

POLITICAL CONNECTIONS, LEGAL LIABILITY and AUDITOR  
BEHAVIOURS:  
EVIDENCE FROM CHINA

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DOCTOR OF PHILOSOPHY

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## **CERTIFICATION**

I, Ku He, declare that this thesis, submitted in partial fulfilment of the requirements for the award of Doctor of Philosophy, in the Department of Applied Finance and Actuarial Studies of the Faculty of Business and Economics at Macquarie University, is wholly my own work unless otherwise referenced or acknowledged. This document has not been submitted for qualifications at any other academic institution.

Ku He

2016.10.07



## **DEDICATION**

This dissertation is dedicated to my parents, Runming He and Dingyu Jiang, and my younger brother, Nan He who always encourage, support and help me to achieve my dream.



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## **ABSTRACT**

External auditing provides reasonable assurance to accounting information quality and alleviates the agency problem in corporations. In China, after the re-establishment of the external auditing profession in the 1980s, the auditing profession developed significantly and came to play an important role in the capital market. However, the institutional mechanisms are still relatively weak and underdeveloped in China. Therefore, this thesis is concerned about whether and how legal liability and political connections can influence auditor behaviour in the Chinese setting.

This thesis begins with examining whether enlarging auditors' liability exposure can lead a superior audit quality and higher audit fees. Since 2010, all Chinese audit firms have been required to transform from a structure of LLC to LLP, which removes the cap on the liability exposure of negligent auditors. By adopting this natural experiment, this thesis documents that after audit firms reorganise as LLPs, auditors are more likely to: (1) issue modified audit opinions and going concern opinions; (2) constrain clients' earnings management, and (3) charge more audit fees. These findings suggest that exerting unlimited legal liability on negligent auditors induces them to make additional audit effort and charge more audit fees.

Next, this thesis investigates whether the sudden termination of corporate political connections influences firms' audit risk and auditor choice patterns, and whether this influence is subject to corporate ownership. The empirical findings suggest that once the connections with the government are terminated, SOEs receive more favourable audit opinions compared to their non-connected counterparts, whereas connected non-SOEs obtain harsher opinions. Moreover, in the following years, connected SOEs are more likely to hire local small auditors, while connected non-SOEs become less likely to do so.



Finally, this thesis examines how political connections of individual auditors influence their audit quality. This thesis finds that compared with their non-connected counterparts, individual auditors with political connections have a significantly lower audit quality. In addition, further evidence also confirms that government interrupts the auditing process of connected auditors to seek clean opinions for SOEs, whereas connected auditors seek protection in not being sanctioned by the government.

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## LIST OF PUBLICATIONS

The following publications are derived from this thesis:

### Refereed Journals

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## ABBREVIATIONS

SOEs	State-owned Enterprises
LLP	Limited Liability Partnership
LLC	Limited Liability Company
GP	General Partnership
CIPCA	Chinese Institute of Public Certified Accountant
AICPA	American Institute of Public Certified Accountant
SASAC	State-Owned Assets Supervision and Administration
NPC	National People's Congress
CPPCC	Chinese People's Political Consultative Conference
MOF	Ministry of Finance
U.S.	United States
U.K.	United Kingdom
DID	Difference-in-difference
CSRC	China Securities Regulatory Commission





# **Chapter 1: Introduction**

## **1.1 Introduction**

Auditing is valued for its ability to assure the credibility of accounting information, which reduces information risk and improves resource allocation efficiency (DeFond and Zhang, 2014). Previous studies document that auditors are able to effectively constrain client firms' earnings management (Becker et al., 1998), improve their earnings informativeness (Teoh and Wong., 1993), and enhance the predictive ability of accruals (Maines and Wahlen, 2006). Moreover, other studies on the relationship between government and auditors further suggest that by reducing information asymmetry, auditors can also mitigate agency problems in client firms and finally prop-up the firm's value (Jensen and Meckling, 1976; Fan and Wong et al., 2005; Minnis, 2011; Firth et al., 2012). Given the importance of auditing, the question that what factors and how they influence the behaviours of auditors draws earnest attention from the accounting profession, the academic community, regulators and policy makers.

Legal liability, the relationship with government and corporate political connections are well documented as major factors that affect auditor behaviours. Conceptually, legal liability exposes the personal wealth of auditors to litigation risk, and is thus expected to influence their incentives to exert audit effort and charge audit fees (Firth et al., 2012; Lennox and Li, 2012). A close relationship with government though may impact auditor independence (Chan et al., 2006; 2012; Wang et al., 2008) and also the market performance of audit firms (Yang, 2013). In addition, corporate political connections are likely to alter firms' governance mechanisms (Qian et al., 2011; Chen et al., 2011a) and reporting incentives (Chaney et al., 2011), which in turn, affect their decisions to appoint auditors (Guedhami, 2014) and auditors'

risk assessments (Gul, 2006).

Many existing studies empirically examine how legal liability, the relationship with government, and corporate political connections influence auditor behaviours, yet the evidence are mixed. Existing studies generally find that increasing the liability exposure of auditors can improve audit quality and increase audit fees (Simunic and Stein, 1995; Liu and Wang, 2006; Choi et al., 2008; Mo et al., 2015), whereas others note that an excessive unlimited legal liability may drive auditors to quit from the auditing market and eventually destroy audit quality (Napier, 1998; Doralt et al., 2008). In addition, a close relationship with government has been found to introduce more intervention and thus impair auditor independence (Chan et al., 2006; 2012; Wang et al., 2008), yet it has also been documented to prop-up the performances of audit firms by granting them more clients and higher auditing prices (Yang, 2013). Moreover, although some studies suggest that corporate political connections deteriorate firms' accounting information quality (Chaney et al., 2011) and motivate them to appoint low-quality auditors (Zhang et al., 2011), others document that politically connected firms are with a lower audit risk (Liu and Subramaniam, 2013), and more likely to choose big audit firms (Guedhami et al., 2014).

The potential endogeneity problems, the confounding effects of other influential factors and the complexities of the economic implications may attribute to the mixed findings of previous studies. The objective of this thesis is to extend prior studies and provide clearer evidence on how legal liability, the relationship with government and corporate political connections and affect auditor behaviours using samples from China.

This thesis first examines whether auditors enhance audit quality and charge more audit fees when their liability exposures are forced to increase. The extent to which auditors'

personal wealth is exposed to the threat of litigation largely depends on the organisational structure of their audit firms. In practice, there are three main forms of organisational structure of audit firms: General Partnership (GP), Limited Liability Company (LLC) and Limited Liability Partnership (LLP). The fundamental difference between the three structures lies in the legal responsibility stipulated for individual auditors. In particular, under the GP structure, both the assets of the audit firm (inside wealth) and each audit partner's personal assets (outside wealth) are at risk in litigation, while LLC structure protects the personal assets of audit partners, no matter whether they are negligent or not. By way of contrast, under the LLP structure, the assets of the audit firm and personal assets of negligent audit partners are at risk, while the personal assets of non-negligent audit partners are protected. In 2010, the Chinese Ministry of Finance (MOF) required all audit firms that have a special licence to audit listed companies to adopt the LLP structure in place of their former LLC structure before the end of 2013. This thesis employs this reform as a natural experiment, and investigates whether LLP adoption leads auditors to exert additional audit effort and increase auditing prices.

This thesis next provides evidence on how auditors with political connections and government seek rents from each other, and how these rent-seeking activities influence audit quality. This thesis concerns that neither the “government intervention” argument nor the “prop-up” argument made by prior studies alone can sufficiently capture the full complexity of the implications of auditor-government relationships. Instead, this thesis employs the framework of rent-seeking with an aim to depict the interactions between politically connected auditors and government in a more comprehensive way. Under the rent-seeking framework, consistent with Chan et al. (2006) and Wang et al. (2008), government will exert

political pressure on connected auditors to seek favourable opinions for SOEs; however on the other hand, these connected auditors also will seek the protection of not being sanctioned by government. Since government interventions jeopardise auditor independence, and the protection from sanctions impedes auditors from exercising due diligence, the connections with government are thus expected to ultimately drive a lower audit quality. Moreover, as auditing is inherently a complex process of judgment and decision-making, the auditing outcomes are ultimately driven by the characteristics of individual auditors (Nelson and Tan 2005; DeFond and Francis, 2005; Wang et al., 2015). A growing body of recent empirical evidence indicates that audit quality varies significantly across individual auditors (Gul et al., 2013; Wang et al., 2015; Knechel et al., 2015). Hence, to achieve a better understanding of the strategic interactions between government and connected auditors, this thesis focuses on investigation at the individual auditor level.

Finally, this thesis further tries to provide some insights on resolving the mixed findings about how corporate political connections influence firms' auditor choice patterns and auditors' risk assessments. Corporate political connections are widespread across the world, and the idea that political connections have profound economic implications is not new and has been identified and discussed extensively (Fishman, 2001; Fan et al., 2008; Faccio et al., 2009; Fan et al., 2014). Recent studies further suggest that the effect of political connections is subject to firm ownership structures, that is, whether the firm is state or privately owned (Chen et al., 2011; Wu et al., 2012). Specifically, political connections are likely to exacerbate the agency problems of the state-owned enterprises (SOEs), but benefit other firms (non-SOEs) by helping them to overcome market and institutional barriers and to seek favourable treatment from government (Wu et al., 2012; Chen et al., 2011b). Thus, the

influence of corporate political connections on auditors' risk assessments and firms' appointments of auditors is likely to be subject to firm ownership structure. Moreover, this thesis also extends prior cross-section studies by mitigating the potential endogeneity problems. In particular, this thesis employs the corruption cases that involve high-level Chinese government bureaucrats (at provincial and ministerial level and above) to construct a natural experiment, and collects a set of audit firms which are connected to these corrupt bureaucrats through bribing and family affiliations. This thesis then examines how these connected firms and their auditors respond to the sudden termination of political connections after the disclosures of anti-corruption cases, and whether the responses differ between SOEs and non-SOEs.

China is chosen for the empirical setting. Besides the mandatory reform which required all audit firms transform their organisational structures from LLC to LLP, and the co-existence of SOE and non-SOEs. The Chinese setting is also appropriate for the investigations of this thesis for the following reasons. First, due to an underdeveloped financial system and severe government intervention, corruption is a common phenomenon in China (Fan et al., 2008). Moreover, the anti-corruption cases which lead to the ousters of high-level government bureaucrats are often nothing but the excuses of one political clique eliminating a competing one (Hung et al., 2015). They are mainly driven by political factors, non-systemic and unlikely to be foreseen by the market (Fan et al., 2014). Thus, by employing the high-level Chinese anti-corruption cases as a natural experiment, this thesis suffers less from endogeneity problems than previous cross-section studies.

Second, auditors in China are required to sign audit reports to identify who was responsible for the audit, and their profile data is also publicly available. This provides usable

research data to conduct the analysis at the individual auditor level. Third, political connections are widespread in China, and the government has historically maintained a substantial influence on the auditing profession (Chan et al., 2006; 2012; Wang et al., 2008). It is thus expected that the influence of political connections of both client firms and auditors will be more significant in China than in other countries.

Lastly, Chinese auditors face lower level of litigation risk, and thus they may have a strong incentive to seek protections from being sanctioned from government (Chan, 2011). Therefore, the unique institutional environment in China provides advantages for conducting the investigations of this thesis. In the next section, the institutional environment in China will be discussed in detail.

## **1.2 Institutional Background**

### **1.2.1 The Chinese auditing market**

The external auditing profession in China was first established in the 1910s. During the next few decades, lots of audit firms, including some international firms, founded audit offices and practiced in the Chinese market. However, after the revolution in 1949, the Chinese auditing market diminished significantly, and finally was completely abolished after the economy was fully nationalized in 1962 (DeFond et al., 2000). Economic reforms in 1978 resulted in decentralisation of SOEs and a rapid growth in foreign investment that once again created a demand for external auditing. In the 1980s, China re-established its auditing profession and the professional body, Chinese Institute of Certified Public Accountants (CICPA), was founded in 1988. The main responsibilities of CICPA are to set auditing standards, organise the national uniform examination of CPAs, oversee auditing practices and provide continuing professional education for auditors. Under China's auditing standards,

auditors are required to sign audit reports with their names. Normally, there are two signing auditors for each engagement, with one mainly responsible for the review work (the review partner) and the other mainly responsible for the field work (the engagement partner). The signing auditors lead the audit team, make decisions on significant matters in the auditing process and are responsible for the final audit outcomes (Chen et al., 2015).

The role of external auditing was further enhanced after the opening of the Shanghai and Shenzhen Stock Exchanges in the 1990s, due to the demand for independent external auditing from listed firms. As a result, the government granted a set of audit firms, which were supposed to be of higher audit quality, with the special licence to audit listed firms. However, due to the lack of capital, almost all of these audit firms were affiliated with the local or central government, a university, or a government department (DeFond et al., 1999; Firth et al., 2012). The relationship between affiliated audit firms and their sponsoring government bodies typically meant that the audit firms were owned by sponsors (Yang et al., 2001). Indeed, auditors who practised within these affiliated firms were mainly from the sponsoring government entities and were still included in the personnel of the sponsoring governments.

In the Chinese capital market, most of the listed firms were under the control of government. Government ownership of audit firms thus brought heavy interventions on auditing practices, impeded auditor independence, and ultimately drove a lower audit quality. With these concerns in mind, in 1996, the Chinese Ministry of Finance (MOF) and CICPA launched the disaffiliation program, which required all audit firms in China to separate from their government-affiliated parent organisations and become independent audit firms (Firth et al., 2012). This program finished in 1998, with almost all Chinese audit firms reconstructed as independent entities.

However, even after becoming disaffiliated from government entities, Chinese audit firms, especially small audit firms, continued to maintain close personal and organisational networks with government officers, because SOE clients were economically important to these audit firms (Chan et al., 2006). Governments can threaten the livelihood of small audit firms by asking SOEs not to use their services. Moreover, governments can exert influence on small audit firms through finance bureaus, audit bureaus, and CPA institutes (Wang et al., 2008). Thus, the Chinese auditing market is characterised as suffering heavy government interventions.

### 1.2.2 The organisational structure of Chinese audit firms

The Chinese CPA Law, the *Law of the People's Republic of China on Certified Public Accountants*, which was published in 1993, provided guidance on the structure of audit firms. Under this law, auditors were permitted to register their audit firms as either GPs or LLCs. Although these two structures stipulate different legal liabilities for audit partners, organising as either GPs or LLCs made almost no difference to the partners in an affiliated firm, because audit firms were still state-owned institutions and the personal wealth of partners was not exposed to any legal risks. However, after they disaffiliated from their sponsoring government bodies in 1998, a series of civil litigations against auditors was initiated. Fully aware of the legal liability, more and more auditors chose to organise their audit firms as LLCs. According to Firth et al. (2012), the proportion of GP audit firms decreased from 31 per cent in 2000 to 10 per cent in 2004. By 2005, almost all Chinese audit firms with a special licence to audit listed companies were under an LLC structure (Firth et al., 2012).

LLP first became an option for Chinese audit firms in 2006 after the revision of the *Law of the People's Republic of China on Partnerships* was published. Compared to LLC, LLP



puts auditors into a more responsible position by imposing unlimited liability on a person who is convicted of negligence. Not surprisingly, of more than fifty audit firms with special licences to audit listed companies, only Guangdong Dahua Delv audit firm became an LLP, while the others all remained LLCs by the end of 2009.

In an effort to improve auditor independence and strengthen public confidence in audits, on 21 July 2010, the Chinese MOF launched the “Interim Provision” to encourage the top 200 audit firms, ranked by the CICPA, to adopt LLP as their organisational structure before the end of 2011. In particular, all audit firms with a special licence were included in the top 200 audit firms. Furthermore, in January 2012, the MOF and China Securities Regulatory Commission (CSRC) issued a notice which stipulates that, beginning in the year 2014, audit firms which still retain the LLC structure will lose their licenses to audit listed companies. As a result, at the end of 2013, all audit firms with a special licence had completed their structural reorganisation, including 42 local Chinese audit firms and 4 joint venture firms (JVs) of the international Big Four (Ernst & Young, KPMG, Deloitte and PWC).

