Corporate Political Connections, Auditor Choice, and Financial Reporting Quality *

Christopher Bleibtreu [†] Roland Königsgruber [‡] Wenqian Yang [§]

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Abstract

This paper reconciles the mixed empirical evidence on how corporate political connections (CPCs) affect financial reporting and auditor choice. We propose a unifying theoretical framework that integrates insights from the political connections and political costs literatures by distinguishing two distinct economic mechanisms: enforcement leniency and performance-sensitive political benefits. First, we show that CPC firms use audit specialization as an ex-ante bonding mechanism to preempt anticipated earnings management. However, the demand for high-quality auditors collapses when capital market and political incentives perfectly offset, or when public transparency regarding regulatory leniency is exceedingly high. Second, while stronger political benefits and enforcement leniency both exacerbate manipulation, we document that high leniency transparency perversely amplifies this effect: it crowds out private auditor effort, thereby weakening audit discipline and inducing further managerial distortion. Finally, we demonstrate that although auditors strategically reduce effort in highly transparent environments, overall market pricing efficiency remains intact because public information perfectly substitutes for private audit evidence. Our results caution that standard empirical proxies for audit quality must be interpreted carefully, as they often conflate baseline environmental transparency with intrinsic auditor effort.

Keywords: Corporate political connections; Auditor choice; Financial reporting quality; Endogenous audit quality; Rational expectations.

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[†]BI Norwegian Business School.
[‡]SKEMA Business School, Université Côte d'Azur.
[§]University of Mannheim.

1 Introduction

Corporate political connections (CPCs) are a pervasive feature of global capital markets, profoundly shaping the regulatory and economic environments in which firms operate. Consequently, a vast empirical literature examines how these connections influence financial reporting and external oversight. However, this literature frequently yields sharply conflicting findings. For instance, do politically connected firms systematically seek or avoid high-quality auditors? Some studies document that connected firms are more likely to hire Big 4 auditors to mitigate heightened agency conflicts (Guedhami et al., 2014; Khan et al., 2016), whereas others find they actively avoid premium auditors to obscure rent extraction (Guedhami et al., 2009; He et al., 2017). Similarly, evidence on financial reporting quality remains deeply fractured: while some research argues that CPCs degrade transparency (Chaney et al., 2011; Hope et al., 2020), other studies find that connected firms actually report more conservatively (Batta et al., 2014; Jennings et al., 2021). Even evidence on regulatory scrutiny is contradictory, with connected firms facing both more lenient SEC enforcement (Correia, 2014) and a higher likelihood of targeted SEC comment letters (Heese et al., 2017).

These apparent contradictions stem from a fundamental tension: accounting information is not merely a signal to capital markets, but a primary input for political and regulatory decision-making. Firms actively internalize the political consequences of their financial reports across a wide range of regulatory settings, including anti-dumping and import relief (Bollom and Simons, 1990; Jones, 1991), competition policy (Cahan, 1992; Makar and Alam, 1998), rate regulation (D'Souza, 1998; Navissi, 1999; Grace and Leverty, 2010), and environmental regulation (Cahan et al., 1997; Johnston and Rock, 2005). Furthermore, regulators systematically rely on these very same financial reports to justify enforcement actions and allocate state resources; for example, Li and Wang (2024) document that the U.S. Environmental Protection Agency actively retrieves corporate accounting information during enforcement investigations. Therefore, evaluating how CPCs influence reporting quality in isolation ignores the endogenous role of the external auditor, whose mandate is to verify these politically sensitive reports while navigating the firm's specific institutional constraints.

In this paper, we develop a rational expectations model to reconcile these conflicting empirical findings. We argue that the contradictions in the literature arise from treating "political connections" as a monolithic construct. Drawing on insights from political economy and finance, we unbundle CPCs into two distinct economic forces: *enforcement leniency*, which shields connected firms from regulatory penalties for aggressive reporting, and *political reporting incentives*, where state benefits—such as procurement contracts, subsidies, or political costs—are strictly allocated based on reported performance. By embedding these dual mechanisms into a unified game among a manager, an independent external auditor, and a competitive capital market, we jointly endogenize the firm's ex-ante choice of audit specialization and its ex-post financial reporting quality.

Our model delivers three main results. First, we explain the auditor choice puzzle in politically

connected firms by endogenizing the manager's ex-ante choice of audit specialization. Consistent with traditional agency frameworks (Watts and Zimmerman, 1978), the manager's commitment to a specialist auditor serves as a costly bonding mechanism to preempt anticipated pricing penalties. This parallels the logic of bonding to higher regulatory standards to enhance credibility (Coffee, 1998; Stulz, 1999). Crucially, we demonstrate that this demand for high-quality auditing is regime-dependent. Greater political transparency reduces the marginal disciplinary value of the audit, leading the auditor to slack; anticipating this, the manager optimally reduces demand for a specialist. These findings highlight a critical policy implication: while disclosures of political affiliations enhance market discipline, transparency regarding enforcement leniency may actually amplify manipulation incentives unless accompanied by strong regulatory enforcement.[1]

Second, we analyze audit quality along two dimensions: the Audit-Reporting Measure and the Investor-Perception Measure. In equilibrium, both market pricing efficiency and the quality of the audited report strictly increase in the chosen level of audit specialization. However, because public information perfectly substitutes for privately acquired audit evidence, improvements in the public information environment entirely crowd out the auditor's private effort. This formalizes a critical limitation highlighted by DeFond and Zhang (2014): observed audit quality in politically connected firms may appear high—and capital markets may price it efficiently—even when the auditor rationally exerts minimal independent effort.

Third, we document a counterintuitive relationship between regulatory transparency and financial reporting quality. While both political benefit incentives and realized regulatory leniency mechanically exacerbate reporting bias, we find that heightened *transparency* regarding enforcement leniency perversely amplifies managerial manipulation. By crowding out the auditor's private verification effort, it weakens audit discipline and induces further distortion. This mechanism helps reconcile mixed empirical evidence, including findings that earnings quality improves with government effectiveness but deteriorates with political stability (Harymawan and Nowland, 2016). More broadly, our model unifies evidence that politically connected firms engage in both upward and downward manipulation in the presence of a strategic auditor.

Our model relates to the theoretical financial accounting and auditing literature. In a rational expectations framework, Dye and Sridhar (2004) introduce an additive random component to the manager's objective function. We build on this approach by incorporating enforcement leniency as an additive random component in the manager's manipulation cost. Our paper also extends applications of rational expectations models within the auditing setting. For instance, Caskey et al. (2010) study a biased audit committee that pre-commits to costly information acquisition and benefits from a higher stock price. They focus on the committee's ex-ante information precision choices and exclude information choices that are contingent on the manager's report. We alter this approach by introducing an independent external auditor who strategically exerts effort in response to the managerial report. Similarly, Patterson et al. (2019) endogenize audit quality through a detection probability that sustains a linear equilibrium, where the auditor either

[1] In the U.S., for example, there remains an ongoing arms race between new forms of political contributions and disclosure regulation (Congressional Research Service, 2010).

fully corrects the manipulation or is entirely deceived and penalized for market mispricing. In contrast, we allow for a continuous effort choice and assume that penalties are tied to undetected deviations from the true fundamental value (regulatory enforcement) rather than pricing errors (investor litigation). Distinct from both Caskey et al. (2010) and Patterson et al. (2019), we endogenize the firm's auditor specialization choice. Furthermore, to the best of our knowledge, our paper is the first to incorporate the dual effects of CPCs (i.e., enforcement leniency and political benefits) into an analytical auditing setting.

We relate our audit quality measures to the classification framework of DeFond and Zhang (2014), who categorize commonly used proxies into financial reporting outcomes (e.g., discretionary accruals), audit outputs (e.g., restatements and going-concern opinions), and perception-based measures (e.g., earnings response coefficients and cost of capital). In line with this framework, we distinguish between two dimensions of audit quality. First, DeFond and Zhang (2014) define audit quality as the extent to which audited financial statements faithfully reflect the firm's underlying fundamentals. We capture this dimension through the informational gain provided directly by the audit, which we refer to as the *Audit-Reporting Measure*. Second, we capture pricing efficiency using perception-based measures that reflect how effectively markets incorporate the audit report into asset prices. Beyer et al. (2019) define earnings quality as reflecting the informativeness of reported earnings, with a lower residual variance indicating less noise and distortion. Similarly, we interpret pricing inefficiency as the residual uncertainty remaining after the auditor filters managerial bias, and we define market pricing efficiency as the extent to which investors can extract informative signals from the disclosures. We refer to this dimension as the *Investor-Perception Measure*. Analogous measures of precision and informativeness are standard in the analytical auditing literature (Petrov and Stocken, 2022). Empirically, this pricing efficiency is reflected in market-based metrics such as earnings response coefficients and cost-of-capital proxies.

The remainder of the paper proceeds as follows. Section 2 presents the model setup. Section 3 characterizes the equilibrium reporting and pricing outcomes and analyzes financial reporting quality. Section 4 examines the auditor's optimal effort and evaluates empirical audit quality measures. Section 5 develops the manager's ex-ante commitment to audit specialization and the associated comparative statics. Section 6 discusses the empirical implications, and Section 7 concludes. All formal proofs are provided in the Appendix.

2 Model Setup

There are three strategic players in the economy: a manager (he), an auditor (she), and a competitive capital market (investors). Additionally, the firm operates within a political environment where enforcement leniency might be granted and economic benefits are allocated based on audited financial reports.

2.1 Economic Environment and Players

Fundamentals and Political Environment The firm's fundamental performance is normally distributed, $\theta \sim \mathcal{N}(\mu_\theta, \tau_\theta^{-1})$. The firm needs to publish an audited report r_A of its performance.

The firm interacts with a political environment characterized by enforcement leniency $\lambda \sim \mathcal{N}(\mu_\lambda, \tau_\lambda^{-1})$ and a political benefit parameter p_r.[2] Leniency λ functions as a structural shield against enforcement penalties; the manager is only punished for manipulation that exceeds λ.

The parameter p_r captures the political sensitivity of the firm's economic benefits to its reported performance. Depending on the institutional setting, the nature of the political connection dictates the sign and magnitude of p_r:

- $p_r > 0$ **(Political Rents):** The firm is rewarded for demonstrating strong financial performance. This typically reflects scenarios where high reported earnings signal competence or stability, allowing the firm to secure lucrative government procurement contracts, state-backed financing, or favorable regulatory approvals. This dynamic creates a marginal incentive for the manager to artificially inflate the report.

- $p_r < 0$ **(Political Costs):** The firm is penalized for reporting high performance. Consistent with the Political Cost Hypothesis (Watts and Zimmerman, 1978), highly profitable firms may attract negative political attention, triggering windfall taxes, antitrust scrutiny, regulatory intervention, or the withdrawal of state subsidies. In this regime, the manager faces a marginal incentive to artificially deflate the report to avoid political visibility.

- $p_r = 0$ **(No Political Connection):** The firm lacks political ties, or its political benefits are entirely independent of its financial reporting. The manager's reporting incentives are driven strictly by capital market incentives.

Ultimately, the net political benefit (or cost) is allocated based on the final audited report according to the linear rule:

$$B(r_A, p_r) = p_r r_A. \tag{1}$$

The Manager Before observing the firm's fundamental performance θ and enforcement leniency λ, the manager chooses an auditor with specialization level S. Conjecturing on the audited report r_A, the manager chooses an internal financial report r_M to maximize the market price $P(r_A)$ less manipulation costs and audit fees $AF(S)$. The parameter $K_M > 0$ captures the manager's marginal cost of manipulating the financial report. The manager's objective function is:

$$\max_{r_M} \mathbb{E}\left[P(r_A) - \frac{K_M}{2}(r_M - \theta - \lambda)^2 - AF(S) \,\middle|\, S, \theta, \lambda, p_r\right] \tag{2}$$

[2] We assume $\mu_i\sqrt{\tau_i} \geq 3$ for $i \in \{\theta, \lambda\}$. These conditions ensure that the fundamental performance (θ) and leniency (λ) remain in the positive domain with high probability (greater than 99.87 percent). Similar assumptions are standard in the analytical auditing literature (Patterson and Smith, 2003; Patterson et al., 2019).

