Table 10: Effect of CPDS and government contracts on lead year profitability

Variables	<i>Roa_Lead1</i>		
	(1)	(2)	(3)
Intercept	2.951 (1.61)	6.563* (1.71)	8.212** (2.39)
<i>Dondum</i>	-0.006* (-1.91)	-0.004 (-0.80)	-0.007 (-1.64)
<i>Lgcon_Lead1</i>		0.029** (2.25)	-0.121 (-1.56)
<i>Dondum*Lgcon_Lead1</i>			0.002*** (3.07)
<i>Bind</i>	-0.007 (-0.24)	0.009 (0.25)	0.027 (1.01)
<i>Femdir</i>	-0.017 (-0.31)	-0.040 (-0.45)	-0.060 (-0.72)
<i>Size</i>	0.012*** (3.45)	0.030** (2.18)	0.040*** (2.61)
<i>Lev</i>	0.005 (0.09)	-0.037 (-0.61)	-0.051 (-1.32)
<i>Capex</i>	0.000* (1.95)	0.000 (0.34)	0.000 (1.00)
<i>Cashta</i>	-0.116*** (-2.83)	-0.066 (-0.81)	-0.097 (-1.19)
<i>Cum_salesgrth</i>	0.001 (0.20)	0.003 (0.53)	0.002 (0.39)
<i>Stdroa</i>	0.021 (0.16)	-0.181 (-0.64)	0.220 (1.35)
<i>Ceoten</i>	0.002 (0.18)	-0.001 (-0.50)	-0.001 (-0.70)
<i>N</i>	283	283	283
<i>Industry</i>	Yes	Yes	Yes
<i>Year</i>	Yes	Yes	Yes
<i>R</i> ²	0.3260	0.3304	0.3319

t-stats in parentheses are adjusted for two-way clustering by firms and year. *, **, *** = statistically significant at less than 0.10, 0.05 and 0.01, respectively. The variable definitions are presented in Appendix 1.

Appendix 1

Notation and definition of variable

Dependent variable used in the main analysis

Laf The natural log of audit fees

Variables in the main analysis

Ldon The natural log of the amount of donation

Dondum A dummy variable that equals 1 if a firm makes donations to a political party, and 0 otherwise

Don (\$) The amount of donation

Lgcon The natural log of amount of government contract awarded to a firm

B4 A dummy variable that equals 1 if a company is audited by a Big 4 audit firm, and 0 otherwise

Bind The total number of independent directors scaled by the total number of directors on the board

Femdir The total number of female directors scaled by the total number of directors on the board

Lnonaf The natural log of non-audit fees

Lsub the natural log of the number of subsidiaries

Opinion_dum A dummy variable that equals 1 if a company receives a going concern modified opinion, and 0 otherwise

Invta The ratio of inventory to total assets

Recta The ratio of receivables to total assets

Loss A dummy variable that equals 1 if a company reported a loss, and 0 otherwise

Roa The ratio of net profit after tax to total assets

Lev The ratio of total debt to total assets

Size The natural log of the book value of total assets

Age The natural log of the incorporation age of a firm

Mbe The ratio of market value to book value of equity

Ceoten The length of service by the CEO

Stdroa The standard deviation of profitability of the previous five years

Stdcf The standard deviation of operating cash flow over total assets of the previous five years

Stdsales The standard deviation of sales over total assets of the previous five years

Audten The natural log of auditor tenure

Audchg A dummy variable that equals 1 if a company changes auditor, and 0 otherwise

Busy A dummy variable that equals 1 for firms with fiscal year ending June 30, and 0 otherwise

Ndebt A dummy variable that equals 1 if a company issues new debt, and 0 otherwise

Nequity A dummy variable that equals 1 if a company issues new equity, and 0 otherwise

MA A dummy variable that equals 1 if a company involves in mergers or acquisition transaction, and 0 otherwise

Exitem A dummy variable that equals 1 if extraordinary items are present in the financial statements, and 0 otherwise

Specialist A dummy variable that equals 1 if an audit firm is an industry specialist using market share measures, and 0 otherwise.

Additional variables used in Instrumental variable approach

P_Dondum Predicted value of Don_dum
P_Ldon Predicted value of Ldon
Mkt_sh The firm's total sales scaled by total industry sales
Herfindahl The Herfindahl sales concentration index
Don_avg Average level of the donation amount for all the other firms in the same industry over the same period

Additional variables used in lead year profitability analysis

Roa_Lead1 Lead year profitability
Capex The ratio of capital expenditure to total assets
Cashta The ratio of cash to total assets
Cum_salesgrth Cumulative sales growth of the previous five years

Additional variables used in earnings quality analysis

AC Difference between change in non-current assets minus the change in current liabilities excluding the current portion of long-term debt minus depreciation and amortization scaled by lagged total assets
Ndac Nondiscretionary accruals
Dac Discretionary accruals
TA Total assets
AR Accounts receivable
Rev Net sales revenue
PPE Property, plant, and equipment
Ocf The ratio of operating cash flow to total assets
Pbank Probability of bankruptcy measured by adjusted Zmijewski score
Small Profit A dummy variable which equals 1 if the change in net income scaled by total assets is within the interval (0.00 and 0.02)
Income Smoothing Five-year volatility of earnings scaled by five-year volatility of operating cash flows