### 1.2.3 The co-existence of SOEs and non-SOEs

All Chinese firms used to be solely owned by the government. Since the market-oriented economic reforms from 1978, some SOEs were partially privatised by issuing minority shares and listed on either the Shenzhen or Shanghai Stock Exchanges. Nonetheless, although these shares were sold to individuals and institutional investors, the Chinese government still controlled a large percentage of listed firms and held the majority of SOE shares. By the end of 2013, among the 2079 Chinese firms listed on both the Shanghai and Shenzhen stock exchanges, 975 were controlled by the government and average ownership held by government was 42.3%.

Privately controlled firms have evolved in the Chinese market since the economic reforms, especially after the Chinese Communist Party leader Deng Xiaoping's South Tour in 1992. In the same year, the first privately controlled firm, Shenzhen HuaYuan, was listed on the Shenzhen Stock Exchange. Another significant change in the development of the private sector happened in 2004, when a constitutional amendment clearly stipulated the protection of private property rights. Moreover, the government published the *Property Law of the People's Republic of China* in 2007, which admitted the legitimacy of individual property and gave a clear definition of personal property rights. The growth rate of the private sector far outpaced that of the public sector during the period from 1978 to 2013. The Chinese private sector grew from nothing to providing over 80% of total employment and industrial output.

#### 1.2.4 Corruption in China

It has been observed that corruption is a common phenomenon in China, due to an underdeveloped financial system and severe government intervention (Fan et al., 2008). China suffers from extreme corruption problems and ranks among the worst countries in terms of political freedom, as well as the protection of property rights (La Porta et al., 2004; Allen et al., 2005). According to the Corruption Perceptions Index published by Transparency International, China ranked 80 out of 177 countries in 2013, with an index of 3.5 out of 10<sup>1</sup>. During the period from 2004 to 2013, there were 307,480 anti-corruption cases either under investigation or concluded, and 743,074 government officers were punished. More than three out of every one thousand government officers were involved in anti-corruption cases<sup>2</sup>.

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<sup>1</sup> Transparency International is a non-profit organisation, which aims to stop corruption and promote transparency, accountability and integrity at all levels and across all sectors of society. The index measures the degree to which corruption is perceived to exist among public officials and politicians. It is a composite index, drawing on 14 different polls and surveys from seven independent institutions, carried out among business people, and analysis of countries, including surveys of residents, both local and expatriate. The index ranges from 0 to 10. The higher the score, the more transparent the country is.

<sup>2</sup> From the website of the Central Commission for Discipline Inspection of the Communist Party of China: <http://www.ccdi.gov.cn/xxgk/xxgknb/>.

More importantly, although there is only one ruling party under the current Chinese political system, several different political cliques or factions co-exist and compete fiercely with each other (Hung et al., 2015). Political scandals, such as corruption, which lead to the ousting of high-level government bureaucrats, are common and often nothing but the excuses of one clique eliminating a competing one (Hung et al., 2015). These are mainly driven by political factors, and thus are non-systemic and unlikely to be foreseen by the market (Fan et al., 2014).

### **1.3 Motivation and contributions**

The questions of how legal liability, the relationship with government and corporate political connections influence auditor behaviours has been studied and examined extensively in previous studies, yet the empirical findings are mixed.

The objective of this thesis is to extend these studies and provide clearer evidence on the impact of liability exposure, the relationship with government and corporate political connections on auditor behaviours. This study uses the Chinese market as the empirical setting because its unique institutional environment facilitates investigation and probing of the research questions.

This thesis contributes to the auditing literature in several ways. First, by employing the mandatory audit firms' organisational transform as a natural experiment, this thesis suffers less endogeneity problem and thus is able to provide clearer evidence on how legal liability influences audit quality and audit fees. In addition, this thesis also provides evidence on the issue that whether enlarging auditors' liability exposure takes effect in emerging markets where the institutional mechanisms are underdeveloped. Moreover, as this thesis makes comparative investigations of both LLC and LLP structures, it serves as a bridge to connect

prior studies that examine the differences between GP and LLC structures (Firth et al., 2012) with those that compare GP and LLP structures (Lennox and Li, 2012).

Secondly, this thesis builds upon previous studies that examine the interactions between government and connected auditors. Specifically, rather than conducting investigations at the firm level, this thesis instead looks at the individual auditor level. Moreover, this research provides a more comprehensive framework to depict how government strategically interacts with closely connected auditors. This thesis suggests that connections with government not only induce severe government intervention, but also provide auditors with protection from sanctions.

Finally, this study advances our understanding of the effects of political connections on auditor choice and auditor behaviour, and helps to interpret the mixed evidence in prior studies. This thesis suggests that the impact of corporate political connections on auditors' risk assessment and clients' auditor choice patterns may be subject to firm ownership structures. Moreover, by employing the Chinese high-level corruption cases, this thesis also suffer less endogeneity problem than previous cross-section studies, and thus can provide clearer evidence on the impact of corporate political connections on auditor behaviour.

#### **1.4 Structure of this thesis**

Chapter 2 examines whether auditors enhance their audit quality and charge higher audit fees after their audit firms transform from an LLC to an LLP structure. Legal liability is a key factor that influences auditor behaviours since it exposes auditors' personal wealth into litigation threats (Lennox and Li, 2012). Previous literature generally finds that larger legal liability is associated with higher audit quality and audit fees (Firth et al., 2012). Yet others argue that excessive liability exposures induce auditors out of the market and results in

driving audit quality down. Therefore, whether enlarging auditors' liability exposures takes effect on audit quality and audit fees is a question still needed to be answered.

Chapter 3 examines the rent-seeking activities between government and politically connected individual auditors, and how these rent-seeking activities influence audit quality. This thesis argues that connections with government not only introduce stronger interventions, but also provide auditors with protection from being sanctioned. Moreover, since government interventions impair auditor independence and protection from sanctions prevent auditors from exercising due diligence, this thesis further examines whether individual auditors' political connections drive their audit quality down.

Chapter 4 investigates how corporate political connections and ownership structures jointly affect the auditors' risk assessments and firms' auditor choice decisions. Corporate political connections are documented to influence firms' governance mechanisms and accounting practices, and in turn, affect firms' choice of auditors and auditors' assessments of audit risk (Gul, 2006; Guedhami et al., 2014). This thesis examines whether the influence of corporate political connections on auditor choice patterns and auditors' risk assessment is subject to firm ownership structures.

Chapter 5 concludes the thesis, discusses the caveats and also provides suggestions for further research.

Pages 14-62 of this thesis have been removed as they contain published material. Please refer to the following citation for details of the article contained in these pages.

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# **Chapter 3: How does rent-seeking between government and auditors influence audit quality? Evidence from individual auditors' political connections in China**

## **3.1 Introduction**

This study examines the rent-seeking activities between government and auditors with political connections, and how these rent-seeking activities influence audit quality in the Chinese market at the individual-auditor level. The issue investigated is whether government is more likely to intervene in the auditing processes of closely connected individual auditors, while at the same time providing them with protection from sanctions; and whether the intervention and protection brought by political connections impair audit quality. Previous studies, normally conducted at the audit firm level, provide extensive evidence on the economic consequences of the auditor-government relationship in China. A predominant view holds that a close tie with government will jeopardize auditor independence. Relevant empirical evidence suggests that the Chinese local audit firms, which are subject to more political influence, issue more unwarranted clean opinions to government-favoured client firms (DeFond et al. 2000; Yang et al., 2001; Chan et al. 2006; Wang et al. 2008, Liu et al., 2011; Chan et al., 2012). Yet others have adopted a more positive view on the relationship between government and auditors. These studies document that connections with regulators prop-up the performance of audit firms by providing them with additional audit fees and a larger market share; which might indicate that these connected auditors gain unique institutional knowledge from their connections (Yang, 2013). However, either the “government intervention” theory or the “prop-up” theory alone may be too narrow to

sufficiently capture the full complexity of the implications of auditor-government relationship.

The objective of this study is to develop a theoretical framework and provide evidence on how government and the auditors with political connections seek rent from each other in China. Under this framework, consistent with Chan et al. (2006) and Wang et al. (2008), government will exert heavy political pressure on connected auditors to seek favourable opinions for SOEs; however, on the other hand, these connected auditors also will seek protections of not being sanctioned from government. This mutual rent-seeking theoretical framework is distinctive from both the “government intervention” theory and the “prop up” theory in two main respects. Firstly, for mutual rent-seeking to exist, connections with government must neither induce government interventions only, nor prop up the performance of audit firms only. Secondly, the rent-seeking activities of auditors under this framework is reflected in the chance of being sanctioned, which is imposed directly by regulators, rather than in the audit fees or market shares, which are subject to many other non-political factors. Since government interventions jeopardize auditor independence, and the protection from sanctions impedes auditors from exercising due diligence, I predict the connections with government ultimately drive a lower audit quality.

Auditing is inherently a complex process of judgment and decision-making, and its outcomes are ultimately driven by the characteristics of individual auditors (Nelson and Tan 2005; DeFond and Francis, 2005; Wang et al., 2015). DeFond and Francis (2005) also suggest that the individual auditor level might be more appropriate than the firm level to analyse auditor behaviour. A growing body of recent empirical evidence further indicates that audit quality varies significantly across individual auditors (Gul et al., 2013; Wang et al., 2015;



Knechel et al., 2015). Hence, following this line of research, I conduct this investigation at the individual auditor level in order to achieve a better understanding of the strategic interactions between government and connected auditors.

China provides a unique setting to study rent-seeking activities between connected individual auditors and government. In particular, Chinese auditors are required to sign audit reports to identify who was responsible for the audit, and their profile data are also publicly available. This provides the usable research data to conduct analysis at the individual auditor level, which is not possible in the US and other major markets, mainly due to the data limitation (Gul et al., 2013). Besides the availability of data, China is also suitable as a site for the present study for the following reasons. Firstly, political connections are widespread in China; and the government has historically maintained a substantial influence on the auditing profession<sup>13</sup>. It is thus expected that the influence of auditors' political connections will be more significant in China. Secondly, due to the underdeveloped legal system, auditors face little risk of litigation in China (Chan et al., 2012). The low level of litigation risk may create a strong incentive for Chinese auditors to seek protections from being sanctioned from government. Thirdly, Chinese regulators usually impose sanctions on individual auditors, but rather the audit firms (Wu, 2008). Such a scenario, which is usually styled as “focus on individual auditors but ignore audit firms”, also facilitates my investigation into the relationship between political connections and the risk of sanctions at the individual auditor level.

I employ a sample consisting of 5851 audits in the Chinese market between 2008 and

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<sup>13</sup> In China, prior to the government's efforts to promote privatization, most audit firms were affiliated with and owned by government agencies or with government-sponsored bodies. Though the disaffiliation program that took place from 1996 to 1999 separated the affiliated audit firms from their sponsoring government bodies, auditors still maintained a close relationship with the government (Chan et al., 2006; Wang et al., 2008).

2013. Of the entire sample, I find that 1386, or 28.6%, firm-year observations are engaged by politically connected auditors. After controlling for other influential factors and the audit firm fixed effect, I document that individual auditors' political connections are associated with a significantly lower frequency of non-clean audit opinions, which indicates that connections with government impair audit quality. I further find that the audit opinions issued by connected auditors are significantly less informative than those issued by the non-connected auditors. I also make an effort to address the potential endogenous problem, and find that the main finding still stands. Further evidence suggests that the influence of individual auditors' political connections is stronger when (1) audit firms are located in underdeveloped regions; and (2) other auditors in the same firms are also connected to government.

To confirm the theoretical framework of this study, I further investigate the rent-seeking activities between government and politically connected auditors. I document that politically connected auditors issue even more clean opinions when they provide auditing services to SOEs, which confirms that connected auditors suffer more government interventions. In addition, I also find that connected auditors are significantly less likely to receive penalties than their non-connected peers. Overall, I conclude that government and auditors with political connections seek rent from each other, and that these rent-seeking activities ultimately impair audit quality.

This study contributes to the existing literature in several ways. Firstly, this paper provides clearer evidence on how government strategically interacts with closely connected auditors. Prior studies observe that local small audit firms are more lenient to SOEs in the same jurisdictions, and thus infer that these auditors are related to government (Chan et al., 2006; 2012; Wang et al., 2008). By focusing on the political connections of individual

auditors, this study is able to measure the relationship between government and auditors in a more direct and explicit way. Furthermore, this study complements these studies by providing a more comprehensive framework, which suggests that connections with government not only induce severe government intervention, but also provide auditors with protection from sanctions.

Secondly, this research extends those studies that examine the economic outcomes of the political connections borne by audit firms. Specifically, focusing on the Chinese IPO market, Yang (2013) finds that, in the Chinese market, audit firms with partners working at the IPO screening committee are able to improve the IPO approval rate of client firms, which in turn enables auditors to charge additional IPO auditing fees and obtain a larger IPO market share. Distinct from his study, which focuses on how political connections help auditors to obtain economic benefits in the IPO market, I instead examine the strategic interactions between politically connected auditors and government in a broader setting, the entire capital market in China. In addition, Yang (2013) fails to find clear evidence that politically connected audit firms seek rent from government; however, this study suggests that connected auditors can obtain the benefits of protection directly from government. Furthermore, the empirical evidence of the individual auditors in this study also indicates that political connections not only take effect in audit firms but also in individual auditors.

Thirdly, this study contributes to the literature on audit quality. Prior studies have documented several factors, such as the economic dependence on client firms (Chen et al., 2010), non-audit services (Kinney et al., 2004), client-auditor affiliations (Lennox, 2005), or auditor tenure (Carey and Simnett, 2006), that are likely to influence audit quality. In the present study, I extend the previous literature by identifying a new influential factor on audit

quality—the political connections of auditors. Moreover, previous studies suggest that the characteristics of individual auditors play an essential role in determining their audit quality (Chen et al., 2010; Gul et al., 2013; Wang et al., 2015). This study further shows that the interactions among individual auditors also potentially affect audit quality.

The remainder of this study proceeds as follows. Section 4.2 introduces the institutional background of the Chinese audit market, and develops testable hypotheses. The research data and the empirical models used in this study are presented in Section 4.3. Section 4.5 lists the main empirical results, and Section 4.6 concludes the study.

### **3.2 Institutional background and hypothesis development**

#### **3.2.1 Chinese auditing market**

The auditing profession vanished in the Chinese market soon after the establishment of the People's Republic of China. In the 1980s, with an aim of introducing foreign investment, several audit firms were set up by the government, and the Chinese auditing profession re-emerged. However, it was not until the establishment of the Shanghai and Shenzhen Stock Exchanges that the profession began to undergo tremendous growth due to the demand for independent auditing from listed firms. According to the CICPA, a total of 8151 audit firms and almost 100,000 individual auditors were practising in the Chinese market at the end of 2013. Moreover, to regulate the development of the auditing profession, between 1994 and 2003, the Chinese Ministry of Finance has stipulated 48 independent auditing standards, through six sets of rules. Under China's auditing standards, auditors are required to sign audit reports. Normally, there are two signing auditors for each engagement, with one mainly responsible for the review work (the review partner) and the other mainly responsible for the field work (the engagement partner). The signing auditors lead the audit team, make decisions

on significant matters in the auditing process and are responsible for the final audit outcomes (Chen et al., 2015).