The Auditor The auditor is characterized by an enforcement strictness $K_A > 0$ (reflecting regulatory oversight, litigation exposure, and reputation costs) and an audit precision cost parameter $c_A > 0$. The auditor's specialization level is defined as $S = K_A/c_A$. We assume that the audit fee increases in the specialization level, such that $AF(S) = \frac{1}{2} f_A S^2$, where $f_A > 0$ is a baseline audit fee parameter.[3]

The auditor observes the internal financial report r_M and decides on her audit effort. Specifically, the auditor exerts effort to determine the precision τ_s of her private audit evidence. The audit provides her with a noisy private signal $s_A = \theta + \varepsilon_s$ of the firm's fundamental performance, where $\varepsilon_s \sim \mathcal{N}(0, \tau_s^{-1})$. Based on r_M and s_A, the auditor issues the published audited report r_A. The auditor minimizes her expected audit costs, which consist of the enforcement penalties from verification failure and the ex-ante cost of acquiring signal precision:

$$\min_{\tau_s \geq 0} \frac{K_A}{2} \mathbb{E}\left[(r_A - \theta)^2\right] + \frac{c_A}{2} \tau_s \tag{3}$$

The Capital Market (Investors) We assume a competitive capital market populated by investors with a Constant Absolute Risk Aversion (CARA) utility function, characterized by an absolute risk aversion coefficient $\rho > 0$.[4] Investors observe the firm's audit specialization choice S, the political sensitivity p_r, and the audited report r_A. Investors know the unconditional distribution of enforcement leniency, $\lambda \sim \mathcal{N}(\mu_\lambda, \tau_\lambda^{-1})$, but observe neither its firm-specific realization nor the manager's internal report r_M.

The total gross value of the politically connected firm is its fundamental performance plus the political benefits generated through connections. Because political benefits are modeled as deterministic transfers conditional on the audited report, the market's risk pricing is isolated to fundamental uncertainty. Investors competitively price the firm by discounting its expected total value by a fundamental risk premium:

$$\begin{aligned} P(r_A) &= \mathbb{E}[\theta + B \mid S, p_r, r_A] - 0.5\rho \operatorname{Var}(\theta \mid S, p_r, r_A) \\ &= \mathbb{E}[\theta \mid S, p_r, r_A] + p_r r_A - 0.5\rho \operatorname{Var}(\theta \mid S, p_r, r_A) \end{aligned} \tag{4}$$

2.2 Timeline

The sequence of events unfolds as follows:

- $t = 0$**:** Nature draws the firm's political benefit parameter p_r, which becomes common knowledge to all players.

[3] Habib (2011) review the extant literature on auditor industry specialization and note that while specialization is theoretically expected to command an audit fee premium to recover costly investments in expertise, empirical evidence is mixed and sensitive to measurement choices.

[4] Empirical evidence suggests that investors perceive politically connected firms as riskier; for instance, institutional ownership in these firms is associated with a stronger demand for high-quality auditing, reflecting underlying concerns over opacity and reporting reliability (Tee et al., 2017).

- $t = 1$**:** The manager chooses an auditor with specialization level S and pays the audit fee $AF(S)$.
- $t = 2$**:** Nature draws the firm's true fundamental performance θ and enforcement leniency λ. The manager privately observes θ and λ and issues an internal report r_M to the auditor.
- $t = 3$**:** The auditor receives the internal report r_M. She chooses an effort level—thereby determining audit precision τ_s—and obtains a private signal s_A about the firm's fundamental performance.
- $t = 4$**:** The auditor releases the audited report r_A on which she is willing to express an unqualified opinion.
- $t = 5$**:** Investors observe p_r, S, and r_A and competitively price the firm. Economic benefits $B(r_A, p_r)$ are allocated based on the audited financial report.

2.3 Equilibrium Definition

We characterize a Perfect Bayesian Equilibrium as follows:[5]

1. The firm's auditor specialization choice $S(p_r)$
2. A managerial internal reporting strategy $r_M(p_r, \lambda, S, \theta)$
3. An auditor information acquisition strategy $\tau_s(p_r, S, r_M)$
4. An auditor reporting strategy $r_A(p_r, S, r_M, s_A)$
5. An investor pricing rule $P(p_r, S, r_A)$
6. Belief systems $\mathbb{E}[\theta, \lambda \mid p_r, S, r_M, s_A]$ of the auditor and $\mathbb{E}[\theta, \lambda \mid p_r, S, r_A]$ of the investors

Such that:

(i) The manager chooses audit specialization S to maximize the expected pricing of the firm net of audit fees, before observing the realizations of θ and λ (given the anticipated continuation equilibrium).

(ii) The manager chooses $r_M(p_r, \lambda, S, \theta)$ to maximize his expected utility conditional on private information (λ, θ) (given the auditor's strategy, the investors' pricing rule, and the political benefit allocation rule).

[5] All aspects of the game, including the timing, action spaces, and payoff functions, are common knowledge. The distributions of the fundamental and political variables (θ, λ) are common knowledge. The political sensitivity parameter p_r is public knowledge, observed by all players. The manager privately observes the realized fundamental performance θ and enforcement leniency λ, while the auditor privately observes her acquired signal s_A.

(iii) The auditor chooses signal precision $\tau_s(p_r, S, r_M)$ to minimize expected verification error and information acquisition costs.

(iv) The auditor chooses $r_A(p_r, S, r_M, s_A)$ according to Bayesian updating.

(v) Investors competitively price the firm according to $P(p_r, S, r_A) = \mathbb{E}[V \mid p_r, S, r_A] - 0.5\rho \operatorname{Var}(\theta \mid p_r, S, r_A)$.

(vi) Beliefs are consistent with equilibrium strategies and are updated according to Bayes' rule whenever possible.

We restrict our attention to linear rational expectations equilibria, which are linear in the available information.

3 Equilibrium Analysis

We solve the game via backward induction, beginning with the reporting and pricing stage. At this stage, the manager has made an ex-ante commitment to auditor specialization S,[6] and the auditor has invested in her signal precision τ_s.

3.1 Conjectured Linear Strategies

The Manager Anticipating the auditor's response to the initial report r_M and the capital market's response to the audited report r_A, the manager issues an initial report that is a linear combination of the firm's true fundamental performance θ, the political sensitivity parameter p_r, and the enforcement leniency λ:

$$r_M = \delta_0 + \delta_\theta \theta + \delta_p p_r + \delta_\lambda \lambda \tag{5}$$

The Auditor The auditor receives the private signal $s_A = \theta + \varepsilon_s$. She observes the manager's report r_M and knows the public political sensitivity parameter p_r. Because p_r is public knowledge, the auditor perfectly filters out the deterministic reporting bias driven by political incentives. However, because the manager privately observes enforcement leniency λ, the auditor cannot perfectly isolate the firm's true fundamentals θ from the filtered report. Consequently, the internal report serves as an informative but composite signal of fundamentals clouded by leniency noise. To minimize her expected verification error, the auditor optimally combines this report with her independent evidence s_A via the Bayesian posterior mean:

$$r_A = \phi_0 + \phi_s s_A + \phi_r r_M \tag{6}$$

[6] The audit fee is thus regarded as a sunk cost at this stage.

The Capital Market (Investors) Investors observe the audited report r_A. They form rational expectations of the firm's total gross value, $V = \theta + B(r_A, p_r)$. The pricing strategy is linear in the audited report:

$$P(r_A, p_r) = \pi_0 + \pi_r r_A \tag{7}$$

3.2 Equilibrium Characterization

Because each player's optimal strategy depends on the conjectured linear strategies of the others, the equilibrium coefficients are jointly determined by solving for a fixed point in the mutual best-response mapping.

Proposition 1. *The unique linear rational expectations equilibrium is as follows:*

$$\textit{Manager:} \qquad r_M = \theta + \lambda + \frac{\tau_\lambda(1 + p_r)}{K_M\sqrt{S}}$$

$$\textit{Auditor:} \qquad r_A = \left(\frac{\tau_\lambda}{\sqrt{S}}\right) r_M + \left(1 - \frac{\tau_\theta + \tau_\lambda}{\sqrt{S}}\right) s_A + \left(\frac{\mu_\theta\tau_\theta - \tau_\lambda\mu_\lambda}{\sqrt{S}} - \frac{\tau_\lambda^2(1 + p_r)}{K_M S}\right)$$

$$\textit{Investors:} \qquad P = (1 + p_r)r_A - \frac{\rho}{\sqrt{S}}$$

All proofs are provided in the Appendix.

Proposition 1 highlights the strategic tension between managerial reporting incentives and the disciplining role of auditor specialization. The manager's optimal reporting strategy r_M incorporates the economic fundamental θ, regulatory leniency λ, and an endogenous discretionary bias. This manipulation increases in the absolute magnitude of the firm's net political incentives p_r and leniency transparency τ_λ, but is strictly constrained by the manager's enforcement exposure K_M and ex-ante bonding via audit specialization S[cite: 9, 35, 5901, 8815].

The auditor's equilibrium strategy r_A reflects an optimal substitution between public information and privately acquired evidence. A specialist auditor strategically reduces her reliance on the manager's potentially biased report (weighted by $\frac{\tau_\lambda}{\sqrt{S}}$) and relies more heavily on her independent private signal s_A[cite: 2367, 7412].

Finally, the investors' linear pricing strategy P demonstrates the informational sufficiency of the audited report. Because the auditor is disciplined by regulatory enforcement rather than ex-post shareholder litigation (Patterson et al., 2019), she fully internalizes the bias-filtering process. Consequently, the capital market optimally defers to the auditor's posterior expectation, treating r_A as a sufficient statistic for valuation. This mechanism structurally diverges from prior rational expectations models (Fischer and Verrecchia, 2000; Dye and Sridhar, 2004; Caskey et al., 2010; Patterson et al., 2019), where investors must independently unravel managerial bias. In our setting, the regulatory framework shifts the burden of filtering bias entirely from the capital market to the external auditor, formalizing her core gatekeeping function[cite: 5849, 5871].

3.3 Financial Reporting Quality

We define ex-post managerial manipulation as the deviation of the internal report from the firm's true fundamental performance:

$$m \equiv r_M - \theta. \tag{8}$$

Corollary 1. *In equilibrium, ex-post managerial manipulation is jointly driven by the firm's directional political incentives (p_r) and realized enforcement leniency (λ), while being moderated by audit specialization (S):*

$$m^* = \lambda + \frac{\tau_\lambda(1 + p_r)}{K_M\sqrt{S}}. \tag{9}$$

Our model identifies four distinct channels through which political connections shape earnings management behavior, filtered through the disciplining mechanism of the external auditor.

The primary channel operates through directional political incentives (p_r) and establishes a critical neutralizing benchmark. Political connections scale the marginal benefit of manipulation directly via the composite term $(1 + p_r)$, which represents the sum of standard capital market incentives (1) and political incentives (p_r). When political rent-seeking incentives are present ($p_r > 0$, hence $1 + p_r > 1$), the manager aggressively inflates the internal report to capture state benefits on top of market rewards; conversely, when political costs are present ($p_r < 0$, hence $1 + p_r < 1$), the manager suppresses reported performance relative to an unconnected firm to avoid regulatory extraction. Crucially, our framework characterizes a unique neutralizing benchmark at $p_r = -1$: when political cost penalties exactly offset capital market pricing incentives ($1 + p_r = 0$), the manager's strategic, price-driven motivation to manipulate completely collapses, leaving only the structural safe harbor λ. This mechanism unifies empirical evidence showing that connected firms engage in aggressive upward earnings management to extract state rents (Gross et al., 2016), but shift toward income-decreasing accruals or real activities manipulation to obscure visibility when political exposure is high (Ramanna and Roychowdhury, 2010; Braam et al., 2015).

A second channel operates through realized enforcement leniency (λ), which enters the reporting strategy additively. Higher realizations of λ directly expand the scope for distortion by relaxing the effective threshold at which regulatory penalties trigger. This safe-harbor expansion formally captures extensive archival evidence documenting that politically connected firms face systematically weaker enforcement and exhibit higher baseline levels of manipulation (Chaney et al., 2011; Yu and Yu, 2011; Correia, 2014).