The Chinese auditing market is historically heavily affected by government. Before 1998, almost all Chinese audit firms were state-owned, and affiliated with the local or central government, a university, or a government department (DeFond et al., 1999; Firth et al., 2012). Even since becoming independent entities after the disaffiliation program in 1998, Chinese auditors still experienced heavy political influence. Government exert its influence on the auditing profession through finance bureaus, audit bureaus, and CPA institutes, in the licensing of audit firms, the administration of qualifying exams, and the audit firms' day-to-day operations (Wang et al., 2008).

Unlike those in U.S and other western countries, Chinese auditors have a lower level of litigation risk, but more concern about regulatory sanctions (Chan et al., 2011). Moreover, Chinese regulators have historically paid more attention to individual auditors rather than audit firms. Specifically, according to Wu (2007), from 2003 to 2006 over 27% of sanctions imposed by Chinese regulators involved only individual auditors; whereas the others involved both individual auditors and audit firms. The unique institutional environment of China thus facilitates my investigation into the interactions between the government and politically connected individual auditors.

### 3.2.2 Hypothesis development

The term rent is used to describe the benefits, normally economic benefits, which are above those generated in competitive markets (Khan and Sundaram, 2000). Rent arises from the exclusivity or scarcity of resources, and the individuals, organizations or politicians seek rent from those having discretionary power to distribute these resources (Khan and Sundaram,

2000). A non-clean audit opinion conveys to the market that the financial statements of client firms are seriously misstated, and can raise these client firms' financial costs (Chen et al., 2010; Chen et al., 2016); whereas being sanctioned will damage auditor reputation and impede their further careers (Shafer et al., 1999). Since auditors can decide whether to issue non-clean opinions to client firms, while government has the discretionary power to impose sanctions on the misbehaved auditors, I thus expect politicians will seek clean audit opinions for their controlled firms from auditors, and auditors also will seek for protections from being sanctioned from government. In what follows, I discuss in detail the rent-seeking activities between auditors and government in the Chinese market.

In China, the reporting incentives of firm managers are mainly driven by contractual restrictions, but not by the needs of the users of accounting information (He et al., 2012). Chinese regulators adopt bright-line accounting-based rules to govern several aspects of listed firm operations. For example, if a listed Chinese firm reports losses for two consecutive years, then it is labelled as a "special treatment" (ST) firm, and its daily stock price changes are restricted to 5 percent, in comparison with the 10 percent restriction on the non-ST firms. The firm will further be delisted if it reports yet another loss in the year after it was classified as an ST firm. Additionally, for a seasoned offering, the listed firm must report a profit for each of the preceding three years. Such accounting-based rules inevitably create a strong incentive for firms to manipulate accounting numbers to meet the regulatory earnings targets (Chen et al., 2004; Haw et al., 2005).

Chinese politicians are likely to have incentive to facilitate the earnings management of firms under their control (Chen et al., 2008). By helping these firms (SOEs) to obtain rights-offering approvals or to fend off the threat of delisting, government reaps the benefits

from the companies' prosperity (Chan et al., 2012). These benefits include the tax revenue, social welfare, infrastructure development, and reduction in unemployment. To facilitate SOEs' earnings management, government thus is likely to appoint lenient auditors who will issue favourable audit opinions.

The incentive for government to shop for favourable audit opinions for SOEs can also arise from political interests. In particular, a modified audit opinion (MAO) conveys auditors' substantial concern that client firms' financial reports are misstated or not fairly presented. Prior studies using US data suggest that MAOs can trigger significantly negative market reactions (Chow and Rice, 1982; Fields and Wilkins, 1991; Jones, 1996). Similar evidence is also found in the Chinese context (Chen et al., 2000). If SOEs obtain an MAO, the negative market reaction is likely to damage the politicians' reputations and impede their careers (Li and Zhou, 2005; Piotroski et al., 2015). Thus, government politicians have strong incentives to seek clean audit opinions for their controlled SOEs from auditors.

On the other hand, Chinese auditors also are motivated to seek protection from being sanctioned. In particular, due to underdeveloped legal structures and a lack of law enforcement, Chinese auditors face significantly less risk of litigation than their counterparts in the US or other Western countries (Chen et al., 2015; Wang et al., 2015). The litigation costs, which are a major driver of high audit quality (DeFond and Zhang, 2014), often have a limited effect on the Chinese auditors (Chan et al., 2011). Therefore, the sanctions imposed by Chinese regulators such as CSRC and MOF could be the main concern of potentially misbehaving auditors. Indeed, according to the argument of La Porta et al. (2000) and Glaeser et al. (2001): "in emerging markets where the costs of verifying the circumstances of specific cases and interpreting statutes are high, regulatory enforcement is an effective way of

fostering the independence of intermediaries”. The sanctions imposed on Chinese auditors can be harsh. Auditors who commit a violation of auditing standards can be sanctioned by public reprimands, warnings, fines, being forbidden to practise, and even imprisonment. For example, in a well-known Chinese financial scandal, the case of Yin Guanxia (stock code: 000556), two Chinese auditors, Liu Jiarong and Xu Linwen, were imprisoned due to their failure to detect fraud in the financial statements of Yin Guanxia. In another case, two negligent Chinese auditors were fined RMB 100,000 and forbidden from practising in the capital market for life, because of their facilitating the misreporting of Lv Da Di (stock code: 002200). Moreover, Gul et al. (2016) also provide evidence that regulatory sanctions are associated with reputation losses for auditors in China. Thus, being sanctioned by the regulator can seriously damage auditor reputation, and impede their careers. Auditors, therefore, have incentives to seek protection from being sanctioned from government.

The political connections of individual auditors can facilitate rent-seeking activities between auditors and government. Specifically, compared with non-connected auditors, the close personal relationship with connected auditors provides politicians with a convenient channel through which to exert their power to influence auditing outcomes. In addition, being well acquainted with politicians, auditors may be reluctant, whether consciously or unconsciously, to question the accounting policies and financial reports of their SOE clients, since a negative opinion on these matters is likely to damage their connections with politicians. Consistent with these arguments, prior studies focusing on China suggest that, under pressure from politicians, small Chinese audit firms are likely to compromise their independence to SOEs under the control of local governments (Chan et al., 2006; 2012; Wang et al., 2008).



The connections with government also enable auditors to seek rent from government. Prior studies suggest that connections with government may benefit connected business entities in terms of “relaxed regulatory oversight” (Faccio, 2006; Gul et al., 2013). For example, Berkman et al. (2011) suggest that, in the Chinese market, the enforcement of new regulations is significantly weaker in firms whose block-holders have strong political connections; and Lu et al. (2011) argue that political ties are helpful in seeking protection from the judiciary to affect the outcome of litigation. Likewise, political connections may also provide some protection for auditors. It thus could be possible that connected auditors receive no or lighter penalties than non-connected others, if both are similarly responsible for an audit failure.

Overall, the rent-seeking activities between auditors and government may induce more government interventions on auditors, and also shield them from sanctions. Government intervention impedes auditors from conducting rigorous auditing, and leads them to become less independent; and the protection from being sanctioned induces auditors to behave less conservatively and report more aggressively, both negatively influence audit quality. Since the presence of political connections facilitates auditors and government to seek rents from each other, I therefore develop my research hypothesis as follows:

*H: auditors with political connections conduct audits of lower quality than those without such connections.*

### **3.4 Research Design**

#### **3.4.1 Measurement of audit quality**

I employ the propensity for auditors to issue modified audit opinions (MAOs) to proxy for audit quality. MAOs conveys auditors’ substantial concern that client firms’ financial

reports are misstated and not fairly presented. Client firms are expected to exert pressure on auditors to issue a clean opinion, since a MAO imposes huge costs on them (Chow and Rice, 1982; Fields and Wilkins, 1991; Chen et al., 2000). Therefore, auditors who succumb to this pressure will be supposed to have a low audit quality.

The Chinese Auditing Standards (Ministry of Finance, 1995) specify four kinds of audit opinion: unqualified opinions, qualified opinions, disclaimer opinions, and adverse opinions. Typical reasons for incurring qualified/disclaimer/adverse opinions include (1) violations of Generally Accepted Accounting Principles (GAAP), (2) scope limitations, and (3) inconsistencies in applying accounting standards. In addition, Chinese auditors also have the discretion to issue unqualified opinions with explanatory notes to indicate events, such as lawsuits and guarantees, which could materially influence a firm's future performance. Although CICPA emphasizes the unqualified opinion with explanatory notes in a manner similar to the "emphasis of a matter" in the US, it has usually been considered as a form of quasi-qualification that reflects a compromise between managers and auditors (Chan et al., 2006; Chen et al., 2000). Moreover, this type of audit opinion is treated in the same way as other non-clean opinions in the disclosure requirement made by CSRC. Therefore, in accordance with prior studies, I classify MAOs as any type of opinion that is unqualified with explanatory notes, qualified, or a disclaimer (Chan et al., 2012; Firth et al., 2012)<sup>14</sup>. The discrete variable *MAO* is assigned the value of 1 if a certain client firm receives an MAO in the current fiscal year, and 0 otherwise.

Different types of MAOs suggest different levels of severity in the misreporting in client firms' accounting statements (Chen et al., 2010; Guan et al., 2014). A lenient auditor can issue

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<sup>14</sup> I don't include adverse opinions because there is no adverse audit opinion in our sample.

an unqualified opinion when an MAO is warranted, or a less severe opinion when a more severe one is appropriate. Therefore, to better capture whether politically connected auditors compromise their independence to SOEs, I further define an ordered audit opinion variable (*MAOOD*). Consistent with Chen et al. (2010), Chan et al. (2012) and Guan et al. (2014), the opinion rankings in order of increasing severity are: unqualified (=0), unqualified with explanatory notes (=1), qualified (=2), and disclaimer (=3).

### 3.4.2 Measurement of individual auditors' political connections

Prior corporate finance literature identifies firms' political connections in several ways. For example, Robert (1990) and Claessens et al. (2008) attempted to identify ties by tracing political donations, while Faccio (2006) and Guedhami et al. (2014) infer political connections through politicians' holdings of corporate stock or membership on corporate boards. Still others identify political connections via educational background (Bertrand et al., 2004), location (Faccio et al., 2009), or historical friendships (Fisman, 2001; Johnson and Mitton, 2003; Gul, 2006). Studies that focus on the Chinese market usually classify firms as politically connected when the management has current or previous political experience (Fan et al., 2007; Zhang et al., 2011; Wu et al., 2012), or participates in the NPC or CPPCC (Li et al., 2006). In the only study which investigates the political connections of audit firms, Yang (2013) identifies politically connected audit firms if any of their auditors serve as a member on the Issuance Committee of CSRC.

Combining the definitions of previous studies and the unique political environment in China, in this study, I identify four main sources for individual auditors to build connections with government: (1) having work experience at affiliated audit firms; (2) working as directors in the CICPA or local CPA institutes; (3) membership of NPC or CPPCC; and (4)

serving on the Issuance Committee of CSRC. I discuss each source in detail in the next parts.

#### *Having working experience at affiliated audit firms*

Since the auditing profession was re-established in China in the early 1980s, a large number of audit firms had been established and affiliated to a local or central government department (DeFond et al., 2000; Firth et al., 2012). The relationship between affiliated audit firms and their sponsoring government bodies typically meant that the audit firms were owned by sponsors (Yang et al., 2001). Auditors who practised within these firms were mainly from the sponsoring government entities and were still included in the personnel of the sponsoring governments. For example, *Baker Tilly China*, one of the biggest Chinese local audit firms, was affiliated with the audit office of Hunan province until 1999. Its managing partner, Mr Chen Yonghong, was the deputy section chief of the audit office of Hunan province before he joined this audit firm. Thus, having work experience in affiliated audit firms means auditors previously worked as government officers. I therefore classify these auditors as politically connected.

#### *Working as a director of the CICPA or local CPA institutes*

The second source that could equip Chinese individual auditors with political connections is serving as a director in central or local ICPAs. As the professional bodies of auditors, CPA institutes were set up in China following the re-establishment of the auditing profession. However, unlike those in the US and most Western countries, CPA institutes in China are not an independent professional organization, but rather a subordinate unit under the direction of the Ministry of Finance or the provincial Department of Finance. Therefore, the directors in Chinese CPA institutes accordingly bear political ranks. For instance, CICPA is directly under the control of the Ministry of Finance, and its secretary, Mr. Chen Liugui,

bears the same political rank as the head of a provincial Department of Finance. Thus, directors of CICPA or local CPA institutes may be viewed as government officials, and I therefore classify auditors who take these positions as politically connected.

#### *Membership of NPC or CPPCC*

The third source that Chinese auditors are able to connect with government through is participating in the PC or PPCC. According to the Chinese constitution, the NPC is the legislature and the organ of supreme power in China, and the CPPCC is an advisory body to the government. The main function of the NPC is to elect government officials, draft and approve laws and policies, and even impeach government officials when necessary, whereas the CPPCC exerts its power by holding political consultations on major policies and exercising democratic supervision over the performance of governments. Li et al. (2006) argue that participating in the NPC or CPPCC provides private entrepreneurs not only with some measure of political power but also easier access for cultivating formal and informal ties with important government bureaucrats. In a similar vein, I classify auditors who are current or former members of the NPC or CPPCC as politically connected. An example is Mr Yao Genchun, who is an auditor of *Beijing Xinghua* audit firm and also served as a member of the CPPCC of Hubei province from 2000 to 2008. Another example is Mr Li Jinhua, a partner of *Lixin* audit firm, who worked as a member of the NPC of Hainan province between 2008 and 2013.

#### *Working in the Issuance Committee of CSRC*

The last source I identified for Chinese auditors to build political connections is through working within the Issuance Committee of CSRC. The CSRC was set up in 1992 under the authority of the NPC, and its Issuance Committee is responsible for examining and verifying

the qualifications of firms applying for IPOs. The committee members may be bureaucrats, lawyers, investment bankers, mutual fund managers, and auditors. According to Yang (2013), work experience in the Issuance Committee provides auditors with the access to key CSRC officials and other committee members. I therefore follow his study and classify auditors who currently or previously served on the Issuance Committee of the CSRC as politically connected. For example, Mr Bai Linxiao, a partner of *Gongzhengtianye* audit firm, served as a committee member from 2009 to 2010.

### 3.4.3 Empirical Model

To examine how political connections of individual auditors influence their audit quality, I construct the following empirical model:

$$MAO(MAOOD) = \alpha + \beta CONNNECTED + \gamma Controlvariables + \varepsilon$$

In this model, *MAO* is assigned the value of 1 if a client firm receives a MAO in the current fiscal year, and 0 otherwise. *MAOOD* is coded from 0 to 3, for unqualified, unqualified with explanatory notes, qualified, and disclaimer opinions, respectively. The experimental variable is *CONNNECTED*, which equals 1 if an auditor is politically connected, and 0 otherwise. In China, audit reports are predominantly signed by two partners. In this study, I follow Gul et al. (2016) and conduct my investigation by focusing on the lead partner (the review partner), who undertakes more responsibility for the auditing process. I also examine the change in audit quality for the concurring audit partner (engagement partner), but do not find an effect, suggesting that the political connections mainly take effect on the lead partners.

Based on prior studies, I include a set of control variables to capture the characteristics of client firms that are likely to affect the reporting incentives of both client firms and auditors

(Francis and Wang, 2008; Guan et al., 2014). Specifically, *SIZE* is defined as the natural logarithm of firm total assets; *LEV* is calculated as the ratio of long-term liability over total assets; and *ROA* is net income over total assets. In addition, *Q* is the year-end Tobin's Q value, measured as the ratio of firm market value to replacement value; and *GROWTH* is the growth rate of firm total assets. *LOSS* is a dummy variable, which equals 1 if the client firm has a negative net income in the previous fiscal year, and 0 otherwise. Since firm risk is related to its ownership structures and listing years (Chan et al, 2006; 2012; Wang et al., 2008), I further include a dummy *SOE* to indicate whether a firm is state-owned, and *AGE* to show the number of years the firm has been listed on stock exchanges. *INV* and *REC*, measured as the inventory and accounts receivable over total assets, respectively, are also included to control for the complexity of a firm's operations. Prior studies suggest that auditors are likely to face a higher risk of litigation when servicing companies with A and B/H share outstanding (Guan et al., 2014; He et al., 2015). Motivated by these studies, I employ the dummy *BHSHARE* to indicate the presence of B and H share issues.

I also include the economic dependence of individual auditors on certain client firms, *CI*, since Chen et al. (2010) document that individual auditors are more likely to compromise their independence to client firms that are economically important to them. I define *CI* following Chen et al. (2010). In addition, I include *LagMAO* (*LagMAOOD*) to indicate the type of audit opinion that a certain firm received in the previous year, to control for the persistence of audit opinion type (Dopuch et al., 1987; Firth et al., 2012). Moreover, prior studies suggest the conservativeness of auditor reporting behaviour is subject to the development of capital markets and the legal environment (Francis and Wong, 2008; Wang et al., 2008). I therefore adopt the Index of Marketization of China's Provinces (*MKTIDX*),

developed by the National Economic Research Institute, to measure the degree of market development in regions where the audit firm is located<sup>15</sup>.

Lastly, following Gul et al. (2013), I include audit firm fixed effects to control for the unobservable characteristics of audit firms. Year and industry dummies are also included to control for their fixed effects. I present the definition and measurement of each variable in Appendix B. As politically connected auditors could keep serving a client firm for years, following Rogers (1993), I adjust the coefficients' standard errors by clustering them at the client firm level. I also winsorize all continuous variables at the 1st and 99th percentiles, to mitigate the impact of extreme values.

#### 3.4.4 Sample and Description

##### *Sample selection*

The sample begins with all the Chinese non-financial firms listed in the Shanghai and Shenzhen Stock Exchanges from 2008 to 2013. The sample starts in 2008 because new accounting standards with international convergence were adopted in China in 2007. A research period starting one year later can thus mitigate the contamination involved in implementing these new standards. Data on client firms' financial information are obtained from the CSMAR Database.

For each sample firm, I collect the audit opinions and the identities of signing auditors from its annual reports. I then cross-check the identities of signing auditors against the online

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<sup>15</sup> Fan et al. (2011) assess the relative progress in marketization of Chinese districts using a comparative method, considering 23 indicators in the following five fields: (1) the relation between the government and the market; (2) the development of the non-state sector in the regional economy; (3) the development of the product market; (4) the development of the factor market; and (5) the development of market intermediaries and the legal environment. Data to calculate these indicators are obtained from either the National Bureau of Statistics or enterprise and household surveys. In 2001, the worst and best performing regions for a particular indicator received a score of zero and 10, respectively, while other districts obtained scores in between. Provinces/municipalities can acquire scores below zero or above 10 in later years, depending upon their evolution over time.



enquiry system compiled by the CICPA<sup>16</sup>. I manually input each auditor's full name into the enquiry system to get the auditors' demographic information, and match the search results with the audit firm and individual auditor data collected from companies' annual reports.

My initial sample contains 11812 firm-year observations. I drop 239 observations from the financial sector; 3385 observations of newly listed companies; 1070 observations whose auditors experienced a merger during the research period; and 1267 observations of firms whose auditors can't be identified or have missing personal information. Table 3.1 summarizes in detail the procedure I adopt to select the research sample.

**Table 3.1 Sample selection**

	Total firm-year observations
Total A-share listed companies from 2008 to 2013	11812
Less: Finance companies	(239)
Companies which were listed after 2007	(3385)
Audit firm encountered mergers	(1070)
	7118
Less: Companies without information on the review or engagement auditors	(1267)
Final sample	5851

Table 3.2 reports the distributions of the individual auditors' political connections and audit opinions. Panle A presents the distribution of politically connected auditors according to year and connection type. As the table shows, over the research period, nearly 28.6% of firm-year observations are engaged by politically connected auditors. The relative percentage of politically connected auditors ranges from 33.9% in 2008 to 24.5% in 2013, but without observable time-tendencies. Additionally, among the four types of political connections I defined above, having work experience in affiliated audit firms makes up the largest proportion.

<sup>16</sup> [http://cmispub.cicpa.org.cn/cicpa2\\_web/public/query0/2/00.shtml](http://cmispub.cicpa.org.cn/cicpa2_web/public/query0/2/00.shtml)

Panel B of Table 3.2 reports the distribution of audit opinions during the sample period. I find almost 6.4% of observations received MAOs over the sample period. In addition, over half MAOs are unqualified opinions with explanatory notes, which might suggest that Chinese auditors would compromise their independence under the pressure of client firms and thus issue less severe MAOs. Moreover, the relative frequencies of MAOs vary over time, but in most years, they are under 7%.

Panel C presents the descriptive statistics of the control variables in the empirical model. I find the average total assets of my sample firms are nearly 3.2 billion RMB ( $e^{21.898}$ ), which is comparable to the RMB 3.3 billion reported by Liu et al. (2012). In addition, consistent with Guan et al. (2014), the descriptive results suggest that over half of my sample firms are controlled by central or local government. The values of other control variables reported in this paper are also mainly in line with those of prior studies (Liu et al., 2012; He et al., 2014).

**Table 3.2 The distribution of individual auditors' political connections and audit opinions**

Panel A The distribution of observations that are audited by politically connected auditors

	<i>Issuance Committee</i>	<i>NPC or PPCC</i>	<i>IPCA</i>	<i>Affiliated firms</i>	<i>others</i>	<i>Total</i>
2008	0 (0.00)	11 (1.13)	71 (7.28)	283 (29.03)	664 (66.06)	975 (100.00)
2009	0 (0.00)	12 (1.73)	56 (8.06)	187 (26.91)	469 (67.48)	695 (100.00)
2010	6 (0.54)	9 (0.81)	69 (6.22)	267 (24.05)	785 (70.72)	1110 (100.00)
2011	7 (0.73)	6 (0.63)	54 (5.65)	216 (22.59)	688 (71.79)	956 (100.00)
2012	7 (0.65)	10 (0.93)	42 (3.89)	229 (21.20)	810 (75.00)	1080 (100.00)
2013	8 (0.77)	15 (1.45)	51 (4.93)	204 (19.71)	783 (75.65)	1035 (100.00)
Total	28 (0.48)	63 (1.08)	343 (5.86)	1386 (23.69)	4179 (71.42)	5851 (100.00)

Panel B The distribution of audit opinions according to year and opinion type

	<i>Unqualified Opinions with explanatory notes</i>	<i>Qualified Opinions</i>	<i>Disclaimer Opinions</i>	<i>Unqualified Opinions</i>	<i>Total</i>
Year 2008	50 (5.13)	9 (0.92)	13 (1.33)	903 (92.62)	975 (100.00)
Year 2009	34 (4.89)	4 (0.58)	5 (0.72)	652 (93.81)	695 (100.00)
Year 2010	60 (5.41)	13 (1.17)	4 (0.36)	1033 (93.06)	1110 (100.00)
Year 2011	52 (5.44)	11 (1.15)	3 (0.31)	890 (93.06)	956 (100.00)
Year 2012	56 (5.19)	7 (0.65)	3 (0.28)	1014 (93.89)	1080 (100.00)
Year 2013	36 (3.48)	10 (0.97)	5 (0.48)	984 (95.07)	1035 (100.00)
Total	288 (4.92)	54 (0.92)	33 (0.56)	5476 (93.59)	5851 (100.00)

Panel C Descriptive statistics of independent variables

<i>Variable</i>	<i>Mean</i>	<i>S.D</i>	<i>Lower quartile</i>	<i>Median</i>	<i>Upper quartile</i>
<i>Size (in million)</i>	3221	8451	1344	3025	7301
<i>LEV</i>	0.091	0.122	0.001	0.041	0.144
<i>BHSHARE</i>	0.087	0.235	0	0	0
<i>ROA</i>	0.030	1.019	0.008	0.029	0.057
<i>AGE</i>	12.23	4.145	9	12	15
<i>Q</i>	1.986	1.037	1.170	1.533	2.237
<i>LOSS</i>	0.118	0.323	0	0	0
<i>LOCAL</i>	0.237	0.425	0	0	0
<i>GROWTH</i>	0.163	0.606	-0.001	0.093	0.224
<i>Lag-MAO</i>	0.072	0.259	0	0	0
<i>Lag-MAOOD</i>	0.095	0.379	0	0	0
<i>CI</i>	0.485	0.370	0.133	0.402	0.925
<i>SOE</i>	0.592	0.491	0	1	1
<i>BIGFOUR</i>	0.058	0.235	0	0	0
<i>MKTIDX</i>	8.757	2.057	7.390	8.930	10.42
<i>INC</i>	0.186	0.178	0.0660	0.137	0.236
<i>REC</i>	0.080	0.089	0.014	0.048	0.116

**Note:**

Panel A reports the distribution of politically connected auditors according to the connecting status and year; Panel B shows the distribution of audit opinions according to the opinion type and year; and Panel C illustrates the descriptive statistics of control variables.

See Appendix B for definitions of variables.

### 3.5 Empirical results

#### 3.5.1 Main results

The test results for the hypothesis are presented in Table 3.3. Panel A shows the results of univariate tests, whereas Panel B reports those of multivariate analysis.

To perform a univariate test, I partition the sample observations according to the political connection status of auditors and compare if the frequency of MAOs (different types of MAOs) is significantly different between the groups of connected and non-connected auditors. As the results suggest, only 4.78% of firm-year observations encounter a MAO when the individual auditor is politically connected, compared to 7.06% when the auditor has no political connections. The difference in the frequency distributions of MAO between the two groups is significant based on the Chi-Square test ( $\chi^2 = 10.30$ ). Moreover, 0.9% observations receive qualified or more severe audit opinions in the political connected group, while the corresponding percentage is 1.72% in the group of non-connected auditors. The mean value of *MAOOD* of the connected group is significantly lower than that of the non-connected group ( $T = 3.21$ ). The results of the univariate analyse thus lend preliminary support to the hypothesis, and suggest that connections with government may impair audit quality.

Panel B presents the multivariate analysis. As the results show, the coefficients of *CONNECTED* are significantly negative in both regressions of *MAO* and *MAOOD* at the at 1% and 5% levels, respectively (t-values in regression of *MAO* and *MAOOD* are -2.69 and -2.43, respectively). To gauge the economic significance of *Connected*, I hold all the other control variables at their mean values and compare the predicted value of *MAO/MAOOD* when *CONNECTED* turns from 0 to 1. The result suggests that when auditors are politically connected, the possibility that they will issue an MAO (a more severe MAO) decreases from 6.9 percentage to 5.4 percentage (from 6.6 percentage to 5.0 percentage), or 22% (24%).

These results, corroborate the earlier evidence, suggest that having political connections can substantially decrease the audit quality of auditors.

For the control variables, generally consistent with prior studies (Wang et al., 2008; Firth et al., 2012), I find bigger or more profitable firms are less likely to receive unfavourable audit opinions. In addition, firms that encounter a loss in the current fiscal year have a higher possibility of receiving MAOs or more serious MAOs. Furthermore, in accordance with Dopuch (1987), I also find audit opinions are highly persistent.

Nonetheless, the significant relationship between individual auditors' political connections and audit quality that I document in this part could be accounted for the measurement errors or potential endogeneity problems. To address these problems, I perform a series of tests to check if the findings are subject to other explanations or caused by other factors, in the next sections.

**Table 3.3 Empirical results****Panel A Univariate test**

	<i>MAOOD</i> = 0	<i>MAOOD</i> = 1	<i>MAOOD</i> = 2	<i>MAOOD</i> =3	<i>Total</i>
<i>CONNECTE</i>	1592	65	8	7	1672
<i>D</i>	(95.22)	(3.89)	(0.48)	(0.42)	(100.00)
<i>Non-</i>	3884	223	46	26	4179
<i>CONNECTED</i>	(92.94)	(5.34)	(1.10)	(0.62)	(100.00)
<i>T-Value</i>	3.21***				
	<i>MAO = 0</i>	<i>MAO = 1</i>	<i>Row Total</i>		
	1592	80	1672		
<i>CONNECTED</i>	(95.22)	(4.78)	(100.00)		
	3884	295	4179		
<i>Non- CONNECTED</i>	(92.94)	(7.06)	(100.00)		
	5476	375	5851		
<i>Column total</i>	(93.59)	(6.41)	(100.00)		

$$\chi^2 = 10.30^{***}$$

**Panel B The multivariate analysis**

<i>Variables</i>	<i>MAO</i>	<i>MAOOD</i>
<i>CONNECTED</i>	-0.537*** (-2.69)	-0.385** (-2.43)
<i>SIZE</i>	-0.252** (-2.30)	-0.365*** (-3.36)
<i>LEV</i>	-1.103 (-1.09)	-1.017 (-1.15)
<i>ROA</i>	-12.724*** (-9.54)	-12.439*** (-9.85)
<i>BHSHARE</i>	0.340 (1.07)	0.245 (0.88)
<i>AGE</i>	0.022 (0.84)	0.028 (1.17)
<i>Q</i>	0.043 (0.51)	-0.019 (-0.27)
<i>LOSS</i>	0.490*** (2.77)	0.387** (2.52)
<i>GROWTH</i>	-1.612*** (-3.99)	-0.969*** (-2.74)
<i>Lag-MAO</i>	3.596*** (20.45)	
<i>Lag-MAOOD</i>		2.059*** (13.54)
<i>CI</i>	-0.121 (-0.55)	-0.153 (-0.82)
<i>SOE</i>	-0.239 (-1.08)	-0.171 (-0.93)

<i>MKTIDX</i>	-0.107** (-2.20)	-0.118*** (-2.92)
<i>INV</i>	-2.026*** (-3.23)	-1.725*** (-3.46)
<i>REC</i>	-1.824 (-1.64)	-1.063 (-1.09)
<i>Cons</i>	2.327 (0.95)	
<i>Intercept 1</i>		-4.749* (-1.85)
<i>Intercept 2</i>		-2.159 (-0.83)
<i>Intercept 3</i>		-0.766 (-0.29)
<i>Audit firm, year and Industry fixed effects</i>	Include	Include
<i>N</i>	5851	5851
<i>Pseudo R-sq</i>	0.552	0.429

**Note:**

This table presents the results of empirical tests for *MAO* and *MAOOD*. Panel A reports the results of univariate tests. I perform a T-test on the mean values of *MAOOD*, and a Chi-square test on the frequencies of *MAO*. Panel B reports the results of multivariate logit/ordered logit regression.

\*\*\*, \*\* and \* indicate two-tailed significance at the 1%, 5% and 10% levels, respectively.

### 3.5.2 Robustness test

#### *Alternative explanation*

In above analyses, I gauge the impact of individual auditors' political connections on audit quality through examining the propensity for auditors to issue MAOs (more serious MAOs). Although a higher propensity for auditors to render MAOs is typically interpreted in auditing literature as evidence of superior audit quality, several studies cast doubt on this form of measurement (Francis, 2004; DeFond and Zhang, 2014; Guan et al., 2014; He et al., 2014). In particular, a low quality auditor may issue a clean audit opinion when a MAO is warranted, or issue a MAO when a clean opinion is appropriate. As I find that politically connected auditors are more likely to issue clean or less severe audit opinions, one could argue that connections with government benefit audit quality by reducing auditors' propensity to issue inappropriate MAOs. In this section, I test this alternative explanation by examining whether



the audit opinions issued by politically connected auditors are more informative.

In accordance with prior studies (Willenborg and McKeown, 2001; Carcello et al., 2009; Guan et al., 2014), I assess the informativeness of audit opinions by testing the predictive power of MAOs for firms' extreme financial condition in the near future. In particular, I mainly focus on the following two events: extremely poor accounting performance; and financial distress. Extremely poor accounting performance is measured by the variable *LowRoa*, which equals 1 if the industry-adjusted ROA of certain firm is in the lowest decile of the whole population of listed firms in the next fiscal year, and 0 otherwise. Financial distress is captured by the variable *Distress*. Consistent with Carcello et al. (2009) and Firth et al. (2012), I assign *Distress* to 1 if any of firm's net income, net working, or net capital, is negative in the next fiscal year, and 0 otherwise.