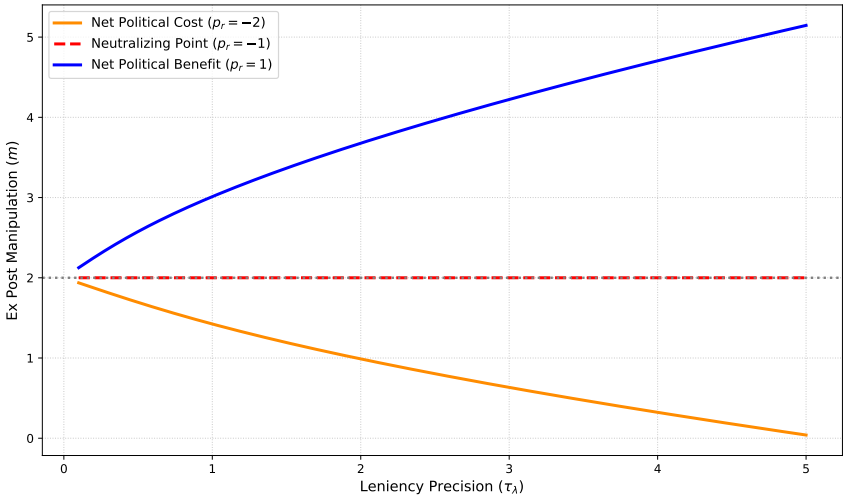
Corollary 2. *In equilibrium, the direction of the marginal change in reporting distortion with respect to leniency transparency is uniquely determined by the firm's net political incentives:*

$$\frac{dm^*}{d\tau_\lambda} \begin{cases} > 0 & \text{if } 1 + p_r > 0 \quad \textit{(Political Rents)} \\ < 0 & \text{if } 1 + p_r < 0 \quad \textit{(Political Costs)} \end{cases} \tag{10}$$

A third channel is governed by leniency transparency (τ_λ) and its interaction with auditor discipline. The prior precision of enforcement leniency (τ_λ) appears in the numerator of the

discretionary bias term. While greater transparency conceptually clarifies regulatory boundaries, it introduces a subtle strategic friction into the reporting game. As detailed in Corollary 2, highly predictable leniency alters the auditor's ex-ante optimization, crowding out independent audit effort and perversely amplifying managerial distortion.

Figure 1: Ex-Post Manipulation and Leniency Transparency



Note: This figure illustrates the relationship between ex-post managerial manipulation (m^*) and enforcement leniency transparency (τ_λ). Baseline parameters are set to $K_M = 1.0$, $\lambda = 2.0$, $p_r = \{-2, -1, 1\}$, and $S = 1.0$ (with background market parameters $\rho = 1.0$ and $f_A = 0.05$).

Finally, both external auditor specialization (S) and managerial manipulation costs (K_M) act as foundational constraints on discretionary distortion. Committing ex-ante to a highly specialized auditor ($\sqrt{S}$) successfully disciplines the manager's ex-post reporting behavior. This provides a formal theoretical foundation for the empirical findings of Guedhami et al. (2014), who document that connected firms audited by Big 4 auditors exhibit lower earnings management and superior transparency outcomes.

4 Audit Effort and Audit Quality Measures

4.1 Auditor Effort Choice

The auditor selects her level of private evidence-gathering effort, $\tau_s \geq 0$, to minimize the joint costs of expected enforcement penalties and effort exertion. This optimization results in an equilibrium effort level that fills the gap between the specialization-mandated assurance target and the informativeness of the existing environment.

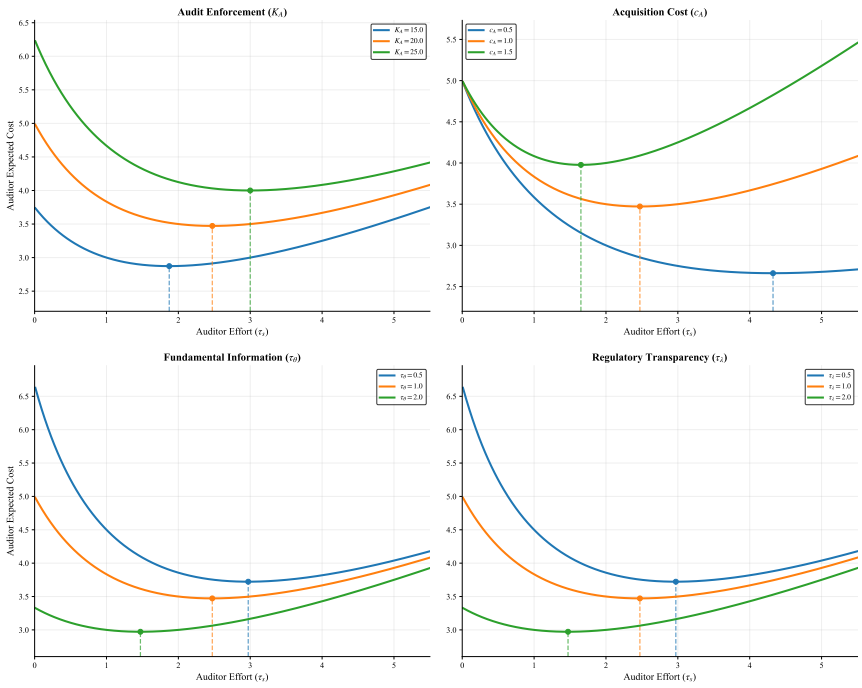
Proposition 2. *The auditor's optimal effort τ_s^* is given by:*

$$\tau_s^* = \begin{cases} \sqrt{S} - \tau_\theta - \tau_\lambda & \text{if } \sqrt{S} > \tau_\theta + \tau_\lambda \\ 0 & \text{otherwise} \end{cases} \tag{11}$$

where $S = K_A / c_A$ represents the auditor's specialization level.

Proposition 2 formalizes the strategic substitution between pre-existing environmental transparency and the auditor's endogenous effort choice. Because the total precision of the information environment is the sum of public transparency and private audit evidence ($\tau_{total} = \tau_\theta + \tau_\lambda + \tau_s$), substituting the optimal effort τ_s^* reveals that the auditor always targets a constant total posterior precision of $\tau_{total} = \sqrt{S}$. When fundamental transparency (τ_θ) or regulatory leniency transparency (τ_λ) is high, these sources provide a baseline level of information that allows the auditor to reduce private information acquisition while still hitting her required precision target.

Figure 2: Auditor Effort Crowding Out



Note: This figure illustrates optimal auditor effort (τ_s^*) as a function of pre-existing environmental transparency ($\tau_\theta + \tau_\lambda$). Private effort is perfectly crowded out once baseline transparency reaches the specialization target $\sqrt{S}$.

The crowding-out effect of private audit effort is conceptually analogous to institutional guidelines governing the extent of substantive testing based on the quality of existing evidence. Specifically, PCAOB, AS 1105 (2010) state:

> "The quantity of audit evidence needed is affected by the risk of material misstatement [...] and the quality of the audit evidence obtained. As the quality of the evidence increases, the need for additional corroborating evidence decreases."

4.2 Empirical Proxies and Measurement Ambiguity

Consistent with the classification framework in DeFond and Zhang (2014), we examine two distinct dimensions of audit quality: (1) an *audit-reporting measure* reflecting the informativeness provided directly by the auditor, and (2) an *investor-perception measure* capturing how efficiently the market prices that information.

We define the quality of the audited report as the precision gain regarding the fundamental value, $Q = \tau(\theta \mid r_A) - \tau_\theta$. Similarly, we define Market Pricing Efficiency (MPE) as the inverse of the pricing error variance, $MPE = 1/\text{Var}(P - (\theta + p_r r_A))$. Substituting the equilibrium strategies yields the reduced-form values for both measures:

$$Q(S) = \sqrt{S} - \tau_\theta, \tag{12}$$

$$MPE(S) = \sqrt{S}. \tag{13}$$

Unsurprisingly, both measures strictly increase in the ex-ante audit specialization level (S). However, evaluating these measures in equilibrium reveals a more subtle institutional friction regarding how audit quality is empirically observed.

Corollary 3. *Conditional on the firm's auditor specialization choice (S), observed audit quality proxies (Q and MPE) are invariant to the transparency of the regulatory environment (τ_λ). Because public transparency perfectly crowds out private audit effort (τ_s^*), standard empirical proxies load entirely on the total precision target ($\sqrt{S}$) rather than the auditor's intrinsic effort.*

Corollary 3 provides a formal theoretical foundation for a critical empirical limitation emphasized by DeFond and Zhang (2014): commonly used audit quality proxies consistently fail to separate pure auditor performance from the underlying information environment. While prior literature treats this primarily as an empirical identification challenge, our model demonstrates that it arises endogenously. Because public transparency crowds out private effort, reporting- and perception-based measures become structurally insensitive to the specific mix of public and private information for a given auditor. Consequently, empirical observations of "high audit quality" in politically connected firms may efficiently reflect the ex-ante specialization target S, even when the auditor rationally exerts minimal independent effort ex-post ($\tau_s^* \approx 0$).

5 Manager's Auditor Choice

We now turn to the auditor-choice stage of the game. The manager seeks to maximize his expected utility, which depends on the market's pricing of the audited report (r_A), the expected internal enforcement penalty, and the audit fee. Formally:

$$\max_S \quad \mathbb{E}[P(r_A, p_r) \mid p_r] - \frac{K_M}{2}\mathbb{E}[(r_M - \theta - \lambda)^2 \mid p_r] - \frac{1}{2} f_A S^2 \tag{14}$$

Proposition 3. *The manager's ex-ante optimal choice of audit specialization (S^{**}) is given by:*

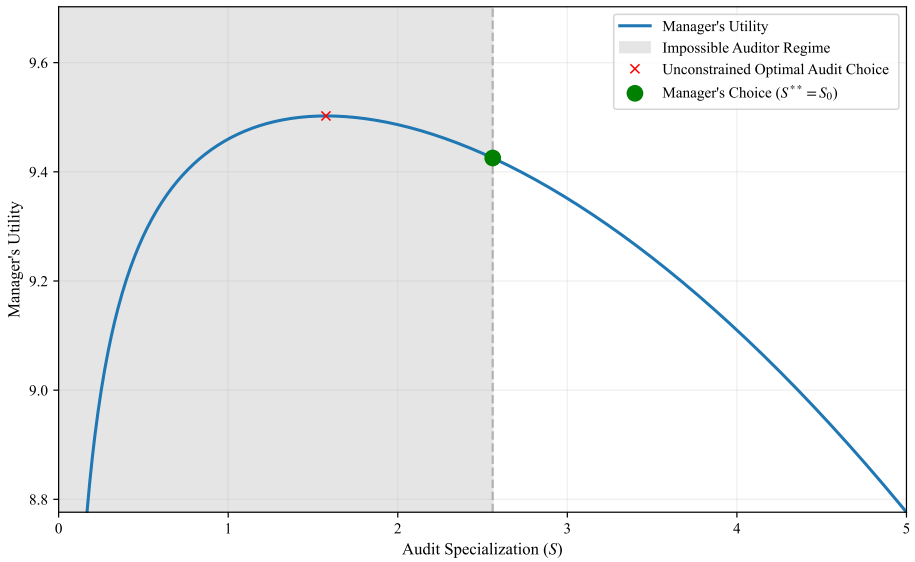
$$S^{**} = \begin{cases} S^* & \text{if } W(S^*) > W(S_0) \text{ and } S^* > S_0 \\ S_0 & \text{otherwise} \end{cases} \tag{15}$$

where S^* uniquely solves $2f_A(S^*)^3 - \rho\sqrt{S^*} - \frac{\tau_\lambda^2(1+p_r)^2}{K_M} = 0$. The boundary floor $S_0 = (\tau_\theta + \tau_\lambda)^2$ represents the minimum precision achieved when the auditor exerts zero private effort ($\tau_s^* = 0$).

The piecewise boundary in Proposition 3 formalizes a critical substitution effect: the crowding out of voluntary private audit verification by public regulatory enforcement. Consistent with Positive Accounting Theory (Watts and Zimmerman, 1978), the manager's ex-ante choice of auditor specialization serves as a costly bonding mechanism. A premium auditor ($S^* > S_0$) is hired if and only if the manager's political incentives to manipulate and the market's required risk premium are severe enough to justify the verification costs required to preempt expected manipulation losses. This theoretical result aligns with Guedhami et al. (2014), who document that connected firms are more likely to hire Big 4 auditors when agency conflicts and expropriation risks are most severe, implying that capital markets price the auditor's active monitoring role.

Crucially, the specialization variable S represents the *total precision* of the audited report, which aggregates the auditor's private effort (τ_s^*) with pre-existing public information quality ($\tau_\theta + \tau_\lambda$). Consequently, the total precision of the information environment is bounded by a structural floor: $S_0 = (\tau_\theta + \tau_\lambda)^2$.