I use logit regressions and include the interaction term *MAO\*CONNECTED* to examine whether the MAOs issued by politically connected auditors are more accurate than those given by other non-connected auditors. After excluding the observations with missing information, the sample size decreases slightly to 5830. To control for other influential factors, I include a set of control variables, such as firm size (*SIZE*), leverage (*LEV*), and profitability (*ROA*). The results are reported in Table 3.4.

As Table 3.4 suggests, *MAO\*CONNECTED* is significantly negative, with both *LOWROA* and *DISTRESS* in the regression results. Thus, for individual auditors, political connections substantially decrease the informativeness of the MAOs they issue. Therefore, the alternative explanation that auditors' political connections increase the informativeness of MAOs does not hold for the main findings. I thus conclude that individual auditors' political connections decrease the audit quality of auditors.

**Table 3.4 Predictive power of MAOs issued by politically connected auditors**

<i>Variables</i>	<i>LOWROA<sub>t+1</sub></i>	<i>DISTRESS<sub>t+1</sub></i>
<i>MAO</i>	0.470*** (2.84)	0.729*** (4.33)
<i>MAO*CONNE</i>	-0.557* (-1.80)	-0.917*** (-2.94)
<i>CTED</i>	0.127 (1.19)	-0.153** (-2.07)
<i>CONNECTED</i>	-0.161*** (-2.89)	0.206*** (5.48)
<i>SIZE</i>	1.059** (2.08)	1.548*** (4.26)
<i>LEV</i>	-20.792*** (-16.56)	-14.763*** (-17.76)
<i>ROA</i>	0.157 (0.92)	-0.0470 (-0.40)
<i>BHSHARE</i>	0.023* (1.81)	0.00500 (0.59)
<i>AGE</i>	-0.0510 (-0.96)	-0.140*** (-3.41)
<i>Q</i>	-0.447*** (-3.14)	-0.202* (-1.65)
<i>LOSS</i>	-0.820*** (-3.13)	-0.626*** (-3.66)
<i>GROWTH</i>	-0.280** (-2.43)	-0.006 (-0.07)
<i>MKTIDX</i>	-0.083*** (-3.37)	-0.078*** (-4.56)
<i>INV</i>	-1.308*** (-3.97)	-5.295*** (-22.10)
<i>REC</i>	0.0490 (0.08)	-6.799*** (-13.94)
<i>Cons</i>		
<i>Year/Industry</i>	Include	Include
<i>Dummy</i>		
<i>N</i>	5830	5830
<i>Pseudo R-sq</i>	0.231	0.232

**Note:**

See Appendix B for definitions of other variables.

T (Z) statistics in parentheses are based on standard errors, adjusted for clustering on client firms. \*\*\*, \*\* and \* indicate two-tailed significance at the 1%, 5% and 10% levels, respectively.

### ***Endogeneity problem***

#### *Omitted variables*

The above empirical evidence suggests that connecting with government substantially impairs auditors' audit quality. However, some other personal characteristics, which are systemically different between politically connected and non-connected auditors, might account for the findings. Therefore, this research may suffer a potential problem of endogeneity caused by omitted variables: i.e. the *CONNECTED* variable may pick up the effect of other personal characteristics on audit quality.

To address the concern of an omitted variable problem, I include the individual auditors' personal characteristics variables (*ACC-MAJOR*, *PARTNER*, *MALE*, *FOREIGN-CPA*, *UNDERGRADUATE*) in the main test. After excluding observations with missing information, the sample size is decreased to 3709. I report the results in Panel A of Table 3.5, while the results for the control variables are omitted for brevity in this and later sections. As the table shows, the effect of the key experimental variable *CONNECTED* is qualitatively similar to that in Table 3.3: the coefficients of *CONNECTED* are significantly negative in the regressions of both *MAO* and *MAOOD*. In untabulated results, I also document that, except for *PARTNER* which is significantly positive with audit quality, none of the other personal characteristics variables is statistically significant. Therefore, including individual auditors' personal characteristics variables does not bias the finding in any particular way.

#### *Self-selection*

In spite of the omitted variables, another source of endogeneity problem could be self-selection. As client firms are free to choose auditors, it is possible that better performing or less risky firms prefer to appoint politically connected auditors. If that is the case, the empirical findings are thus attributed to the differences in the client firms, but not audit quality of the connected and non-connected auditors.

Since the error terms of logit and ordered logit models do not conform to the normal distribution, the Heckman two-stage approach would be not suitable and I thus employ the Propensity Score Matching (PSM) method (Woodridge, 2006). To conduct the PSM method, I begin by regressing *Connected* on a set of variables that are likely to influence client firms' auditor choice decisions, using a logit approach<sup>17</sup>. The propensity score for each client firm is obtained based on the conditional probability of appointing a politically connected auditor. I then match each client firm of connected auditor to that of a non-connected auditor, using the approach of the nearest neighbour without a replacement. The objective of matching is to build a new sample where each client firm has an almost identical propensity to hire a politically connected auditor to control for potential self-selection biases.

After the PSM procedure, the sample contains 3344 observations. I repeat the main analyses using the matched new samples and report the results in Panel B of Table 3.5. The results suggested by Panel B are still very similar to those in Table 3.3, except that *CONNECTED* becomes significantly and negatively associated with *MAOOD*. Thus, the main findings are robust even after controlling for the self-selection problem.

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<sup>17</sup> I regress *Connected* on *Size*, *Lev*, *Roa*, *BH-Share*, *Q*, *Growth*, *SOE*, *Mkt-Index*, *Inv* and *Receivable* separately for review and engagement partners. The results are untabulated for brevity. Please contact the author for the results.

**Table 3.5 Robustness test to address the potential endogeneity problem****Panel A Omitted variables**

<i>Variables</i>	<i>MAO</i>	<i>MAOOD</i>
<i>CONNECTED</i>	-0.526** (-2.06)	-0.398** (-2.00)
<i>Control variables</i>	Include	Include
<i>N</i>	3709	3709
<i>Pseudo R-sq</i>	0.555	0.435

**Panel B Self-selection**

<i>Variables</i>	<i>MAO</i>	<i>MAOOD</i>
<i>CONNECTED</i>	-0.522** (-2.30)	-0.352* (-1.89)
<i>Control variables</i>	Include	Include
<i>N</i>	3344	3344
<i>Pseudo R-sq</i>	0.552	0.438

**Note:**

See Appendix B for definitions of other variables.

Panel A reports the results after I address the problem of omitted variables by including the individual auditors' personal characteristics variables. Panel B presents the results after controlling for self-selection by adopting a PSM research approach.

T (Z) statistics in parentheses are based on standard errors adjusted for clustering on client firms. \*\*\*, \*\* and \* indicate two-tailed significance at the 1%, 5% and 10% level, respectively.

**3.5.3 Further studies**

In this section, I conduct a set of tests of moderating effects that examine whether the influence of individual auditors' political connections is stronger under certain environments. In particular, I consider whether political connections damage audit quality even more when (1) audit firms are located in underdeveloped regions; and (2) the other auditors in the same audit firms are also connected to government. Performing these identification tests will help to get a more comprehensive understanding of the association between auditors' political connections and audit quality, and further confidence that the main findings are not driven by the potential endogenous problem.

*Audit firms are located in underdeveloped regions*

In markets with underdeveloped investor protection mechanisms and legal systems, corporate political connections are found to play a more important role in influencing firms'

operations and financing activities (Faccio, 2006; Chaney et al., 2011). China's reform process shows significant characteristics of an uneven distribution of growth and development across different regions (Chan et al., 2006; Firth et al., 2012). Taking advantage of this fact, I expect that the effect of auditors' political connections is more pronounced in underdeveloped regions.

I construct a dummy, *UNDERDEVELOPED*, to stand for the underdeveloped regions. *UNDERDEVELOPED* equals 1 if the regional marketization index is above the median level for each year and 0 if it is below the median level. I include the interaction term, *UNDERDEVELOPED \*CONNECTED* in the empirical models to see if the effect of auditors' political connections is more pronounced in underdeveloped regions. I present the test results in Panel A of Table 3.6. As the results show, *UNDERDEVELOPED \*CONNECTED* is significantly negative with *MAO* and *MAOOD*.

*Other auditors in the same audit firms are also politically connected*

The performance of auditors can be influenced by other auditors who practise in the same audit firms (Muzatko et al., 2004; Lennox and Li, 2012; He et al., 2013). The impact of political connections on audit quality is thus likely to be altered if other auditors from the same audit firm also have connections with politicians. With more connected auditors in the same audit firm, politicians can have additional channels to influence the final auditing outcomes, e.g., through both the performing and the other connected auditors. Likewise, when encountering an audit failure, the connected auditors are more likely to avoid or receive less sanctions if some of their auditor colleagues are also connected to politicians. Thus, the presence of other connected auditors may induce more intensive rent-seeking activities between government and auditors who have a political connection. I therefore conjecture that political connections of auditors could cause other connected auditors in the audit firm to behave even more aggressively.

I build two variables to capture the situation where other auditors have political

connections. The first variable *EXIST* is a dummy. For every firm-year observation, *EXIST* equals 1 if any auditor who practices in the same audit firm as the company's auditor at the same fiscal year is politically connected, 0 otherwise. The second variable *PERCENTAGE* is a continuous variable. If a certain client firm's auditor is politically connected,  $PERCENTAGE = (n - 1)/(N - 1)$ , where  $N$  is the total number of auditors in an audit firm at a certain fiscal year, and  $n$  is the number of politically connected auditors in the audit firm. If the client firm's auditor is not politically connected, then  $PERCENTAGE = (n)/(N - 1)$ . If none of auditors in the audit firm are politically connected,  $PERCENTAGE = 0$ . I include *Exist* (*PERCENTAGE*) and the interaction term *EXIST\*CONNECTED* (*PERCENTAGE \* CONNECTED*) into the model to investigate whether the relationship between individual auditors' political connections and audit quality are affected by the presence of other politically connected auditors. The results reported in Panel B of Table 3.6 confirm above expectation, and show significantly negative coefficients of *PERCENTAGE \* CONNECTED* and *EXIST\*CONNECTED*.

**Table 3.6 Further study**

Panel A When audit firms are located in underdeveloped regions

<i>Variables</i>	<i>MAO</i>	<i>MAOOD</i>
<i>Connected</i>	-0.754** (-1.96)	-1.030** (-2.42)
<i>Underdeveloped*Connected</i>	-0.579** (-2.05)	-0.348*** (-3.10)
<i>Control vairables</i>	Include	Include
<i>N</i>	5851	5851
<i>Pseudo R-sq</i>	0.565	0.478

Panel B When other auditors in the same audit firms are also politically connected

<i>Variables</i>	<i>MAO</i>		<i>MAOOD</i>	
<i>Connected</i>	-1.102* (-1.89)	-0.534* (-1.94)	-0.979* (-1.77)	-0.423* (-1.79)
<i>Exist*Connected</i>	-1.924*** (-2.95)		-1.640*** (-2.66)	
<i>Percentage* Connected</i>		-1.892** (-2.38)		-1.151* (-1.76)
<i>Control vairables</i>	Include	Include	Include	Include
<i>N</i>	5851	5851	5851	5851
<i>Pseudo R-sq</i>	0.553	0.552	0.448	0.431

**Note:**

See Appendix B for definitions of other variables.

Panel A reports the effect of auditors' political connections in underdeveloped regions; and Panel B reports the impact of auditors' political connections when other auditors in the same audit firms are also politically connected.

T (Z) statistics in parentheses are based on standard errors adjusted for clustering on client firms. \*\*\*, \*\* and \* indicate two-tailed significance at the 1%, 5% and 10% levels, respectively.

## 3.5.4 The rent-seeking activities between government and connected auditors

Untill now, I have provided solid evidence that individual auditors' political connections impair audit quality. In this section, I take a further step to examine the rent-seeking activities between connected auditors and government. In particular, I investigate whether (1) connected auditors suffer more severe government interventions; and (2) connected auditors are less likely to be sanctioned.

*Whether connected auditors suffer more severe government interventions*

The theoretical framework of this study predicts that government will seek clean opinions for SOEs from the connected auditors. Thus, auditors who bear political connections



may suffer heavier interventions from government than other non-connected auditors. To test this expectation, I add the interaction term *SOE\* CONNECTED* to the model. If political connections do not bring heavier government intervention, *SOE\*CONNECTED* will be insignificantly correlated with either of the proxies of audit quality.

The testing results are reported in Panel A of Table 3.7. From the table, I find *SOE\* CONNECTED* is significantly negatively related to both *MAO* and *MAOOD* in the testing results. This empirical finding suggests that politically connected auditors are more likely to compromise their independence under pressure from government.

*Whether connected auditors are less likely to be sanctioned*

The rent-seeking theoretical framework also conjectures that connected auditors tend to seek protection from government. If this conjecture is true, then politically connected auditors will be less likely to encounter sanctions than the other non-connected ones. To test this conjecture, I employ the sample of individual auditors and examine whether the ones with political connections are less likely to be punished. Over the sample period, I am able to collect the personal information for 2158 individual auditors, of which 302 bear connections with government. The following model is constructed to help to assess the protection function of auditors' political connection:

$$PUNISH(PUNISHTIMES) = \alpha + \beta CONNECTED + \gamma Control + \epsilon$$

where the dependent variable *PUNISH* is a dummy. I assign *PUNISH* to be 1 if a certain auditor has been punished by the regulators, which usually are CSRC or CIPCA, and 0 otherwise. The other dependent variable *PUNISHTIMES* is a count variable, which equals the times the auditors has been punished since they began to practice. In order to control for other influential factors, I include a set of variables that stand for the personal characteristics of individual auditors (*ACC-MAJOR*, *PARTNER*, *MALE*, *FOREIGN-CPA* and *UNDERGRADUATE*). The logit (Poisson) regression is employed to conduct the investigation.

The results presented in Panel B of Table 3.7 show that, after controlling other factors, the coefficients of *CONNECTED* are significantly negative in both regressions of *PUNISH* and *PUNISHTIMES*, which supports the argument that government shields connected auditors from sanctions. Combining with the empirical evidence in above sections, I therefore conclude that government and auditors will seek rent from each other. In particular, government seek clean audit opinions for SOEs under their control from connected auditors; whereas connected auditors seek the protection of being free from sanctions from government.

**Table 3.7 Tests of the rent-seeking activities between government and politically connected auditors**

Plane A Whether connected auditors suffer more severe government interventions

<i>Variables</i>	<i>MAO</i>	<i>MAOOD</i>
<i>CONNECTED</i>	-0.357* (-1.75)	-0.296* (-1.66)
<i>SOE*CONNECTED</i>	-1.479* (-1.89)	-1.567** (-2.11)
<i>Control variables</i>	Include	Include
<i>N</i>	5851	5851
<i>Pseudo R-sq</i>	0.554	0.449

Panel B Whether connected auditors are less likely to be sanctioned

<i>Variable</i>	<i>Punishment</i>	<i>Punishmenttime</i>
<i>CONNECTED</i>	-0.703* (-1.84)	-0.351** (-2.52)
<i>Control variables</i>	Include	Include
<i>N</i>	2158	2158
<i>Pseudo R-sq</i>	0.023	0.022

**Note:**

See Appendix B for definitions of variables.

Panel A reports the results for government intervention on politically connected auditors; and Panel B presents the results for government protection for connected auditors.

T (Z) statistics in parentheses are based on standard errors adjusted for clustering on client firms. \*\*\*, \*\* and \* indicate two-tailed significance at the 1%, 5% and 10% level, respectively.