Figure 3: Impossible Audit Regime



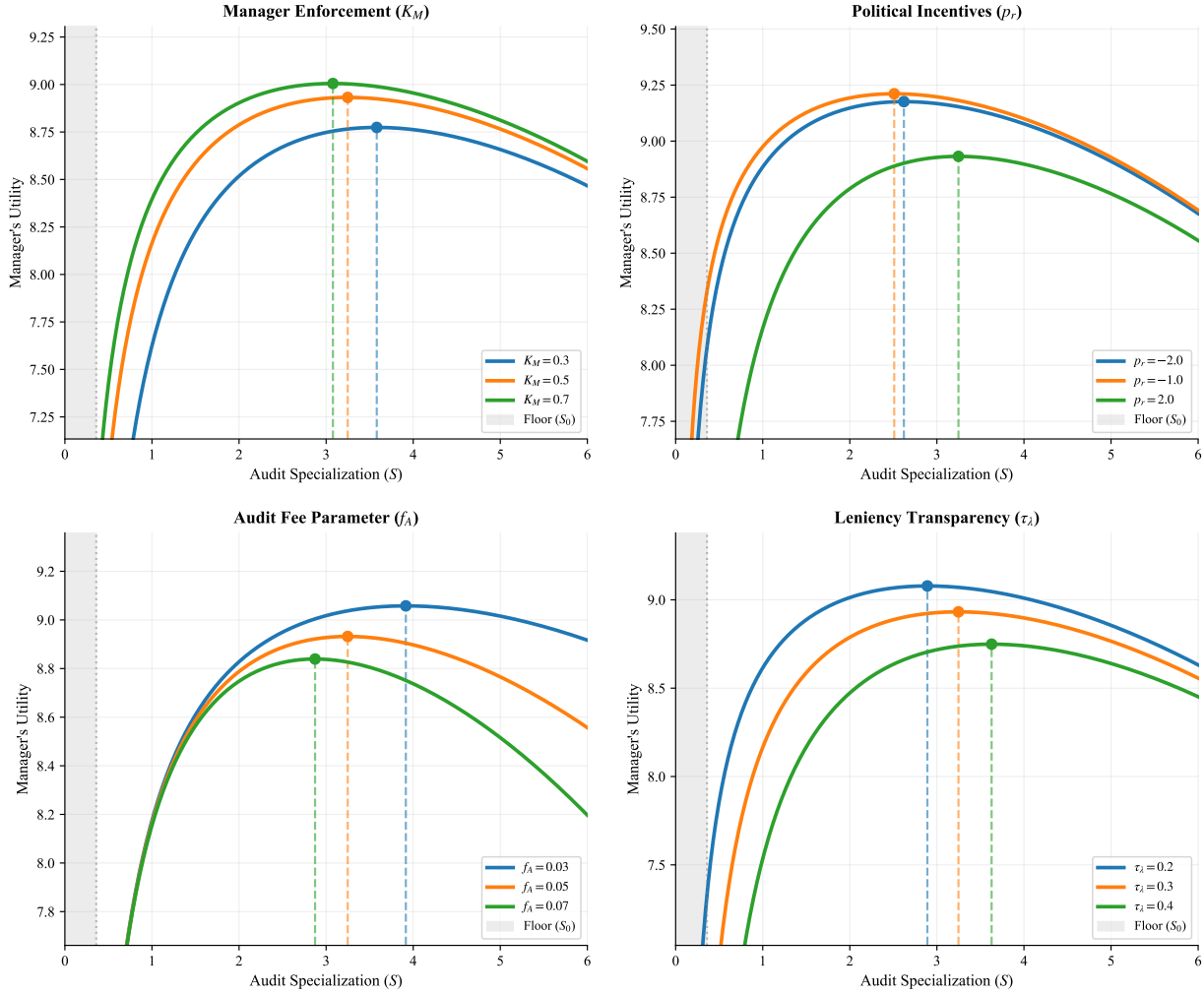
Note: This parameter set illustrates the "crowding out" corner solution where public transparency entirely substitutes for private audit effort. Baseline parameters are set to $K_M = 1.0$, $f_A = 0.05$, $\tau_\theta = 0.6$, $\tau_\lambda = 1.0$, $p_r = -1.0$, $\rho = 0.5$, and $\theta = 10.0$. By setting the political multiplier to the neutralizing point ($p_r = -1.0$) alongside a low risk premium ($\rho = 0.5$) and high audit fees ($f_A = 0.05$), the manager's endogenous demand for total audit capacity drops to a minimum ($\sqrt{S^*} \approx 1.38$). Because the prior public precision from fundamentals and leniency transparency ($\tau_\theta + \tau_\lambda = 1.6$) strictly exceeds this demanded capacity, the auditor's optimal private effort hits the zero lower bound ($\tau_s^* = 0$). This captures the economic regime where strict public regulation and a transparent information environment completely crowd out the need for private audit verification.

As illustrated in Figure 3, the net benefit of inducing private audit effort can become strictly negative. Economically, choosing $S^{**} = S_0$ is equivalent to hiring a minimum-compliance auditor from the lowest available tier. In this impossible audit regime, an external auditor simply free-rides on existing public disclosures, rendering the incurred audit fee a pure deadweight cost that yields no incremental information. Consequently, to avoid dissipating resources on unutilized verification capacity, the firm optimally hires the lowest-cost auditor ($S^{**} = S_0$).

Empirical evidence confirms that external auditing does not always provide substantial incremental information beyond the pre-existing disclosure environment. Prior research establishes that overall financial reporting quality reflects multiple institutional factors, with audit quality representing only a single composite element, making the auditor's marginal contribution difficult to isolate (DeFond and Zhang, 2014). Furthermore, systematic differences in commonly used audit quality proxies are frequently driven by client characteristics rather than variations in intrinsic auditor effort (Lawrence et al., 2011). Consistent with these dynamics, politically connected firms frequently select low-quality auditors to obscure rent-seeking activities, indicating that the audit functions primarily as a minimal compliance signal rather than an active monitoring mechanism (Habib et al., 2017). Together, these findings support the notion that in sufficiently transparent

environments, the incremental value of private audit effort is heavily constrained, corroborating our model's prediction of a "useless" audit regime.

Figure 4: Optimal Choice of Auditor



Note: Baseline parameters are set to $K_M = 0.5$, $f_A = 0.05$, $\tau_\theta = 0.3$, $\tau_\lambda = 0.3$, $p_r = 2.0$, and $\rho = 1.0$.

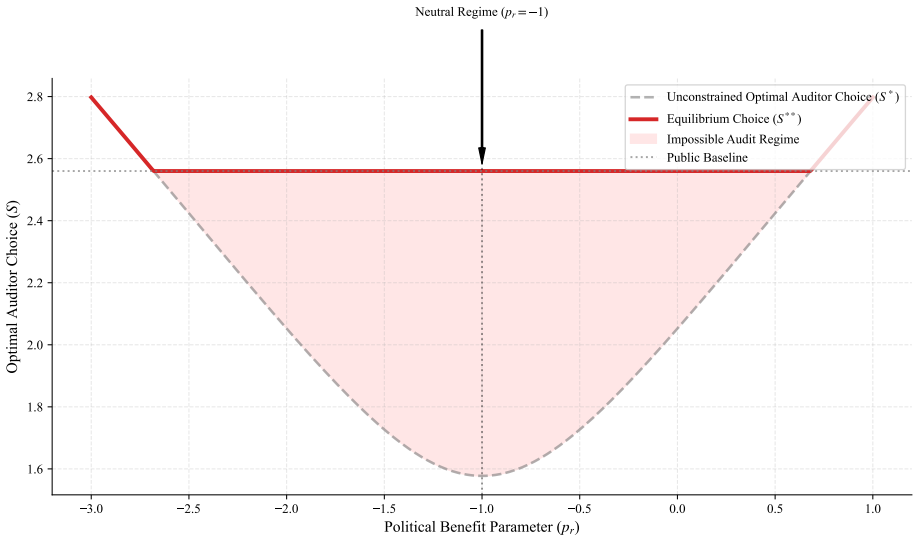
Corollary 4. *The comparative statics for the manager's unconstrained ex-ante optimal audit specialization choice (S^*) are summarized in Table 1:*

Table 1: Comparative Statics for Unconstrained Audit Specialization (S^*)

	Sign of $\frac{\partial S^*}{\partial x}$		
Parameter (x)	$1 + p_r > 0$	$1 + p_r = 0$	$1 + p_r < 0$
Political benefit parameter (p_r)	+	0	−
Managerial Enforcement (K_M)	−	0	−
Leniency Precision (τ_λ)	+	0	+
Investor Risk Aversion (ρ)	+	+	+
Audit Fee Parameter (f_A)	−	−	−

Interpretation of Comparative Statics When net reporting incentives are positive ($1 + p_r > 0$), firms face sufficient combined capital market and political pressures to inflate earnings, driving the manager to optimally pre-commit to a more specialized auditor. Conversely, when political costs dominate ($1 + p_r < 0$), political penalties for reported profitability (e.g., windfall taxes or antitrust scrutiny) severely outweigh standard market rewards. This incentivizes aggressive downward manipulation that similarly demands specialist verification to restore pricing credibility. At the neutralizing benchmark ($1 + p_r = 0$), capital market incentives and political costs perfectly offset one another, leaving the manager with zero net incentive to distort the report. Here, the sole remaining motive for audit specialization is compressing the investors' required risk premium (ρ); if baseline risk aversion is sufficiently mild, the manager rationally abandons costly bonding and defaults entirely to the minimum-compliance auditor ($S^{**} = S_0$).

Figure 5: U-Shaped Auditor Choice Around $p_r = -1$



When $1 + p_r \neq 0$, the equilibrium demand for audit specialization is jointly determined by managerial enforcement costs, audit fee structures, investor risk aversion, and leniency transparency. To preempt expected manipulation losses—which are fully anticipated and priced by the

market—the manager voluntarily pre-commits to a specialist auditor. The optimal auditor choice occurs where the marginal cost of specialization ($f_A S^*$) equals the marginal benefit from reducing expected deadweight manipulation losses and risk discounting. Specifically, stricter managerial enforcement (K_M) acts as a direct substitute for external audit discipline, compressing the need for specialized verification.[7] Higher audit fee parameters (f_A) naturally scale up these marginal bonding costs and crowd out demand for specialization.

Interestingly, pre-existing leniency precision (τ_λ) exhibits a non-monotonic dual effect. On the margins, higher transparency increases the expected penalty of reporting deviations, driving the manager to demand a more specialized auditor to offset heightened agency risks ($\frac{\partial S^*}{\partial \tau_\lambda} > 0$). However, if regulatory leniency becomes *extremely* transparent to the market, the public structural floor (S_0) expands to the point that it overtakes unconstrained optimal demand. At this critical threshold, private verification becomes redundant, and the manager defaults strictly to the lowest-cost compliance auditor (see Figure 5).

Because the manager commits to the auditor specialization S^* prior to observing the realized fundamental performance θ and leniency λ, the auditor selection functions purely as an ex-ante bonding mechanism rather than an ex-post signaling device. By publicly locking in external verification capacity before the state of the world is realized, the manager effectively constrains his own future ability to engage in unobservable signal-jamming during the reporting stage (Stein, 1989).

Empirical evidence broadly supports these comparative statics in politically connected firms. Political ties generate conflicting incentives: managers may seek lower-quality auditors to shield rent-seeking extraction from scrutiny, while simultaneously facing strong demands to bond with investors via high-quality auditors, yielding mixed empirical outcomes (Habib, 2011; Ma et al., 2013). Consistent with our documented substitution effects, research confirms that firms in weaker overall institutional environments systematically rely on high-quality auditors as a substitute to bond with investors (Guedhami et al., 2014). However, when political connections provide direct idiosyncratic protection from regulatory enforcement—effectively lowering the manager's expected penalty exposure—the firm's demand for external audit discipline is heavily compressed, resulting in lower overall reporting quality (Chaney et al., 2011; Correia, 2014). Furthermore, capital markets price the elevated informational risk of connected firms by demanding superior audit quality, a dynamic directly reflected in corresponding audit fee premiums (Francis et al., 2005; Tee et al., 2017). Ultimately, auditor selection remains highly sensitive to cost frictions and structural client characteristics, confirming the endogenous and non-monotonic nature of the specialization choice (Lawrence et al., 2011).

As formally established in Corollary 2, an increase in leniency transparency (τ_λ) strictly amplifies the absolute magnitude of managerial manipulation. This highlights an unintended consequence driven by the auditor's endogenous effort substitution. When regulatory leniency becomes highly predictable, the auditor optimally substitutes costly private information acquisition

[7] We note that the manager's endogenous preference for higher audit specialization partially reflects the assumed quadratic curvature of internal manipulation costs.

with pre-existing public disclosures while maintaining her target posterior precision. Anticipating this strategic reduction in private effort—and the resulting relaxation of direct audit discipline—the manager optimally expands reporting manipulation.

This mechanism provides a formal theoretical foundation for the empirical evidence documented by Harymawan and Nowland (2016). In our framework, broad improvements in government effectiveness enhance the overall fundamental information environment, strengthening reporting discipline and compressing manipulation. Conversely, political stability increases the specific transparency of enforcement leniency, crowds out private audit effort, and consequently induces greater managerial distortion.

Corollary 5. *Given the public structural baseline $S_0 = (\tau_\theta + \tau_\lambda)^2$, equilibrium report quality is defined piecewise:*

$$Q = \begin{cases} \sqrt{S^*} - \tau_\theta & \text{if } S^* > S_0 \\ \tau_\lambda & \text{otherwise} \end{cases} \tag{16}$$

where S^* uniquely solves the manager's unconstrained first-order condition. The comparative statics for equilibrium auditor effort (τ_s^*) and total audited report quality (Q) are summarized in Table 2.

Table 2: Comparative Statics for Audit Effort and Report Quality

Increase in Parameter (x)	**Audit Effort** $\left(\frac{\partial \tau_s^*}{\partial x}\right)$	**Report Quality** $\left(\frac{\partial Q}{\partial x}\right)$
Fundamental Precision (τ_θ)	$-$	$-$
Leniency Precision (τ_λ)	$+/-$	$+$
Investor Risk Aversion (ρ)	$+$	$+$
Audit Fee Parameter (f_A)	$-$	$-$
Managerial Penalty (K_M)	$-$	$-$
Political Parameter (p_r) *if* $1 + p_r > 0$	$+$	$+$
Political Parameter (p_r) *if* $1 + p_r < 0$	$-$	$-$
Realized Leniency (λ)	0	0

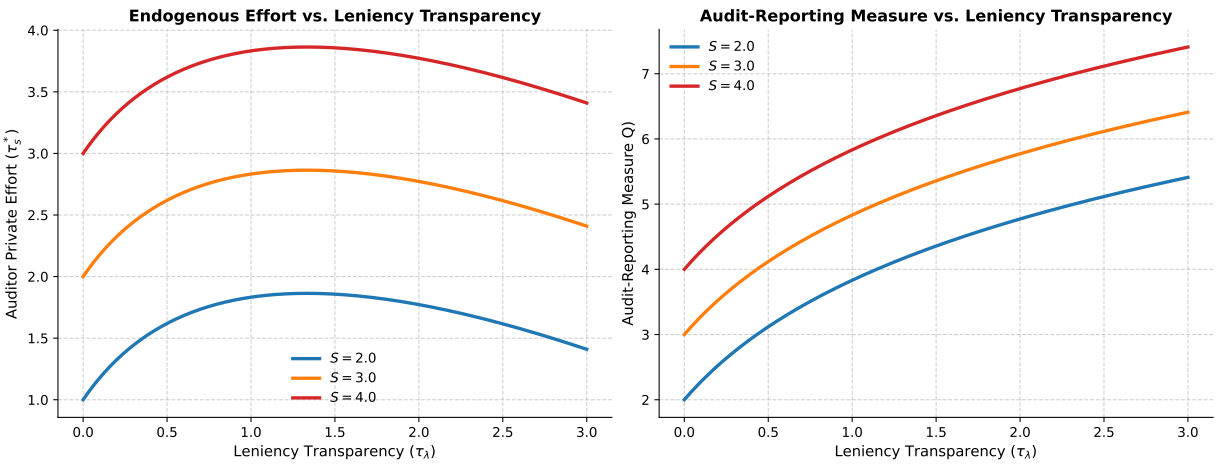
Note: For leniency precision (τ_λ), there exists a strictly positive transparency threshold governed by investor risk aversion ρ where the direct substitution effect overtakes the capacity expansion effect. Beyond this threshold, equilibrium private effort τ_s^* transitions from increasing to decreasing in τ_λ, ultimately collapsing to zero when the structural floor S_0 binds.

Fundamental transparency (τ_θ) affects audit effort through a pure substitution channel: as pre-existing disclosures regarding fundamental performance improve, the auditor optimally reduces private evidence gathering, leaving total informational value unchanged.

In contrast, leniency transparency (τ_λ) generates a highly non-monotonic response in audit effort driven by two opposing economic forces. At very low levels, the direct substitution effect

dominates: the auditor immediately scales back private effort as public transparency improves. As transparency continues to rise, however, it severely inflates expected enforcement risk, driving a massive capacity expansion by the manager that forces the auditor to work harder. Finally, at extreme levels of transparency, the baseline environment becomes so precise that the auditor optimally shirks entirely. Despite this non-monotonic pattern in private effort, total audited report quality increases monotonically because it is strictly pinned down by the manager's total capacity commitment. While private effort adjusts endogenously within that constraint, heightened transparency ultimately expands the composite precision of the environment, ensuring that report quality continues to scale even as private verification effort declines (see Figure 6).

Figure 6: Auditor Effort and Total Report Quality



Investor risk aversion (ρ) drives baseline demand for audit quality. Because investors demand superior compensation to bear informational uncertainty, the manager optimally commits to greater audit specialization to minimize discounting and sustain asset prices. Conversely, higher fee parameters (f_A) directly compress the demand for specialization by inflating the marginal cost of bonding. Stronger internal reporting discipline (K_M) similarly reduces external demand, acting as an internal substitute that directly bounds managerial distortion.

The political benefit parameter (p_r) governs auditor choice through its direct scaling of manipulation incentives. When net reporting incentives are positive ($1 + p_r > 0$), expanding p_r intensifies upward manipulation, forcing the manager to secure higher specialization to credibly bond with the market. Conversely, when political costs dominate ($1 + p_r < 0$), a more severe political penalty (a more negative p_r) intensifies downward manipulation, subsequently raising optimal specialization demand.

Collectively, we predict that private audit effort is systematically lower in highly transparent regimes, such as heavily regulated industries or jurisdictions mandating robust disclosures of political ties. This formalizes arguments by Lawrence et al. (2011), who posit that standard empirical audit quality proxies (e.g., Big-N affiliation) largely capture underlying client characteristics rather than intrinsic auditor performance. When enforcement leniency is highly predictable, the auditor optimally scales back private evidence gathering while flawlessly clearing her mandated

assurance targets. This mechanism provides an equilibrium rationale for empirical findings by Myers et al. (2018), suggesting that the pure incremental informational value of external audits may be systematically overstated in archival literature.

Finally, both private audit effort and total report quality (Q) are entirely independent of the realized ex-post level of regulatory leniency (λ). Because the specialization contract is designed strictly to resolve ex-ante informational frictions, equilibrium effort is governed entirely by environmental distribution parameters (τ_λ) rather than localized state realizations.

6 Empirical Implications

The empirical literature on the accounting and financial effects of corporate political connections (CPCs) has grown voluminous, yet frequently produces conflicting findings. Our analytical framework suggests that these mixed results arise because political connections capture distinct underlying economic mechanisms. By separating the effects of enforcement leniency (λ) and the sensitivity of economic benefits to reported performance (p_r), while endogenizing audit specialization (S^*), the model provides a unified structure for empirical analysis.

Explaining the Auditor Choice Puzzle and Financial Report Quality Existing evidence on how CPCs affect auditor choice is ambiguous. Some studies find that politically connected firms hire high-quality auditors to reduce agency conflicts (Guedhami et al., 2014; Khan et al., 2016), whereas others document a preference for lower-quality oversight to facilitate opacity and rent extraction (Guedhami et al., 2009; He et al., 2017).

Our framework reconciles these conflicting findings by modeling auditor choice as an endogenous equilibrium outcome:

$$S_i^* = F(p_{r,i}, \tau_{\lambda,i}, K_{M,i}, \rho_i, f_{A,i})$$

where audit specialization reflects the firm's optimal tradeoff between the bonding benefits of credible reporting and the costs of external discipline. Stronger political incentives increase expected manipulation and therefore raise the demand for specialist auditors to mitigate anticipated enforcement and pricing penalties. In contrast, stronger internal discipline (K_M) acts as a substitute for external monitoring, while higher audit fee parameters (f_A) directly increase the marginal cost of bonding, both of which reduce the equilibrium demand for audit specialization.

The model further predicts that the informational environment fundamentally shapes this tradeoff. When enforcement leniency becomes sufficiently transparent, auditors optimally substitute away from costly private verification toward publicly available information, reducing the incremental disciplining value of specialist auditing. Anticipating this crowding-out effect, managers rationally weaken their demand for high-quality auditors.

Consequently, politically connected firms may optimally select either high- or low-quality auditors depending on the relative strength of political incentives, enforcement transparency, investor demand for credibility, and audit costs. The framework therefore provides empiricists

with a theory-guided structure for jointly analyzing endogenous auditor choice and reporting quality:

$$FRQ_i = G(S_i^*, p_{r,i}, \tau_{\lambda,i}, \lambda_i, K_{M,i})$$

highlighting that observed reporting quality reflects both the direct effect of political incentives and the endogenous audit quality.

Empirical Proxies Empirical studies have used a wide range of variables to proxy for CPCs, often treating them as a single uniform variable. For example, Chaney et al. (2011) define firms as politically connected if a board member or large shareholder is a member of parliament; Fisman et al. (2012) classify firms as connected if they shared board members with Halliburton during U.S. Vice President Cheney's tenure; Faccio and Parsley (2009) look at whether headquarters are in a politician's hometown; Correia (2014) uses monetary contributions to politicians and lobbying expenditures; Wu et al. (2012) define connections via CEOs who formerly served in government or the military; Kostovetsky (2015) considers state-level representation on the U.S. Senate Banking Committee; and Child et al. (2021) examine prior business ties to Donald Trump.

These metrics likely proxy for different underlying constructs. Our model highlights the need to differentiate these proxies and map them to either the "enforcement leniency" (λ) or "economic benefit" (p_r) mechanisms in our framework.

- **Leniency Proxies (λ):** Financial contributions to political action committees or lobbying expenditures directed at oversight committees (e.g., the SEC) likely map directly to our enforcement leniency parameter. As shown in our analysis, this increases expected manipulation mechanically without generating convex market pricing.
- **Economic Benefit Proxies (p_r):** Prior business relations with an executive branch official (e.g., Child et al., 2021) or geographic ties to politicians controlling government budgets are highly likely to result in privileged access to government procurement contracts, but are less likely to influence accounting enforcement.

By classifying political connections based on their underlying economic mechanisms, future empirical work can formulate sharper hypotheses regarding financial reporting quality and market valuation.

7 Conclusion

In this article, we develop an analytical model of financial reporting under corporate political connections (CPCs). Built on the dual role of government as both regulator and allocator of political rents, we show CPCs simultaneously shaping enforcement leniency and the allocation of political benefits. By endogenizing both reporting behavior and auditor choice, our results clarify how these channels jointly determine the manager's ex-ante commitment to audit specialization and

ultimate financial reporting quality. This unified framework helps reconcile the mixed empirical evidence on reporting quality and auditor choice among politically connected firms.

By embedding these dual political forces into a rational expectations framework, our results yield fundamentally distinct conclusions compared to prior analytical models (Fischer and Verrecchia, 2000; Dye and Sridhar, 2004; Caskey et al., 2010; Patterson et al., 2019).

First, we demonstrate that CPCs operate through two distinct channels: enforcement leniency and directional political benefits. Greater realized enforcement leniency directly expands the safe harbor for manipulation, while stronger political benefits scale the marginal return to inflating or suppressing reported performance. Crucially, when the transparency of the regulatory environment is high, public disclosures perfectly crowd out private audit effort. Anticipating this reduction in direct audit discipline, managers perversely exploit highly predictable leniency to aggressively expand reporting manipulation.

Second, CPCs reshape the auditor's optimization problem by introducing endogenous reporting noise and tying her effort directly to the political information environment. We find that the auditor strategically substitutes public information for private evidence gathering to meet her specialization-mandated precision target. Consequently, audit effort rises when CPCs and fundamental environments are opaque, but falls heavily when the baseline information environment is intrinsically transparent.

Third, the firm trades off the auditor's market signaling value against constraints on rent extraction. The manager utilizes the ex-ante commitment to audit specialization as a costly bonding device to credibly minimize expected manipulation losses. When internal enforcement is intrinsically strict, it acts as a direct substitute for external discipline, compressing the demand for specialized auditors. Furthermore, in regulatory environments with highly transparent leniency, pre-existing public disclosures entirely crowd out the need for private verification. In this "impossible audit regime," the external audit yields no incremental informational value, driving the firm to abandon costly bonding and default to a minimum-compliance auditor. This regime-dependent interaction among enforcement, the information environment, and audit costs provides an equilibrium rationale for the conflicting empirical findings regarding auditor selection in politically connected firms.