### 3.6 Conclusion

In this study, I examine whether the politically connected individual auditors and government seek rent from each other, and how these rent-seeking activities influence audit quality. I find that government seeks clean opinions for SOEs from the connected auditors, and connected auditors also seek protection from government. Moreover, connections with government impair audit quality.

My research extends prior studies on the relationship between political connections and auditor behaviour by directly investigating the variation in audit quality between politically connected and non-connected individual auditors. I also provide empirical evidence that the behaviour of certain auditors is influenced by his/her colleagues. My findings can be used by the users of financial reports to gauge reporting quality. Policy makers and other participants in financial markets may also benefit from my study in identifying another source of impaired audit quality. For example, to improve overall audit quality, the Public Company Accounting Oversight Board (PCAOB) in the US has recently enacted amendments to auditing standards, which require auditors to identify themselves in the audit report. However, auditors unanimously oppose the Proposed Standard by arguing that audit quality reflects the collaborative effort of the entire firm rather than any particular individual. Although the institutional environment of the US is substantially different from that of China, my results lend some initial support to the view that disclosing the identity of auditors could be of benefit to the users of accounting reports.

## **Chapter 4: Political Connections, Audit Opinions and Auditor Choice:**

### **Evidence from the ousters of government officers**

#### **4.1 Introduction**

Corporate political connections are widespread across the world, and have been widely recognized as having profound economic implications for firms' accounting practice and corporate governance (Fishman, 2001; Faccio, 2006; Chaney et al., 2011). In recent years, a growing body of literature has begun to investigate the impact of corporate political connections on firms' audit risk and auditor choice patterns. One strand of literature focuses on examining how auditors respond to the presence of corporate political connections, albeit the evidence is mixed. Several studies find that politically connected firms suffer heavier agency problems and are likely to be perceived as of higher audit risk (Gul, 2006; Wahab et al., 2009; 2011), while others argue that political connections provide firms with an "informal and invisible guarantee" from the government, and can drive auditors to assess their audit risk as being lower (Liu and Subramaniam, 2013). The other strand of literature focuses on investigating how political connections shape the incentives of firm executives in choosing external auditors, though it also fails to find consistent results. Guedhami et al. (2014) adopt an international sample and find that politically connected firms are eager to appoint large auditors to improve accounting transparency. However, Zhang et al. (2011) provide evidence that in the Chinese setting, family firms with CEOs who are former government officials will be more opaque and reluctant to assign high-quality auditors.

Given these mixed findings, the direction in which corporate political connections affect auditors' assessments of audit risk and firms' choice of auditors is thus still unclear. Moreover,

although it is known that connections with government cause significant variations in firms' audit risk and auditor choice patterns, the impact of political regime shifts, which alter the status of firms' political ties, has not yet been carefully studied. In an economy where government exerts considerable control, non-SOEs cultivate political connections to protect their property rights and overcome market and institutional barriers (Li et al., 2006; Chen et al., 2011c). However, since SOEs are naturally connected with the government through state ownership and are already granted favourable government treatment, political connections in these firms are primarily exploited by the connected management to pursue their personal benefits (Wu et al., 2012; Chen et al., 2011b). Thus, the real effects of political connections are expected to vary according to firm ownership structures. The interplay of political connections and ownership structures is expected to influence firms' corporate governance and the property of accounting numbers, which in turn affect auditors' assessment of audit risk and firm decisions in choosing external auditors. If this is the case, the change in the status of firms' political connections might impact the interactions between them and their auditors, and the impact could vary across SOEs and non-SOEs.

In this study, I examine how the sudden termination of corporate political connections influences firms' audit risk and auditor choice patterns, and whether the influence is subject to firm ownership structure. Understanding these questions not only helps to gauge the effect of corporate political connections from a dynamic perspective, but also facilitates the interpretation on the mixed findings in previous studies. I choose China as the empirical setting, because of the co-existence of both SOEs and non-SOEs, the prevalent rent-seeking activities, and the heavy government intervention in the auditing market (Chan et al., 2006; 2012; Wang et al., 2008). More importantly, as explained later, the unique Chinese political

environment also enables me to construct a natural experiment to check the economic consequences when firms lose their political ties suddenly and unexpectedly.

In China, the government exerts great influence over the economy (Chen et al., 2011a; Cao et al., 2014). Although there is only one ruling party under the current Chinese political system, several different political cliques co-exist and compete fiercely with each other (Hung et al., 2015). Political scandals, such as corruption, which lead to the ousters of high-level government bureaucrats, are common and often nothing more than a pretext put up by one clique intent on eliminating a competing clique (Hung et al., 2015). They are mainly driven by political factors, are non-systemic and unlikely to be foreseen by the market (Fan et al., 2014). I take advantage of this unique setting and employ the anti-corruption cases which involve high-level Chinese government bureaucrats (at provincial and ministerial level and above) to construct a natural experiment. Then, I collect a set of firms which are connected to these corrupt bureaucrats and examine how firms and their auditors respond to the sudden termination of political connections after the disclosure of anti-corruption cases. Such a research design allows me to explore the influence of political connections from a dynamic perspective, rather than compare the cross-sectional variations of the economic outcomes between firms with and without political connections, that is, the static research setup used in most prior literature. Moreover, since the anti-corruption cases are not directly caused by the connected firms, my study consequently suffers less from endogeneity concerns.

Existing studies of corporate political connections identify firms' connections through the friendship of top executives with politicians or the political experience of top executives (Gul, 2006; Wahab et al., 2009; 2011; Zhang et al., 2011). These definitions, however, only indicate the presence of political connections, and it is unclear whether and how these political

connections have been exploited by firms. They may also be too broad and overstate the value of political connections. For this reason, I follow Fan et al. (2008) and take an alternative approach in studying the connections between firms and politicians. The premise is that politicians may give favourable treatment to or collude with firms' top executives who directly bribe them or are members of their families (such as spouse or descendant), due to politicians' incentives to pursue monetary and political benefits or their concerns to look after their families (Faccio, 2006; Fan et al., 2008; Cheung et al., 2012; Zeume, 2014). Thus, bribery and family affiliations form a powerful basis for political connections. Specifically, I define a firm as politically connected if any of its senior managers or directors (1) is directly involved in bribery activities towards the corrupt bureaucrats; or (2) is a member of the family of the corrupt bureaucrats. Although relatively narrow, the key advantage of this approach is that it provides us with a more direct, explicit and powerful indicator of ties between firms and politicians.

I collect 84 high-level anti-corruption cases in China between 2004 and 2014. During this period, 91 firms are identified as connected to corrupt government officials through direct bribery or family affiliations. A set of non-connected firms are further collected as a control group to make sure that my empirical findings are not spuriously attributed to firm features other than political connections. Specifically, in accordance with Guehami et al. (2014), the non-connected firms are matched with the connected ones according to industry, owner type and closest total assets in the event years.

I begin by investigating how auditors respond to the termination of client firms' political connections by examining the variations in firms' audit opinions between the pre-event period (t-3 to t-1) and the event year (t) of anti-corruption cases. I find that after anti-corruption cases,

auditors issue less clean audit opinions to connected non-SOEs, whereas they give additional favourable audit opinions to connected SOEs. In particular, relative to the non-connected counterparts, the possibility that connected non-SOEs receive modified audit opinions (MAOs) increases by 11.2%, whereas that for connected SOEs decreases by 9.3% once they lose their political connections. I then compare the auditor choice patterns of connected firms between the pre-event years ( $t-3$  to  $t-1$ ) and the post-event years ( $t+1$  to  $t+3$ ), and document that during the years following anti-corruption cases connected non-SOEs are likely to switch from local small auditors to more reputable auditors, while connected SOEs are more likely to appoint local small auditors, compared with the non-connected counterparts respectively. These findings are robust after I adopt a set of robustness tests, such as reconstructing the non-connected control groups; reclassifying the politically connected firms; and applying alternative measurements for the dependent variables. Overall, my empirical results suggest that the termination of political connections has substantial effects on auditors' risk assessments and firms' auditor choice patterns. Moreover, these effects are subject to firm ownership structure.

This study makes two major contributions. First, I extend previous studies which investigate the impact of shifts in the political regime on the capital market (Fishman, 2001; Faccio et al., 2009). By focusing on the shift caused by high-level anti-corruption cases in China, this paper examines how the sudden termination of political connections influences auditors' assessments of audit risk and firms' choice of auditors. Thus, my study helps to understand how these capital market players respond to political shifts and changes in the business environment in emerging markets. In addition, adopting such a dynamic research setup also enables me to mitigate the potential problem of endogeneity existing in previous



cross-sectional studies, and thus to get a clearer sense on the association between corporate political connections and the auditor-client interactions.

Second, my paper also advances the understanding of the effects of political connections on auditor choice and auditor behaviour. The findings of my study indicate that, at least in China, auditors are likely to evaluate SOEs with political connections as having a higher audit risk, but evaluate connected non-SOEs as having a lower audit risk. My findings also suggest that the positive linkage between political connections and firms' propensity to appoint high-quality auditors only exists in SOEs, while non-SOEs with political connections are more likely to hire auditors of lower quality. Thus, my paper will help in interpreting the mixed evidence found in prior studies (Gul, 2006; Wahab, 2009; 2011; Liu and Subramaniam, 2013).

The remainder of the paper is organized as follows. Section 3.2 introduces the institutional background and ownership structures in Chinese listed firms. Section 3.3 develops the hypotheses. Section 3.4 describes the data and variables. Section 3.5 presents the empirical results, and Section 3.6 concludes the paper.

## **4.2. Institutional background**

### **4.2.1 The development of SOEs and non-SOEs**

Before 1978, all Chinese firms were solely owned by the government. Since the economic reform in 1978 when China adopted a market-oriented economy, some SOEs were partially privatized by issuing minority shares and listed on either the Shenzhen or Shanghai stock exchanges, which were established in 1990 and 1991, respectively. Nonetheless, although these shares were sold to individuals and institutional investors, the Chinese government still ultimately controlled a large percentage of listed firms and held the majority

of SOE shares. By the end of 2013, among the 2079 Chinese firms listed on both the Shanghai and Shenzhen stock exchanges, 975 were controlled by the government and average ownership held by the government was 42.3%.

The privately controlled firms have evolved in the Chinese market since the economic reform, especially after Deng Xiaoping's South Tour in 1992. In the same year, the first privately controlled firm, *Shenzhen HuaYuan*, was listed on the Shenzhen Stock Exchange. Another significant change in the development of the private sector happened in 2004, when a constitutional amendment first clearly stipulated the protection of private property rights. Moreover, the Chinese government further published the Property Law in 2007, which admitted the legitimacy of individual property and gave a clear definition of personal property rights. The growth rate of the private sector far outpaced that of the public sector. During the period from 1978 to 2013, the Chinese private sector grew from nothing to providing over 80% of total employment and industrial output<sup>18</sup>.

#### 4.2.2 Chinese auditing profession

The Chinese auditing market historically suffered severe intervention from the government. After the reestablishment of the auditing profession in the 1980s, almost all Chinese audit firms were state-owned and affiliated with the local or central government, or a government department (DeFond et al., 1999). Even after becoming disaffiliated from government entities in 1998, these audit firms, especially local small audit firms, continued to maintain close personal and organizational networks with government officers, because SOE clients were economically important to these audit firms (Chan et al., 2006). Government can thus threaten local small audit firms by asking SOEs not to use their services. Moreover,

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<sup>18</sup> From the website of the National Bureau of Statistics of the People's Republic of China: <http://data.stats.gov.cn/index>.

government can also exert influence on local small audit firms through finance bureaus, audit bureaus, and CPA institutes (Wang et al., 2008). Thus, local small audit firms are more likely to compromise their independence under pressure from the government.

#### 4.2.3 Corruption in China

It has been observed that corruption is a common phenomenon in emerging markets, due to an underdeveloped financial system and severe government intervention (Shleifer and Vishny, 1994). The Chinese economy is under the control of the government and characterized by an underdeveloped legal system, and thus is a typical country with an embedded high level of corruption (Fan et al., 2008). Existing studies also document that China suffers from an extreme corruption problem and ranks among the worst countries in terms of political freedom, as well as the protection of property rights (La Porta et al., 2004; Allen et al., 2005). According to the Corruption Perceptions Index published by Transparency International, China ranked 80 out of 177 countries in 2013, with an index of 3.5 out of 10<sup>19</sup>. During the period from 2004 to 2013, there were 307,480 anti-corruption cases either under investigation or concluded, and 743,074 government officers were punished. That is, more than three out of every one thousand government officers were involved in anti-corruption cases<sup>20</sup>.

#### 4.3 Hypothesis development

The idea that political connections have profound economic implications is not new and has been identified and discussed extensively in previous literature (Fishman, 2001; Fan et al.,

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<sup>19</sup> Transparency International is a non-profit organization, which aims to stop corruption and promote transparency, accountability and integrity at all levels and across all sectors of society. The index measures the degree to which corruption is perceived to exist among public officials and politicians. It is a composite index, drawing on 14 different polls and surveys from seven independent institutions, carried out among business people, and analysis of countries, including surveys of residents, both local and expatriate. The index ranges from 0 to 10. The higher the score, the more transparent the country is.

<sup>20</sup> From the website of the Central Commission for Discipline Inspection of the Communist Party of China: <http://www.ccdi.gov.cn/xxgk/xxgknb/>.

2008; Faccio et al., 2009; Fan et al., 2014). Once bureaucrats fail in political struggles and are arrested under the pretext of anti-corruption cases, their rivals take over the positions and come into power. In this case, firms which were connected to the arrested bureaucrats suddenly lose their political ties and may find it hard to re-establish new ties within a new and less friendly political regime (Leuz and Oberholzer, 2006). Such a shock might sharply alter the corporate governance of politically connected firms and managements' incentive for scrupulous financial reporting, which in turn can affect auditors' risk assessment and firms' choice of external auditors. Moreover, recent studies further suggest that the effect of political connections is subject to firm ownership structures (Chen et al., 2011; Wu et al., 2012). Therefore, due to the different effects of political connections in SOEs and non-SOEs, the impact of the termination of political connections resulting from anti-corruption cases may vary from SOEs to non-SOEs. In this section, I develop my testable hypotheses based on the above arguments.

In the Chinese market, despite the market-oriented reform being in place for the last few decades, the government still possesses considerable control over the allocation of economic resources, and the product and credit markets are still not well developed (Chen et al., 2011c). In this context, non-SOEs, which are ultimately owned and controlled by non-government units, have long experienced ideological discrimination and faced huge obstacles in obtaining valuable resources (Li et al., 2006; Wu et al., 2012). Additionally, government very often intervenes in the operations of non-SOEs through direct rent-seeking activities (Chen et al., 2011c)<sup>21</sup>, and other soft channels, such as unnecessary regulations and/or extremely high tax

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<sup>21</sup> Anecdotal evidence suggests that non-SOEs are often the targets of discretionary fees and charges imposed by the government. The various discretionary charges imposed on the companies often constitute a significant proportion of their total operating expenses. In some extreme cases, unjustified charges amount to one third of the operating expenditure of these firms (Chinese Business Daily, 2000).

rates (Piotroski and Zhang, 2014). Therefore, management of non-SOEs are eager to establish connections with government to overcome ideological discrimination and protect their property rights. Indeed, previous studies suggest that political connections enhance the value of non-SOEs by providing them with various benefits, which include better access to loans from state-owned banks (Brandt and Li, 2003; Li et al., 2008), valuable investment opportunities (Chen et al., 2011c), and a higher chance of being bailed out in the event of financial distress (He et al., 2014). Thus, such a value-enhancing effect of political connections props up the accounting performance of non-SOEs and provides them with large security margins from bankruptcy (Gul, 2006; Fan et al., 2014).