To keep the model tractable and parsimonious, we abstract from a few potentially important institutional features. For instance, while we model audit effort under a convex cost function, we assume that baseline specialization is fully observable and verifiable via the engagement contract, abstracting from deeper agency frictions or moral hazard exclusively on the auditor's side. We also do not model complementary forms of public or private enforcement, such as ex-post shareholder litigation or internal control regulations. Exploring how these alternative disciplinary mechanisms interact with political connections constitutes a promising avenue for future analytical research.

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Appendix A: Summary of Notation

Table 3: Summary of Notation

Public Variables	**Description**
μ_θ, τ_θ	Mean and precision of firm fundamentals.
$\mu_\lambda, \tau_\lambda$	Mean and precision of enforcement leniency.
p_r	Realized value of political benefit parameter.
K_M	Managerial manipulation cost parameter (including enforcement penalty and personal manipulation costs).
ρ	Investors' degree of risk aversion.
K_A	Auditor enforcement strictness.
c_A	Auditor marginal cost parameter of acquiring information.
f_A	Audit fee parameter.
$AF(S)$	Audit fee; $AF(S) = \frac{1}{2} f_A S^2$.
Private Variables	
θ	Realized firm fundamental value; $\theta \sim \mathcal{N}(\mu_\theta, \tau_\theta^{-1})$; privately observed by manager.
λ	Realized enforcement leniency; $\lambda \sim \mathcal{N}(\mu_\lambda, \tau_\lambda^{-1})$; privately observed by manager.
s_A	Auditor's private signal of fundamentals; $s_A = \theta + \varepsilon_A$, where $\varepsilon_A \sim \mathcal{N}(0, \tau_s^{-1})$.
Strategic Choice	
$S = \dfrac{K_A}{c_A}$	Audit specialization level (chosen by manager), which represents the marginal cost of precision.
r_M	Manager's internal report (chosen by manager).
r_A	The audited report released to investors (chosen by auditor).
B	Political benefit allocated by politician; $B(r_A, p_r) = p_r r_A$.
$P(r_A)$	Market price determined competitively; $P(r_A) = \mathbb{E}[V \mid r_A]$.

Independence. We assume mutual independence among the state variables:

$$\mathrm{Cov}(\theta, \lambda) = 0, \qquad \mathrm{Cov}(\theta, p_r) = 0, \qquad \mathrm{Cov}(\lambda, p_r) = 0. \tag{17}$$

Appendix B: Proofs

Proof of Proposition 1

We solve the game by backward induction. We first solve the managerial reporting subgame by taking auditor specialization S as fixed, treating the initial audit fee as a sunk cost.
Manager: The manager maximizes his expected payout minus the penalty cost:

$$U(r_M) = \mathbb{E}\left[P(r_A, p_r) - \frac{K_M}{2}(r_M - \theta - \lambda)^2 \,\middle|\, \theta, \lambda, p_r\right] \tag{18}$$

Substituting the risk-averse linear pricing function $P(r_A, p_r) = \mathbb{E}[\theta \mid r_A] + p_r r_A - \rho \operatorname{Var}(\theta \mid r_A, S) = \pi_0 + (\tilde{\pi}_r + p_r) r_A$ yields:

$$U(r_M) = \mathbb{E}\left[(\tilde{\pi}_r + p_r) r_A + \pi_0 - \frac{K_M}{2}(r_M - \theta - \lambda)^2 \,\middle|\, \theta, \lambda, p_r\right] \tag{19}$$

Because the risk premium contained in π_0 is a deterministic constant, it drops out of the marginal optimization. Using the auditor's expected reporting rule, $\mathbb{E}[r_A \mid \theta, \lambda, p_r] = \phi_0 + \phi_s \theta + \phi_r r_M$, the first-order condition with respect to r_M is:

$$(\tilde{\pi}_r + p_r)\phi_r - K_M(r_M - \theta - \lambda) = 0 \tag{20}$$

Solving for r_M yields the manager's best response:

$$r_M = \theta + \lambda + \frac{\phi_r}{K_M}(\tilde{\pi}_r + p_r) \tag{21}$$

Matching coefficients establishes the manager's equilibrium strategy:

$$\delta_\theta = 1, \quad \delta_\lambda = 1, \quad \delta_p = \frac{\phi_r}{K_M}, \quad \delta_0 = \frac{\phi_r}{K_M}\tilde{\pi}_r \tag{22}$$

Auditor: The auditor observes the manager's internal report r_M and acquires a private signal $s_A = \theta + \varepsilon_s$, where $\varepsilon_s \sim \mathcal{N}(0, \tau_s^{-1})$. Because the political connection p_r is public knowledge, it introduces no signal extraction uncertainty. The only residual noise in the manager's report arises from the unobserved enforcement leniency $\lambda \sim \mathcal{N}(\mu_\lambda, \tau_\lambda^{-1})$.

The auditor computes the final report $r_A = \mathbb{E}[\theta \mid s_A, r_M]$ using standard Bayesian updating. Defining the observation vector $X = (s_A, r_M)^T$, the variance-covariance matrix Σ_{XX} and covariance vector $\Sigma_{\theta X}$ are:

$$\Sigma_{XX} = \begin{pmatrix} \tau_\theta^{-1} + \tau_s^{-1} & \delta_\theta \tau_\theta^{-1} \\ \delta_\theta \tau_\theta^{-1} & \delta_\theta^2 \tau_\theta^{-1} + \delta_\lambda^2 \tau_\lambda^{-1} \end{pmatrix}, \quad \Sigma_{\theta X} = \begin{pmatrix} \tau_\theta^{-1} & \delta_\theta \tau_\theta^{-1} \end{pmatrix} \tag{23}$$

The auditor's linear projection weights (ϕ_s, ϕ_r) are obtained via $\Sigma_{\theta X}\Sigma_{XX}^{-1}$. Given the manager's

equilibrium strategy $\delta_\theta = 1$ and $\delta_\lambda = 1$, calculating the determinant and inverting the matrix yields the simplified Bayesian precision weights. Applying the projection theorem, we have:

$$\phi_r = \frac{\tau_\lambda}{\tau_\theta + \tau_s + \tau_\lambda}, \quad \phi_s = \frac{\tau_s}{\tau_\theta + \tau_s + \tau_\lambda} \tag{24}$$

To fully resolve the auditor's weights, we must first solve for the optimal precision τ_s^*:

Proof of Proposition 2 (Auditor's Optimal Precision)

The auditor chooses precision $\tau_s \geq 0$ to minimize the expected verification loss and the information acquisition cost:

$$\min_{\tau_s \geq 0} \quad \frac{K_A}{2}\mathbb{E}[(r_A - \theta)^2] + \frac{c_A}{2}\tau_s. \tag{25}$$

Because $r_A = \mathbb{E}[\theta \mid s_A, r_M]$, the expected squared error $\mathbb{E}[(r_A - \theta)^2]$ is exactly the posterior variance of θ. In the observable p_r regime, the manager's reporting strategy simplifies to $\delta_\theta = 1$ and $\delta_\lambda = 1$. Because p_r is public information, the auditor perfectly filters out the observable bias, yielding an adjusted signal:

$$\tilde{r}_M = r_M - \delta_0 - \delta_p p_r = \theta + \lambda. \tag{26}$$

Since λ is independent noise with variance τ_λ^{-1}, the manager's adjusted report $\tilde{r}_M$ is an unbiased signal of θ with exact precision τ_λ. Under normal updating, posterior precision equals the sum of independent precisions:

$$\tau_{post} = \tau_\theta + \tau_s + \tau_\lambda. \tag{27}$$

The auditor's minimization problem thus reduces to a strictly exogenous, convex optimization problem:

$$\min_{\tau_s \geq 0} \quad \frac{K_A}{2}(\tau_\theta + \tau_s + \tau_\lambda)^{-1} + \frac{c_A}{2}\tau_s. \tag{28}$$

Taking the first derivative with respect to τ_s and setting it to zero yields the first-order condition:

$$(\tau_s + \tau_\theta + \tau_\lambda)^2 = \frac{K_A}{c_A}. \tag{29}$$

Replacing $S \equiv K_A/c_A$, we solve for τ_s:

$$\tau_s^* = \sqrt{S} - \tau_\theta - \tau_\lambda \tag{30}$$

The assumption $\sqrt{S} > \tau_\theta + \tau_\lambda$ guarantees a unique, strictly positive interior solution for auditor effort.

□

Returning to the projection weights, substituting τ_s^* simplifies the total posterior precision in the

denominator perfectly to $\sqrt{S}$, yielding:

$$\phi_r = \frac{\tau_\lambda}{\sqrt{S}}, \quad \phi_s = 1 - \frac{\tau_\theta + \tau_\lambda}{\sqrt{S}} \tag{31}$$

The weight reflects the precision of the manager's report after filtering out strategic bias, which is governed by (τ_λ).

Substituting the unconditional means into the intercept ϕ_0 and factoring in the manager's baseline and political inflation yields:

$$\phi_0 = \frac{\mu_\theta \tau_\theta - \tau_\lambda(\mu_\lambda + \delta_0 + \delta_p p_r)}{\sqrt{S}} \tag{32}$$

$$r_A = \left(\frac{\mu_\theta \tau_\theta - \tau_\lambda \mu_\lambda}{\sqrt{S}} - \frac{\tau_\lambda^2 (1 + p_r)}{K_M S} \right) + \left(\frac{\tau_\lambda}{\sqrt{S}} \right) r_M + \left(1 - \frac{\tau_\theta + \tau_\lambda}{\sqrt{S}} \right) s_A \tag{33}$$

Investor: Firm value is $V = \theta + p_r r_A$. Investors observe (r_A, p_r) and form prices:
The conditional expectation of θ given r_A is defined via the projection:

$$\mathbb{E}[\theta \mid r_A] = \mu_\theta + \frac{\mathrm{Cov}(\theta, r_A)}{\mathrm{Var}(r_A)} (r_A - \mu_A) \tag{34}$$

$$P(r_A, p_r) = \mathbb{E}[\theta \mid r_A] + p_r r_A - 0.5\rho \,\mathrm{Var}(\theta \mid r_A, S) = \pi_0 + (\tilde{\pi}_r + p_r) r_A \tag{35}$$

where the Earnings Response Coefficient (ERC) is $\tilde{\pi}_r = \mathrm{Cov}(\theta, r_A)[\mathrm{Var}(r_A)]^{-1}$.

From the linear strategy:

$$r_A = (\phi_s + \phi_r)\theta + \phi_s \varepsilon_s + \phi_r \lambda. \tag{36}$$

Since ε_s and λ are independent of θ, the covariance is:

$$\mathrm{Cov}(\theta, r_A) = (\phi_s + \phi_r)\,\mathrm{Var}(\theta) = (\phi_s + \phi_r)\tau_\theta^{-1}. \tag{37}$$

Plug in:

$$\mathrm{Var}(r_A) = (\phi_s + \phi_r)^2 \tau_\theta^{-1} + \phi_s^2 \tau_s^{-1} + \phi_r^2 \tau_\lambda^{-1}. \tag{38}$$

Substituting the equilibrium weights:

$$\phi_r = \frac{\tau_\lambda}{\sqrt{S}}, \quad \phi_s = \frac{\tau_s^*}{\sqrt{S}}, \quad \tau_s^* = \sqrt{S} - \tau_\theta - \tau_\lambda, \tag{39}$$

we obtain:

$$\mathrm{Cov}(\theta, r_A) = \frac{\sqrt{S} - \tau_\theta}{\sqrt{S}} \cdot \tau_\theta^{-1}. \tag{40}$$

$$\text{Var}(r_A) = \frac{(\sqrt{S} - \tau_\theta)^2}{S}\tau_\theta^{-1} + \frac{\tau_s^* + \tau_\lambda}{S}. \tag{41}$$

Using $\tau_s^* + \tau_\lambda = \sqrt{S} - \tau_\theta$, this simplifies to:

$$\text{Var}(r_A) = \frac{(\sqrt{S} - \tau_\theta)^2}{S}\tau_\theta^{-1} + \frac{\sqrt{S} - \tau_\theta}{S}. \tag{42}$$

Substituting into the ERC:

$$\tilde{\pi}_r = \frac{\frac{\sqrt{S}-\tau_\theta}{\sqrt{S}}\tau_\theta^{-1}}{\frac{(\sqrt{S}-\tau_\theta)^2}{S}\tau_\theta^{-1} + \frac{\sqrt{S}-\tau_\theta}{S}}. \tag{43}$$

Factoring the denominator:

$$\text{Var}(r_A) = \frac{\sqrt{S} - \tau_\theta}{S}\left[(\sqrt{S} - \tau_\theta)\tau_\theta^{-1} + 1\right], \tag{44}$$

we obtain:

$$\tilde{\pi}_r = \frac{S}{\sqrt{S}} \cdot \frac{\tau_\theta^{-1}}{(\sqrt{S} - \tau_\theta)\tau_\theta^{-1} + 1}. \tag{45}$$

Noting that:

$$(\sqrt{S} - \tau_\theta)\tau_\theta^{-1} + 1 = \frac{\sqrt{S}}{\tau_\theta}, \tag{46}$$

we obtain:

$$\tilde{\pi}_r = 1. \tag{47}$$

The residual fundamental uncertainty for the market relies solely on r_A. Thus, $\text{Var}(\theta \mid r_A, S) = \tau_{post}^{-1}$. Anticipating the result from the auditor's subgame where the total posterior precision is $\tau_{post} = \sqrt{S}$, the risk premium simplifies to a deterministic constant:

$$0.5\rho \,\text{Var}(\theta \mid r_A, S) = \frac{\rho}{\sqrt{S}} \tag{48}$$

By the Law of Iterated Expectations, the unconditional mean of the auditor's report equals the unconditional mean of the fundamental ($\mu_A = \mu_\theta$). Therefore, the pricing intercept captures solely the fundamental risk penalty:

$$\pi_0 = -\frac{\rho}{\sqrt{S}} \tag{49}$$

The investor's pricing rule is:

$$P(r_A, p_r) = -\frac{\rho}{\sqrt{S}} + (1 + p_r)r_A \tag{50}$$

Equilibrium Manager Coefficients Plugging $\tilde{\pi}_r = 1$ and the simplified auditor weight $\phi_r = \tau_\lambda/\sqrt{S}$ back into the manager's best response function yields the final, closed-form managerial

reporting coefficients:

$$\delta_\theta = 1, \quad \delta_\lambda = 1, \quad \delta_p = \frac{\tau_\lambda}{K_M\sqrt{S}}, \quad \delta_0 = \frac{\tau_\lambda}{K_M\sqrt{S}} \tag{51}$$

□

Derivation of the Audit-Reporting Measure (Q)

$$\begin{aligned} Q &= \tau_\lambda + \tau_s^* \\ &= \tau_\lambda + \left(\sqrt{S} - \tau_\theta - \tau_\lambda\right) \\ &= \sqrt{S} - \tau_\theta \end{aligned}$$

□

Derivation of the Investor-Perception Measure (MP and $\mathrm{Var}(MP)$)

From Proposition 1, the equilibrium pricing function is $P(r_A, p_r) = (1 + p_r)r_A - \frac{\rho}{\sqrt{S}}$, and the allocated political benefit is $B(r_A, p_r) = p_r r_A$. The ex-post market mispricing is defined as the deviation of the market price from the firm's true total value $(\theta + B)$. Substituting the pricing and benefit functions gives:

$$MP = P(r_A, p_r) - (\theta + B) = \left((1 + p_r)r_A - \frac{\rho}{\sqrt{S}}\right) - (\theta + p_r r_A) = r_A - \theta - \frac{\rho}{\sqrt{S}} \tag{52}$$

From equation 33 we already have:

$$r_A = \left(\frac{\mu_\theta\tau_\theta - \tau_\lambda\mu_\lambda}{\sqrt{S}} - \frac{\tau_\lambda^2(1 + p_r)}{K_M S}\right) + \left(\frac{\tau_\lambda}{\sqrt{S}}\right) r_M + \left(1 - \frac{\tau_\theta + \tau_\lambda}{\sqrt{S}}\right) s_A \tag{53}$$

Extract the manager's reporting bias from the constant term ϕ_0. Let $bias = \frac{\tau_\lambda(1+p_r)}{K_M\sqrt{S}}$. The manager's observable report is $r_M = \theta + \lambda + bias$. Grouping the manager's report with the bias term from ϕ_0, we isolate the unbiased public signal $(\theta + \lambda)$:

$$\begin{aligned} \frac{\tau_\lambda}{\sqrt{S}} r_M - \frac{\tau_\lambda^2(1 + p_r)}{K_M S} &= \frac{\tau_\lambda}{\sqrt{S}}\left(r_M - \frac{\tau_\lambda(1 + p_r)}{K_M\sqrt{S}}\right) \\ &= \frac{\tau_\lambda}{\sqrt{S}}(\theta + \lambda) \end{aligned}$$

Substituting these simplified components back into the original equation, alongside the audi-

tor's signal $s_A = \theta + \varepsilon_s$:

$$r_A = \frac{\mu_\theta \tau_\theta - \tau_\lambda \mu_\lambda}{\sqrt{S}} + \frac{\tau_\lambda}{\sqrt{S}}(\theta + \lambda) + \frac{\tau_s^*}{\sqrt{S}}(\theta + \varepsilon_s) \tag{54}$$

Because $\tau_s^* + \tau_\lambda = \sqrt{S} - \tau_\theta$, we can rewrite the θ coefficient to separate it from the error terms:

$$r_A = \theta + \frac{\tau_\theta(\mu_\theta - \theta) + \tau_s^* \varepsilon_s + \tau_\lambda(\lambda - \mu_\lambda)}{\sqrt{S}} \tag{55}$$

Substituting Equation 55 back into the mispricing equation $MP = r_A - \theta - \frac{\rho}{\sqrt{S}}$ gives:

$$MP = \frac{\tau_\theta(\mu_\theta - \theta) + \tau_s^* \varepsilon_s + \tau_\lambda(\lambda - \mu_\lambda) - \rho}{\sqrt{S}} \tag{56}$$

Using $\mathrm{Var}(\theta) = \tau_\theta^{-1}$, $\mathrm{Var}(\varepsilon_s) = (\tau_s^*)^{-1}$, and $\mathrm{Var}(\lambda) = \tau_\lambda^{-1}$:

$$\begin{aligned} \mathrm{Var}(MP) &= \mathrm{Var}\left(r_A - \theta - \frac{\rho}{\sqrt{S}}\right) \\ &= \mathrm{Var}(r_A - \theta) \\ &= \frac{\tau_\theta^2(\tau_\theta^{-1}) + (\tau_s^*)^2(\tau_s^*)^{-1} + \tau_\lambda^2(\tau_\lambda^{-1})}{S} \\ &= \frac{\tau_\theta + \tau_s^* + \tau_\lambda}{S} \end{aligned}$$

Substituting the optimal auditor effort $\tau_s^* = \sqrt{S} - \tau_\theta - \tau_\lambda$ into the numerator:

$$\begin{aligned} \mathrm{Var}(MP) &= \frac{\tau_\theta + (\sqrt{S} - \tau_\theta - \tau_\lambda) + \tau_\lambda}{S} \\ &= \frac{\sqrt{S}}{S} = \frac{1}{\sqrt{S}} \end{aligned}$$

□

Proof of Proposition 3 (Manager's Ex-Ante Audit Specialization Choice)

In the ex-ante stage, the manager commits to an auditor specialization level S to maximize their unconditional expected utility. The objective function incorporates the expected market price, the expected manipulation loss, and the cost of the audit fee:

$$W(S) = \mathbb{E}[P(r_A, p_r) \mid p_r] - \frac{K_M}{2}\mathbb{E}[(r_M - \theta - \lambda)^2 \mid p_r] - \frac{1}{2} f_A S^2 \tag{57}$$

Since $\mathbb{E}[r_A] = \mu_\theta$, the expected market price is:

$$\mathbb{E}[P(r_A, p_r) \mid p_r] = (1 + p_r)\mu_\theta - \frac{\rho}{\sqrt{S}} \tag{58}$$

From the reporting subgame, the equilibrium effective penalty is $r_M - \theta - \lambda = \frac{\tau_\lambda(1+p_r)}{K_M\sqrt{S}}$. The expected misreporting cost is therefore:

$$\frac{K_M}{2}\mathbb{E}[m^2 \mid p_r] = \frac{K_M}{2}\mathbb{E}[(r_M - \theta - \lambda)^2 \mid p_r] = \frac{\tau_\lambda^2(1 + p_r)^2}{2K_M S} \tag{59}$$

Substituting these components back into the objective function, and dropping the constant term $(1 + p_r)\mu_\theta$, the optimization problem becomes:

$$\max_{S>0} \; W(S) = -\frac{\rho}{\sqrt{S}} - \frac{\tau_\lambda^2(1 + p_r)^2}{2K_M S} - \frac{1}{2}f_A S^2 \tag{60}$$

Taking the first-order condition (FOC) with respect to specialization S:

$$\frac{dW}{dS} = \frac{\rho}{2S^{3/2}} + \frac{\tau_\lambda^2(1 + p_r)^2}{2K_M S^2} - f_A S = 0 \tag{61}$$

Rearranging this condition yields the fundamental marginal benefit equals marginal cost ($MB = MC$) equation:

$$f_A S = \frac{\rho}{2S^{3/2}} + \frac{\tau_\lambda^2(1 + p_r)^2}{2K_M S^2} \tag{62}$$

Multiplying both sides by $2S^2$ cleanly isolates the structural drivers of audit demand into an implicit polynomial function for the unconstrained optimal specialization S^*:

$$2f_A(S^*)^3 = \rho\sqrt{S^*} + \frac{\tau_\lambda^2(1 + p_r)^2}{K_M} \tag{63}$$

Because the left-hand side is strictly increasing in S^* from 0 to ∞, and the right-hand side is strictly increasing and concave with a strictly positive intercept, there exists exactly one unique interior solution $S^* > 0$.

The second-order condition confirms this is a global maximum:

$$W''(S) = -\frac{3\rho}{4S^{5/2}} - \frac{\tau_\lambda^2(1 + p_r)^2}{K_M S^3} - f_A < 0 \tag{64}$$

Because $W''(S)$ is strictly negative for all $S > 0$, the objective function $W(S)$ is strictly globally concave, meaning S^* is the unique unconstrained global maximum.

However, the manager's choice is structurally bounded from below by the baseline information environment, $S \geq S_0$, where $S_0 = (\tau_\theta + \tau_\lambda)^2$ represents the minimum structural precision when the auditor exerts zero private effort ($\tau_s^* = 0$). Because $W(S)$ is strictly concave and strictly

decreasing for all $S > S^*$, the constrained optimization yields a simple piecewise solution:

$$S^{**} = \begin{cases} S^* & \text{if } S^* > S_0 \\ S_0 & \text{otherwise} \end{cases} \tag{65}$$

□

Proof of Corollary 4: Comparative Statics for S^*

We establish the comparative statics using the Implicit Function Theorem.

We define the equilibrium condition from Equation 63 as:

$$\Omega(S^*, x) = 2f_A(S^*)^3 - \rho\sqrt{S^*} - \frac{\tau_\lambda^2(1+p_r)^2}{K_M} = 0 \tag{66}$$

By the Implicit Function Theorem, $\frac{\partial S^*}{\partial x} = -\frac{\Omega_x}{\Omega_S}$. We first evaluate the derivative of Ω with respect to the unconstrained optimal specialization S^*:

$$\Omega_S = 6f_A(S^*)^2 - \frac{\rho}{2\sqrt{S^*}} \tag{67}$$

From the first-order condition $\Omega(S^*) = 0$, we know $2f_A(S^*)^3 = \rho\sqrt{S^*} + \frac{\tau_\lambda^2(1+p_r)^2}{K_M}$. Dividing this by S^* and substituting it into Ω_S yields:

$$\Omega_S = 3\left(\frac{\rho}{\sqrt{S^*}} + \frac{\tau_\lambda^2(1+p_r)^2}{K_M S^*}\right) - \frac{\rho}{2\sqrt{S^*}} = \frac{5\rho}{2\sqrt{S^*}} + \frac{3\tau_\lambda^2(1+p_r)^2}{K_M S^*} > 0 \tag{68}$$

Because Ω_S is strictly positive for all interior solutions ($S^* > 0$), the sign of any comparative static is determined entirely by the opposite sign of the partial derivative Ω_x:

$$\operatorname{sgn}\left(\frac{\partial S^*}{\partial x}\right) = -\operatorname{sgn}(\Omega_x) \tag{69}$$

We differentiate Ω with respect to each parameter in the information and political environment:

- **Political Connections (p_r):** Differentiating Ω with respect to the political benefit parameter yields:

$$\Omega_{p_r} = -\frac{2\tau_\lambda^2(1+p_r)}{K_M} \implies \frac{\partial S^*}{\partial p_r} = \frac{2\tau_\lambda^2(1+p_r)}{K_M \Omega_S} \tag{70}$$

  The sign of the derivative is strictly determined by $\operatorname{sgn}(1+p_r)$. The relationship is strictly **U-shaped** with a global minimum at $p_r = -1$. This indicates that as the magnitude of political incentives (whether as a net benefit or a net cost) increases, the manager faces stronger

incentives to manipulate, and consequently endogenously chooses higher specialization to provide a credible bonding mechanism to the market.