The incentive for firm executives to pursue political connections exists not only in non-SOEs, but also in SOEs, which are owned by government. In practice, SOEs are under the ultimate control of the State-owned Assets Supervision and Administration Commission of the State Councils (SASACs), institutions set up by State Council or local governments and in charge of conducting appraisals of firm performance, monitoring the use of firm resources, and selecting external auditors for SOEs (The State Council, 2008)<sup>22</sup>, whereas SOE executives are only state agents, who are in charge of firms' daily operations. In most situations, these executives are directly appointed by SASACs and have equivalent administrative ranks. Their salaries, which are paid according to their political ranks, are usually mismatched with, and cannot adequately compensate for, their managerial efforts (Mi and Wang, 2001; Wu et al., 2012). Coupled with low wages, SOE executives also often face less monitoring, due to SOEs' weak corporate governance mechanisms (Chen et al., 2011b; Fan et al., 2013). As a result, SOE managers have strong incentives to collude with

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<sup>22</sup> The duty of SASACs is at <http://www.sasac.gov.cn/n85463/n85976/index.html> (In Chinese).

government officials through bribery or personal connections in order to obtain political and monetary benefits, which may lower firm value and worsen firm accounting performance (Chen et al., 2011c; Wu et al., 2012). To hide rent-seeking activities and the company's real economic situation, connected executives of SOEs are thus more likely to overstate profits and engage in earnings management than those in non-connected firms.

The ousters of corrupt bureaucrats suddenly terminate connected firms' political ties, and it can be very difficult for them to re-establish new connections within a new regime (Leuz and Oberholzer, 2006). In addition, there is also very little possibility for the corrupt government bureaucrats to be reinstated in their official positions after being arrested or questioned in detention in anti-corruption cases. Moreover, even if a formerly connected firm undertakes huge costs to seek new political ties immediately after anti-corruption events, the benefits usually take a rather long time to materialize (Fan et al., 2014)<sup>23</sup>. Thus, the sudden loss of political connections may sharply alter the corporate governance and reporting incentives of connected firms<sup>24</sup>. In particular, connected non-SOEs might report more aggressively after anti-corruption events, because the loss of political connections weakens firm performance and increases their business risk. However, for connected SOEs, after the breaking of political ties, their state ownership can still ensure preferential government treatment, yet managers' self-dealing behaviours, such as high entertainment and travel costs, can be mitigated (Chen et al., 2015). Hence, the quality of SOEs' accounting information is likely to improve after the loss of their executives' political connections.

Audit risk refers to the risk that auditors fail to appropriately modify their opinions on

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<sup>23</sup> Fan et al. (2014) examine the impact of the termination of political connections on connected firms' earnings informativeness by comparing the ERC (Earnings Response Coefficients) of firms in the five years pre and post the breaking of political ties. The underlying premise is that the newly established political connections may not take effect in the relatively short period of at least five years.

<sup>24</sup> Even giving the above arguments, we still can't rule out the possibility that connected firms rebuild their connections after the anti-corruption cases. So we urge readers to bear this caveat in mind.

financial statements that are materially misstated (AICPA, 1983; CICPA, 2007). The reporting quality of a firm is directly linked to and reflected in the frequency of material misstatements in its financial reports, and thus affects the audit risk assessed by auditors (Simunic and Stein, 1996; Gul, 2006; Kaplan and Williams, 2012). I therefore expect that auditors will assess the audit risk of connected non-SOEs as being higher, and the connected SOEs as being lower, once their political ties are broken. Based on the above arguments, I posit the following hypotheses:

*Hypothesis 1a: Politically connected non-SOE firms will receive more unfavourable audit opinions once their political connections are terminated.*

*Hypothesis 1b: Politically connected SOEs will receive more favourable audit opinions once their political connections are terminated.*

The termination of political ties may not only influence the audit risk of the connected firms, but also affect their choice of external auditors. External auditing is valued, as it provides reasonable assurance on firms' accounting information (DeFond and Zhang, 2014). High-quality auditors provide better assurance on the credibility of accounting information, and thus can play a monitoring role to mitigate the agency conflicts in client firms (Fan and Wong, 2005; Jensen and Meckling, 1976, Watts and Zimmerman, 1983). In addition, with more reputation capital at stake, high-quality auditors can also be hired as a positive signal to inform investors about the underlying firm value (Aobdia et al., 2015; Titman and Trueman, 1986). Connections with government may influence firms' corporate governance differently in SOEs and non-SOEs, and therefore connected SOEs and non-SOEs are likely to have different incentives to select new auditors after anti-corruption cases.

In non-SOEs, the controlling insiders are in a dominant position to choose auditors. With

connections to government, non-SOEs can have less incentive to appoint reputable auditors as a positive signal or monitoring mechanism, because of the “informal and invisible guarantee” provided by government (Liu and Subramaniam, 2013). Moreover, to avoid unnecessary non-clean audit opinions, connected non-SOEs might appoint local small audit firms, who are found to suffer heavier government intervention and likely to compromise independence under pressure from government officials (Chan et al., 2006; Wang et al., 2008; Zhang et al., 2011).

However, in SOEs, SASACs are in charge of selecting and voting on the auditors<sup>25</sup> (Hung et al., 2015). The state ownership of SOEs may reduce the need for high-quality auditors for the purpose of signalling. In addition, several studies document that SASACs often allocate local small audit firms to SOEs, in order to help them to meet the accounting-based regulations and contracts (Chan et al., 2006; 2012; Wang et al., 2008). However, once the SOE executives are connected to corrupt bureaucrats, severe agency problems might motivate SASACs to appoint high-quality auditors to monitor the self-dealing behaviour of connected management.

The termination of political connections, due to the ouster of corrupt bureaucrats, may cause great changes in the corporate governance of connected firms and thus influence their incentives for choosing external auditors. Specifically, after corrupt bureaucrats are arrested, local small auditors no longer suffer interventions from them, and thus connected non-SOEs may have little incentive to retain these auditors. Moreover, without political connections,

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<sup>25</sup> In particular, the *Regulations on the Auditing Works for the Central SOEs* ([http://www.gov.cn/gongbao/content/2004/content\\_62973.htm](http://www.gov.cn/gongbao/content/2004/content_62973.htm)), which was published in 2004, authorizes the SASACs to be in charge of choosing auditors for central SOEs. Many local governments, under the influence of the central government, have also announced similar stipulations on the choice of auditor for local SOEs. For example, the government of Shanghai published *Regulations on the Auditing Works for the SOEs in Shanghai*, which also put the local SASAC in charge of the auditor choice decisions for local SOEs. See <http://www.shanghai.gov.cn/shanghai/node2314/node2319/node12344/u26ai29799.html>.



non-SOEs will depend more heavily than before on the market to win the confidence and trust of their investors and clients. Therefore, to convey to the market the information that their operations are still stable and their financial conditions are still healthy, connected non-SOEs are likely to switch auditors from the local small to more reputable ones when they lose connections with corrupt bureaucrats. However, on the other hand, the agency problem in connected SOEs becomes weaker after anti-corruption cases and the incentive for SASACs to select high-quality auditors is thus likely to be reduced. The arguments above formulate my second hypotheses, which concern the association between the termination of political ties and the auditor choice patterns of connected firms:

*Hypothesis 2a: Politically connected non-SOE firms are more likely to choose large or non-local auditors after political connections are terminated.*

*Hypothesis 2b: Politically connected SOEs are more likely to choose local small auditors after political connections are terminated.*

Although I predict that the ouster of corrupt bureaucrats causes different impacts on audit risk and auditor choice patterns between connected SOEs and non-SOEs, there are still countervailing forces that could lead to alternative predictions. First, as the loss of political benefits will increase connected non-SOEs' business risk and drive their management to report more aggressively, high-quality auditors, who face a higher litigation risk, might be reluctant to accept these firms as clients after anti-corruption cases in order to avoid potential litigation costs (Johnstone, 2000; Hsieh and Lin, 2016). Second, being concerned for their reputation, auditors, especially those of high quality, may be more likely to issue modified opinions following anti-corruption events to disassociate themselves from the connected firms and corrupt bureaucrats. Thus, it could be possible for both connected SOEs and non-SOEs to

get more unfavourable opinions and retain/reappoint local small auditors after anti-corruption events. I hereby test my hypotheses empirically in next section.

## **4.4 Data**

### **4.4.1 Sample construction**

To investigate changes in auditor reporting behaviour and firms' auditor choice patterns before and after the termination of political connections, I manually collect a list of anti-corruption cases, which involve high-level bureaucrats in China from 2004 to 2014. I focus on these high-level anti-corruption cases because they have a larger impact on the corporate sector and better disclosures. Moreover, in China, high-level anti-corruption cases are usually caused by political factors and are less likely to be anticipated by the market (Fan et al., 2008; Hung et al., 2015). Therefore, the anti-corruption cases are likely to be exogenous shocks, and my research suffers less from a potential endogeneity problem.

To collect the high-level anti-corruption cases, I check the websites of the Central Commission for Discipline Inspection, the Supreme People's Procuratorate of PRC, as well as the Supreme People's Court of PRC. By searching key words, such as "provincial and ministerial level" and "corruption", I have been able to identify 84 high-level anti-corruption cases which occurred during the research period<sup>26</sup>. The identification of high-level cases in my study is also consistent with Fan et al. (2008).

I next identify a set of firms which are connected with the corrupt bureaucrats. To do this, I search through all available information about each anti-corruption case, and the family background of each corrupt bureaucrat in the aforementioned three government websites. I further made efforts to collect additional information by using search engines, such as Baidu

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<sup>26</sup> The detailed information for these anti-corruption cases is provided in the Table 1 of Appendix C.

(www.baidu.com) and Google (www.google.com). A firm is identified as politically connected if any of its senior managers or directors directly bribed the corrupt bureaucrats or was a member of their families<sup>27</sup>. During the research period, I am able to identify 179 firms with such connections, including both unlisted firms and firms listed on the Shanghai, Shenzhen or Hong Kong Stock Exchanges. Due to data unavailability, I exclude 18 firms listed on the Hong Kong Stock Exchange and 67 unlisted firms. In addition, three firms in the finance sector are also excluded. The final sample contains 91 connected firms around the time of the ouster of corrupt bureaucrats.

I admit that there is a possibility that I have omitted some anti-corruption cases and connected firms due to information limitations. Such omissions would naturally weaken the results. However, to the extent that the misclassifications are random, the empirical findings will not suffer significantly from this potential bias.

In addition, although I treat the remaining firms without connections to corrupt bureaucrats as non-connected firms, these firms may well be connected with other bureaucrats. However, as long as those bureaucrats were not involved in anti-corruption scandals, the connections of these firms will remain and their auditor choice patterns and auditor reporting behaviour are unlikely to be affected by the anti-corruption events<sup>28</sup>.

I summarize the 84 anti-corruption cases and 91 politically connected firms in Table 3.1. The distribution of anti-corruption cases in Panel A suggests that more than 70% of anti-corruption cases took place at the provincial level (59 out of 84). In addition, during the

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<sup>27</sup> However, there is a concern about my definition of politically connected firms. In particular, management who are directly involved in bribery might be prosecuted or fired after the disclosure of anti-corruption cases, and this, rather than the termination of political connections, could influence the connected firms' audit risk. To address this concern, in a later part of the paper I perform a robustness test by excluding the firms that are directly involved in bribing activities. The test results are generally consistent with the main findings.

<sup>28</sup> I thank the anonymous reviewers for pointing this out. In addition to the argument that the non-connected firms will not be influenced by anti-corruption cases, I further employ several empirical techniques, such as different matching methods, to address this concern. The test results are generally consistent.

research period, the frequency of anti-corruption cases is relatively high, with no less than four cases in each calendar year. In Panels B and C, I report the distribution of politically connected firms according to year and ownership, and industry and ownership, respectively. The results indicate that the number of SOEs (45) is almost equal to that of non-SOEs (46). The number of connected firms fluctuates over time, but there is no obvious trend of increase or decrease. In addition, connected firms come from a broad array of industries, which includes Agriculture (1), Mining (5), Manufacturing (37), Energy (6), Construction (9), Information (5), Merchandising (2), Real Estate (14), Utilities (6), Publishing (3) and other industries (3). Moreover, the industry distribution of connected firms doesn't show a significant difference between SOEs and non-SOEs<sup>29</sup>.

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<sup>29</sup> I perform a chi-square test to examine whether the industry distribution of connected SOEs is significantly different from that of connected non-SOEs. The value of chi-square is 8.3, and the corresponding P-value is 0.600, which is not significant at conventional levels.

**Table 4.1 Distribution of corruption cases and connected firms****Panel A Distribution of high-level corruption cases by section and by year**

Year	Central	Banks	Provincial	Total
2004	2	1	6	9
2005	0	1	7	8
2006	2	0	4	6
2007	0	0	5	5
2008	1	0	4	5
2009	4	1	4	9
2010	1	0	3	4
2011	3	0	2	5
2012	1	0	4	5
2013	6	0	12	18
2014	2	0	8	10
Total	22	3	59	84

**Panel B Distribution of connected firms by ownership and year**

Year	Connected Non-SOEs	Connected SOEs	Total
2004	4	2	6
2005	2	2	4
2006	4	10	14
2008	4	4	8
2009	2	5	7
2010	1	1	2
2011	2	4	6
2012	10	6	16
2013	12	4	16
2014	5	7	12
Total	46	45	91

**Panel C Distribution of connected firms by ownership and industry**

Industry	Connected Non-SOE	Connected SOE	Total
Agriculture	1 (2.17)	0 (0.00)	1 (1.10)
Mining	1 (2.17)	4 (8.89)	5 (5.49)
Manufacturing	20 (43.48)	17 (37.78)	37 (40.66)
Energy	2 (4.35)	4 (8.89)	6 (6.59)
Construction	2 (4.35)	7 (15.56)	9 (9.89)
Information	3 (6.52)	2 (4.44)	5 (5.49)
Merchandising	1 (2.17)	1 (2.22)	2 (2.20)
Real Estate	8	6	14

	(17.39)	(13.33)	(15.38)
Utilities	4	2	6
	(8.70)	(4.44)	(6.59)
Publishing	2	1	3
	(4.35)	(2.22)	(3.30)
other industries	2	1	3
	(4.35)	(2.22)	(3.30)
Total	46	45	91
	(100.00)	(100.00)	(100.00)

**Notes:**

Panel A presents the distribution of corruption cases in China by section and year over the sample period 2004-2014. Central refers to central government bureaucrats; Banks include the People's Bank of China, the big four banks and three policy banks; Provincial officers include (Vice) Secretary, (Vice) Governor, (Vice) Chairman of both provincial NPC and CPPCC. Panel B reports the distribution of connected firms according to year and ownership. Panel C reports the distribution of connected firms according to industry and ownership.

#### 4.4.2 Matching firms

The following analysis examines changes in the patterns of auditor choice and auditor reporting behaviour in connected firms relative to those of a set of matching non-connected firms. I identify a matching non-connected firm for each of the politically connected firms as follows: a potential match is any firm not identified as politically connected from the same industry and with the same type of ultimate owner as the connected firm in the event years. From the set of potential matches, I select the one with total assets closest to that of each connected firm. The purpose of building a non-connected matching sample is to improve identification and mitigate the threat that differences in firm characteristics, other than political connections, are spuriously responsible for any of the empirical findings. Because matching occurs without replacement, a matching firm can be used only once.

I collect financial and auditing data for each of the connected and non-connected firms from the CSMAR Financial Statement Dataset.