- **Managerial Enforcement (K_M):**

$$\Omega_{K_M} = \frac{\tau_\lambda^2(1+p_r)^2}{K_M^2} > 0 \implies \frac{\partial S^*}{\partial K_M} < 0 \tag{71}$$

Higher internal manipulation costs reduce the manager's latent incentive to bias reports, thereby diminishing the marginal benefit of hiring a strict auditor to tie their own hands.

- **Specialization Fee (f_A):**

$$\Omega_{f_A} = 2(S^*)^3 > 0 \implies \frac{\partial S^*}{\partial f_A} < 0 \tag{72}$$

An increase in the marginal cost of specialization fees directly crowds out the manager's ex-ante demand for audit capacity.

- **Leniency Precision (τ_λ):**

$$\Omega_{\tau_\lambda} = -\frac{2\tau_\lambda(1+p_r)^2}{K_M} < 0 \implies \frac{\partial S^*}{\partial \tau_\lambda} > 0 \tag{73}$$

Greater predictability in enforcement leniency removes uncertainty from the manager's manipulation strategy, increasing the expected manipulation costs. This increases the marginal "bonding" benefit, leading the manager to hire a more specialized auditor.

- **Investor Risk Aversion (ρ):**

$$\Omega_\rho = -\sqrt{S^*} < 0 \implies \frac{\partial S^*}{\partial \rho} > 0 \tag{74}$$

As the capital market becomes more risk-averse, investors demand a larger risk premium (discount) for fundamental uncertainty. To support the expected firm value, the manager optimally commits to a higher level of audit specialization to reduce the market's residual uncertainty.

□

Proof of Corollary 2: Marginal Effect of Leniency Transparency on Manipulation

To find the marginal effect of τ_λ on manipulation, we differentiate $m^* = \lambda + \frac{\tau_\lambda(1+p_r)}{K_M\sqrt{S^*}}$ with respect to τ_λ:

$$\frac{\partial m^*}{\partial \tau_\lambda} = \frac{1+p_r}{K_M}\left[\frac{\sqrt{S^*} - \tau_\lambda \frac{\partial \sqrt{S^*}}{\partial \tau_\lambda}}{S^*}\right] \tag{75}$$

Substituting the capacity expansion term $\frac{\partial\sqrt{S^*}}{\partial\tau_\lambda} = \frac{\tau_\lambda(1+p_r)^2}{K_M\sqrt{S^*}\Omega_S}$, the numerator of the bracketed term becomes:

$$\sqrt{S^*} - \frac{\tau_\lambda^2(1+p_r)^2}{K_M\sqrt{S^*}\Omega_S} = \frac{K_M S^*\Omega_S - \tau_\lambda^2(1+p_r)^2}{K_M\sqrt{S^*}\Omega_S} \tag{76}$$

From the derivation of Ω_S, we know $K_M S^*\Omega_S = \frac{5}{2}\rho K_M\sqrt{S^*} + 3\tau_\lambda^2(1+p_r)^2$. Substituting this into the numerator yields:

$$\frac{5}{2}\rho K_M\sqrt{S^*} + 2\tau_\lambda^2(1+p_r)^2 \tag{77}$$

Because this term is strictly positive for all $S^* > 0$, the entire bracketed term is strictly positive. Therefore, the sign of the derivative is uniquely determined by the sign of the political multiplier:

$$\operatorname{sgn}\left(\frac{\partial m^*}{\partial \tau_\lambda}\right) = \operatorname{sgn}(1+p_r) \tag{78}$$

□

Proof of Corollary 5: Comparative Statics of Audit Quality τ_s and Report Quality Q

The unconstrained auditor specialization S^* is defined implicitly by the first-order condition $\Omega(S^*) = 0$. The auditor's optimal private effort is given by $\tau_s^* = \sqrt{S^*} - \tau_\theta - \tau_\lambda$. By the chain rule, the marginal effect of any exogenous parameter x on auditor effort is:

$$\frac{\partial \tau_s^*}{\partial x} = \frac{\partial\sqrt{S^*}}{\partial x} - \frac{\partial\tau_\theta}{\partial x} - \frac{\partial\tau_\lambda}{\partial x} = \frac{1}{2\sqrt{S^*}}\left(\frac{\partial S^*}{\partial x}\right) - \frac{\partial\tau_\theta}{\partial x} - \frac{\partial\tau_\lambda}{\partial x} \tag{79}$$

Applying the comparative statics of S^* derived previously (where $\Omega_S > 0$), we obtain the comparative statics for equilibrium auditor effort:

- **Fundamental Precision (τ_θ):** Because baseline fundamental precision τ_θ does not appear in the unconstrained optimal S^* condition ($\frac{\partial S^*}{\partial \tau_\theta} = 0$), the one-to-one crowding-out effect on private effort remains perfectly intact:

$$\frac{\partial \tau_s^*}{\partial \tau_\theta} = \frac{1}{2\sqrt{S^*}}(0) - 1 = -1 < 0 \tag{80}$$

- **Leniency Precision (τ_λ):** We decompose the marginal change in effort into the manager's capacity expansion effect and the direct substitution effect:

$$\frac{\partial \tau_s^*}{\partial \tau_\lambda} = \frac{1}{2\sqrt{S^*}} \left(\frac{\partial S^*}{\partial \tau_\lambda} \right) - 1 \tag{81}$$

To evaluate this, we apply the Implicit Function Theorem to the manager's first-order condition for audit specialization, $G(S^*) = 2f_A(S^*)^3 - \rho\sqrt{S^*} - \frac{\tau_\lambda^2(1+p_r)^2}{K_M} = 0$. Taking the partial derivatives gives $G_{\tau_\lambda} = -\frac{2\tau_\lambda(1+p_r)^2}{K_M}$ and $G_{S^*} \equiv \Omega_S = 6f_A(S^*)^2 - \frac{1}{2}\rho(S^*)^{-1/2}$. This yields the capacity expansion term:

$$\frac{\partial S^*}{\partial \tau_\lambda} = \frac{2\tau_\lambda(1+p_r)^2}{K_M \Omega_S} \tag{82}$$

Substituting this back, we obtain:

$$\frac{\partial \tau_s^*}{\partial \tau_\lambda} = \underbrace{\frac{\tau_\lambda(1+p_r)^2}{K_M\sqrt{S^*}\Omega_S}}_{\text{Capacity Expansion}} - \underbrace{1}_{\text{Direct Substitution}} \tag{83}$$

To find the exact threshold where the auditor's private effort decreases ($\frac{\partial \tau_s^*}{\partial \tau_\lambda} < 0$), we isolate the condition where the direct substitution effect dominates:

$$\frac{\tau_\lambda(1+p_r)^2}{K_M\sqrt{S^*}\Omega_S} < 1 \tag{84}$$

To solve this analytically without a high-order polynomial, we exploit the original first-order condition to substitute out f_A from the denominator Ω_S. Multiplying $G(S^*) = 0$ by $\frac{3}{S^*}$ yields $6f_A(S^*)^2 = 3\rho(S^*)^{-1/2} + \frac{3\tau_\lambda^2(1+p_r)^2}{K_M S^*}$. Substituting this into Ω_S provides:

$$\Omega_S = \frac{5}{2}\rho(S^*)^{-1/2} + \frac{3\tau_\lambda^2(1+p_r)^2}{K_M S^*} \tag{85}$$

Multiplying by $K_M\sqrt{S^*}$, the denominator of our inequality becomes:

$$K_M\sqrt{S^*}\Omega_S = \frac{5}{2}\rho K_M + \frac{3\tau_\lambda^2(1+p_r)^2}{\sqrt{S^*}} \tag{86}$$

Substituting this back into the inequality and rearranging to isolate the term containing $\sqrt{S^*}$ simplifies the condition to:

$$\frac{3\tau_\lambda}{\sqrt{S^*}} > 1 - \frac{5\rho K_M}{2\tau_\lambda(1+p_r)^2} \tag{87}$$

This condition reveals a non-monotonic effort response governed by investor risk aversion. If leniency transparency is sufficiently small ($\tau_\lambda \leq \frac{5\rho K_M}{2(1+p_r)^2}$), the RHS is weakly nega-

tive. Because the LHS is strictly positive, the inequality strictly holds and marginal effort unambiguously decreases.

If $\tau_\lambda > \frac{5\rho K_M}{2(1+p_r)^2}$, we can invert the inequality to isolate the required capacity boundary:

$$\sqrt{S^*} < \frac{6\tau_\lambda^2(1+p_r)^2}{2\tau_\lambda(1+p_r)^2 - 5\rho K_M} \equiv \tau_0 \tag{88}$$

Because the implicit objective function $G(\sqrt{S^*}) = 2f_A(\sqrt{S^*})^6 - \rho\sqrt{S^*} - \frac{\tau_\lambda^2(1+p_r)^2}{K_M}$ is strictly monotonically increasing and crosses zero at the optimal root, the condition $\sqrt{S^*} < \tau_0$ is mathematically equivalent to evaluating the function at the boundary τ_0 and finding it to be positive. Therefore, the condition for decreasing private effort is:

$$2f_A(\tau_0)^6 - \rho(\tau_0) - \frac{\tau_\lambda^2(1+p_r)^2}{K_M} > 0 \tag{89}$$

- **Other Parameters (f_A, K_M, ρ, p_r):** Because these parameters do not enter the public precision baseline directly, their impact flows entirely through the endogenous specialization choice. Their signs perfectly match the direction of the manager's demand for specialization:

$$\frac{\partial\tau_s^*}{\partial f_A} = \frac{1}{2\sqrt{S^*}}\left(\frac{\partial S^*}{\partial f_A}\right) < 0 \quad , \quad \frac{\partial\tau_s^*}{\partial K_M} = \frac{1}{2\sqrt{S^*}}\left(\frac{\partial S^*}{\partial K_M}\right) < 0 \tag{90}$$

$$\frac{\partial\tau_s^*}{\partial\rho} = \frac{1}{2\sqrt{S^*}}\left(\frac{\partial S^*}{\partial\rho}\right) > 0 \quad , \quad \operatorname{sgn}\left(\frac{\partial\tau_s^*}{\partial p_r}\right) = \operatorname{sgn}(1+p_r) \tag{91}$$

Comparative Statics of Audited Report Quality Q

We define the total incremental quality of the audited report over the baseline fundamental knowledge as $Q = \tau_\lambda + \tau_s^*$. Substituting the auditor's effort condition yields $Q = \sqrt{S^*} - \tau_\theta$.

Differentiating this expression yields the comparative statics for equilibrium report quality:

- **Fundamental Precision (τ_θ):** Confirms the direct crowding-out effect where baseline transparency reduces the incremental value of the audit.

$$\frac{\partial Q}{\partial\tau_\theta} = \frac{1}{2\sqrt{S^*}}(0) - 1 = -1 < 0 \tag{92}$$

- **Leniency Precision (τ_λ):** We decompose the marginal change in report quality $Q = \tau_\lambda + \tau_s^*$ into the direct information gain and the auditor's effort response:

$$\frac{\partial Q}{\partial\tau_\lambda} = \underbrace{1}_{\text{Info Gain}} + \underbrace{\frac{\partial\tau_s^*}{\partial\tau_\lambda}}_{\text{Effort Response}} \tag{93}$$

Substituting the auditor's response from Equation 83:

$$\frac{\partial Q}{\partial \tau_\lambda} = 1 + \left[\underbrace{\frac{\tau_\lambda (1+p_r)^2}{K_M \sqrt{S^*}\Omega_S}}_{\text{Expansion}} - \underbrace{1}_{\text{Substitution}} \right] = \frac{\tau_\lambda (1+p_r)^2}{K_M \sqrt{S^*}\Omega_S} > 0 \tag{94}$$

While high leniency transparency crowds out the auditor's *private* effort, it strictly increases the *overall* quality of the audited report because the manager's capacity expansion perfectly absorbs the substitution effect.

- **Other Parameters (f_A, K_M, ρ, p_r):** The remaining primitives do not interact with the regulatory baseline, meaning the directional change in report quality maps one-to-one with the manager's optimal specialization choice:

$$\frac{\partial Q}{\partial f_A} < 0 \quad , \quad \frac{\partial Q}{\partial K_M} < 0 \quad , \quad \frac{\partial Q}{\partial \rho} > 0 \quad , \quad \operatorname{sgn}\left(\frac{\partial Q}{\partial p_r}\right) = \operatorname{sgn}(1+p_r) \tag{95}$$

□

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