### 4.5 Empirical Tests

#### 4.5.1 Model Specification

This study investigates the changes in audit opinions between the pre-event period and the event years of anti-corruption cases. Consistent with Fan et al. (2008), the pre-event period is defined as three years before the anti-corruption case<sup>30</sup>. To test hypotheses 1a and 1b, I estimate the logit (ordered logit) model as follows:

$$MAO_{i,t} (MAOOD_{i,t}) = \alpha_0 + \alpha_1 PCON_{i,t} + \alpha_2 PCON_{i,t} * EVENT_{i,t} + \alpha_3 EVENT_{i,t} + \alpha_4 SIZE + \alpha_5 ROE_{i,t} + \alpha_6 LEV_{i,t} + \alpha_7 LOSS_{i,t} + \alpha_8 LOCALSMALL_{i,t} + \alpha_9 Q_{i,t} + \alpha_{10} CR_{i,t} + \alpha_{11} AGE_{i,t} + \alpha_{12} INVAR_{i,t} + \alpha_{13} BSHSHARE_{i,t} + \alpha_{13} MKTDIX_{i,t} + \sum \delta YearDummy_{i,t} + \sum \gamma IndustryDummy_{i,t} + \varepsilon_{i,t} \quad (4.1)$$

where, in eq. (3.1), the dependent variable *MAO* is a dummy variable, having a value of one if a firm receives a modified audit opinion (MAO) in the current fiscal year, and zero otherwise. Audit opinions in the Chinese market include unqualified opinion, unqualified opinion with explanatory notes, qualified opinion, disclaimer and adverse opinion. Following prior studies (Chan et al., 2006; Chen et al., 2000), I classify MAO as any one of unqualified opinion with explanatory notes, qualified opinion, disclaimer or adverse opinion.

Moreover, to better capture the change in the auditors' reporting decisions, I also employ an ordered audit opinion variable, *MAOOD*. Specifically, consistent with Chan et al. (2012) and Guan et al. (2014), the opinion rankings in order of increasing severity are unqualified (=0), unqualified with explanatory notes (=1), qualified (=2), and disclaimer (=3)<sup>31</sup>.

As to the independent variables, *PCON* is a dummy variable, and equals one if firms are connected to the corrupt bureaucrats, and zero otherwise. *EVENT* takes a value of one if the observation is in the years of the anti-corruption cases, and zero if it falls in the pre-event

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<sup>30</sup> The major empirical results would not change when I redefine the pre-event period as two or four years before the anti-corruption cases.

<sup>31</sup> There is no adverse audit opinion in the sample.

years. What I am interested in is the relationship between *MAO* (*MAOOD*) and the interaction term, *PCON\*EVENT*, which captures the change of *MAO* (*MAOOD*) between the pre-event and the event years for connected firms, relative to the non-connected matching firms. I follow Chen et al. (2011c) and estimate eq. (1) separately for non-SOEs and SOEs. Using separate regressions also avoids the problem that the associations between dependent and control variables differ significantly between firms with alternative kinds of ownership (Choi and Wong, 2007; Mo et al., 2015). According to hypotheses 1a and 1b, I predict that the coefficients of *PCON\*EVENT* will be negative in the results of SOEs, but positive in those of non-SOEs.

In accordance with prior studies (Wang et al., 2008; Chan et al., 2006; 2012), I also include a set of control variables which are likely to influence auditor reporting behaviour. In particular, I include firm size (*SIZE*), return on equity (*ROE*), financial leverage (*LEV*), financial loss in current fiscal year (*LOSS*), local small auditors (*LOCALSMALL*), Tobin Q (*Q*), current ratio (*CR*), firm age (*AGE*), inventory and accounting receivable (*INVAR*), , issuance of B/H shares (*BHSHARE*) and the marketization index (*MKTIDX*). The definition of each variable is given in Appendix B.

The second hypothesis concerns whether and how connected firms switch auditors following anti-corruption cases. In China, listed firms often make decisions about hiring external auditors at the beginning of the fiscal year, and seldom change them during the course of that fiscal year<sup>32</sup>. Therefore, the ousters of corrupt bureaucrats are unlikely to affect firms' choice of auditors in the same year. Moreover, the audit opinions received by connected firms during years in which anti-corruption cases occur also affect their incentives for

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<sup>32</sup> See “Notice about Problems in Choosing and Switching Auditors of Chinese Listed Firms” [http://china.findlaw.cn/fagui/p\\_1/225409.html](http://china.findlaw.cn/fagui/p_1/225409.html), in Chinese.



selecting auditors in subsequent years. For the above two reasons, I therefore examine firms' auditor choice patterns in the three pre-event years and the three post-event years. I remove observations in the event year with the aim of getting a clearer empirical inference<sup>33</sup>. I also drop the sample firms which lost their connections in the last year of my research period (which is 2014), because they don't have observations in the post-event period. To test the hypotheses 2a and 2b, following prior studies (Wang et al., 2008, Chan et al., 2012; Guedhami et al., 2014), I estimate the logit model as follows:

$$\begin{aligned} LOCALSMALL_{i,t} = & \alpha_0 + \alpha_1 PCON_{i,t} + \alpha_2 PCON_{i,t} * POST_{i,t} + \alpha_3 POST_{i,t} + \alpha_4 SIZE + \\ & \alpha_5 ROE_{i,t} + \alpha_6 LEV_{i,t} + \alpha_7 Q_{i,t} + \alpha_8 CR_{i,t} + \alpha_9 INVAR_{i,t} + \alpha_{10} BSHARE_{i,t} + \\ & \alpha_{11} MKTIDXX_{i,t} + \alpha_{12} LSH_{i,t} + \sum \delta YearDummy_{i,t} + \sum \gamma IndustryDummy_{i,t} + \varepsilon_{i,t} \end{aligned} \quad (4.2)$$

where, in eq. (3.2), the dependent variable *LOCALSMALL* is a dummy variable, and has a value of one for local small audit firms, and zero otherwise. I employ *POST* to stand for the post-event period. If any observation falls in three-year post-event period, I assign *POST* the value of one, and otherwise zero. *PCON* represents politically connected firms and is defined as before. The main test variable is the interaction term *PCON\*POST*, which captures the change in the auditor choice pattern of connected firms after the anti-corruption event relative to that of the matching non-connected firms. I estimate eq. (2) separately for SOEs and non-SOEs. According to the hypotheses 2a and 2b, I predict the coefficients of *PCON\*POST* to be negative for non-SOEs, but positive for SOEs.

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<sup>33</sup> The regression results are quantitatively similar when I include the event-year observations in our analysis.

I include firm size (*SIZE*), return on equity (*ROE*), financial leverage (*LEV*), Tobin Q (*Q*), inventory and accounting receivable (*INVAR*), current ratio (*CR*), issuance of B/H shares (*BHSHARE*), the marketization index (*MKTIDX*) and the shareholding ratio of the controlling shareholder (*LSH*) to control for other factors that are likely to influence firms' auditor choice decisions.

I include the year and industry indicators in the above two equations to control for their fixed effects. As the sample is pooled across firm-year observations, the annual observations of a given firm might not be drawn independently (Caramanis and Lennox, 2008), so I follow previous studies (Firth et al., 2012; Lennox and Li, 2012), and adjust the standard errors of coefficients by clustering them at the firm level. Lastly, all continuous variables are winsorized at the 1% level to mitigate the impact of extreme values.

Table 3.2 provides the summary statistics of variables employed in this study. On average, 12.1% of the firm-year observations have received MAOs during the research period; and 45.7% have appointed local small auditors. In addition, the total assets of the sample firms amounted to nearly three billion RMB, over half of which consist of liability. Moreover, almost 37.24% of firm shares are held in the hands of controlling shareholders, which is consistent with Wu et al. (2012) and suggests a high level of controlling rights in my sample firms. The values for the other control variables are generally in line with those documented in prior studies using Chinese data (Chen et al. 2010; Firth; 2012; Gul et al. 2013).

**Table 4.2 Descriptive Statistics**

Variable	Mean	S.D.	Lower quartile	Median	Upper quartile
<i>MAO</i>	0.121	0.327	0	0	0
<i>MAOOD</i>	0.185	0.568	0	0	0
<i>LOCALSMALL</i>	0.457	0.498	0	0	1
<i>SIZE</i>	21.81	1.810	20.64	21.63	22.59
<i>ROE</i>	0.061	0.247	0.0190	0.0660	0.127
<i>LEV</i>	0.575	0.370	0.359	0.527	0.708
<i>LOSS</i>	0.146	0.354	0	0	0
<i>Q</i>	2.226	2.655	0.703	1.314	2.471
<i>CR</i>	1.867	2.218	0.841	1.288	1.955
<i>AGE</i>	9.617	5.214	5	10	14
<i>INVAR</i>	0.296	0.216	0.124	0.252	0.430
<i>BSHARE</i>	0.059	0.235	0	0	0
<i>MKTIDX</i>	8.823	2.195	7.390	8.970	10.42
<i>LSH</i>	37.24	17.44	24.23	33.40	50.32

**Note:**

This table reports the descriptive statistics of control variables employed in my model.

See Appendix B for variable definitions.

#### 4.5.2 Empirical Results

I present the empirical results for hypotheses 1a and 1b in Table 3. Panel A provides the results of univariate tests, and Panel B reports the regression results.

In the univariate tests, for *MAO* and *MAOOD*, I report their mean values in the pre-event and event years, and their change over time, which is defined as the event-year value minus the pre-event three-year mean value. Moreover, I also present the differences between connected and non-connected firms.

The results for non-SOEs suggest that once the political connections are terminated, connected firms receive more (more severe) MAOs. However, the audit opinions received by non-connected firms do not change significantly. The differences in changes of audit opinion are significant, indicating that relative to the non-connected counterparts, connected firms are more likely to receive unfavourable opinions once their connections are broken. In addition, for SOEs I find that in the pre-event years, the connected firms receive more (more severe)

MAOs than the non-connected, but the audit opinions of connected and non-connected firms do not differ significantly in the event years. The differences in changes further suggest that once the corrupt bureaucrats are arrested, connected SOEs receive more favourable audit opinions, relative to the non-connected matching firms. These results thus give preliminary supporting evidence to the hypotheses 1a and 1b.

In Panel B, columns (1) and (2) give the regression results for non-SOEs, and columns (3) and (4) present those for SOEs. The results for non-SOEs show that the experimental variable *PCON\*EVENT* is significantly and positively associated with both *MAO* and *MAOOD* (the coefficient of *PCON\*EVENT* is 2.269 and the T-value is 2.34 in the result for *MAO*; the coefficient is 2.169 and the T-value is 1.96 in that for *MAOOD*). However, in the results for SOEs, the coefficients of *PCON\*EVENT* are negative and significant at conventional levels in both regressions (the coefficient is -3.773 and the T-value is -1.77 in the *MAO* regression; the coefficient is -3.607 and the T-value is -2.36 in the *MAOOD* regression). I further estimate the economic significance of *PCON\*EVENT*, and find that once the anti-corruption case takes place, the possibility of connected non-SOEs receiving an MAO has increased by 11.2%, but that of connected SOEs has decreased by 9.3%, both compared with those without political connections. The findings indicate that auditors are likely to perceive the termination of political connections as an increment of audit risk for non-SOEs and thus issue more (more severe) MAOs; whereas they assess the audit risk of connected SOEs as being lower, and give them more favourable opinions after the anti-corruption cases. Hence, the hypotheses 1a and 1b are confirmed.

With respect to the control variables, consistent with prior studies (Wang et al., 2008; Firth et al., 2012; Guan et al., 2014), I find that firms which are of smaller size, have higher

financial leverage, greater growth potential or are experiencing a financial loss, are more likely to receive unfavourable audit opinions. In addition, I find SOEs which issue both A and B/H shares are more likely to receive more severe opinions, which might suggest that managers of SOEs listed their firms overseas mainly for political benefits and put less emphasis on firm profitability, which corresponds to the argument of Huang and Wong (2012).

Table 4.3 Empirical results for hypotheses 1a and 1b

Panel A Univariate tests

Non-SOEs	Connected Firms			Non-connected Firms			Difference		
	Pre-event (N=126)	Event (N=46)	Change	Pre-event (N=125)	Event (N=45)	Change	Pre-event	Event	Change
<i>MAO</i>	0.079	0.196	0.116**	0.16	0.109	-0.051	-0.081**	0.087	0.167**
<i>MAOOD</i>	0.095	0.370	0.274***	0.264	0.152	-0.112	-0.169**	0.217	0.386**

  

SOEs	Connected Firms			Non-connected Firms			Difference		
	Pre-event (N=118)	Event (N=45)	Change	Pre-event (N=124)	Event (N=45)	Change	Pre-event	Event	Change
<i>MAO</i>	0.144	0.111	-0.033	0.032	0.089	0.057	0.112***	0.022	-0.090**
<i>MAOOD</i>	0.22	0.200	-0.02	0.032	0.178	0.146**	0.188***	0.022	-0.166***

Panel B Regression results

	<i>Non-SOEs</i>		<i>SOEs</i>	
	<i>MAOOD</i>	<i>MAO</i>	<i>MAOOD</i>	<i>MAO</i>
<i>PCON</i>	0.164 (0.28)	-0.693 (-1.06)	2.656** (2.51)	2.950* (1.90)
<i>PCON*EVENT</i>	2.269** (2.34)	2.196** (1.96)	-3.607** (-2.36)	-3.773* (-1.77)
<i>EVENT</i>	-0.776 (-1.05)	-0.428 (-0.51)	2.339* (1.83)	2.043 (1.26)
<i>SIZE</i>	-1.044*** (-3.89)	-0.0560 (-0.18)	-0.536 (-1.53)	-1.112** (-2.29)
<i>ROE</i>	0.995 (1.61)	0.0940 (0.13)	-0.756 (-0.81)	-1.236 (-0.55)
<i>LEV</i>	0.870* (1.76)	1.737 (1.64)	3.904*** (2.67)	13.520*** (2.75)
<i>LOSS</i>	1.780*** (3.33)	1.538** (2.56)	2.518*** (2.73)	2.530* (1.82)
<i>LOCALSMALL</i>	0.020 (0.04)	0.441 (0.77)	-1.200 (-1.49)	-1.44* (-1.81)
<i>Q</i>	0.038 (0.43)	0.471*** (3.11)	0.361 (1.55)	0.437 (0.99)
<i>CR</i>	-0.729** (-2.20)	-1.279*** (-2.96)	-1.644 (-1.54)	-0.415 (-0.27)
<i>AGE</i>	0.028 (0.48)	-0.032 (-0.44)	-0.300*** (-2.82)	-0.422** (-2.19)
<i>INVAR</i>	2.408* (1.85)	1.455 (0.99)	-0.234 (-0.10)	-4.040 (-1.27)
<i>BSHARE</i>	-18.390 (-0.01)	-18.500 (-0.01)	2.661** (2.13)	2.817 (1.41)
<i>MKTIDX</i>	0.157 (1.29)	0.127 (1.00)	-0.434** (-1.99)	-0.320 (-1.14)
<i>Cons</i>		-3.950		17.379*

		(-0.56)		(1.64)
<i>Intercept 1</i>	-16.992*** (-3.16)		-11.60 (-1.55)	
<i>Intercept 2</i>	-15.181*** (-2.84)		-8.207 (-1.09)	
<i>Intercept 3</i>	-14.268*** (-2.68)		-6.636 (-0.88)	
<i>Year/Industry dummy</i>			<i>include</i>	
<i>Adj-R square</i>	0.382	0.550	0.615	0.760
<i>N</i>	343	343	332	332

**Note:**

This table reports the empirical results for hypotheses 1a and 1b. Panel A reports the univariate tests and Panel B gives the regression results. “Change” is measured as the event year value of a variable minus its mean value in the pre-event period. I also report the differences of each dependent variable between the connected and non-connected firms in the pre-event period, event year and the change. Connected firms refer to the firms which are connected to corrupt government officers. Non-connected firms are matched with connected firms according to year, industry, ownership and closest assets. \*\*\*, \*\* and \* indicate two-tailed significance at the 1%, 5% and 10% level, respectively. The definitions of variables are presented in Appendix B.

Table 3.4 reports the univariate tests and the regression results for hypotheses 2a and 2b. Similar to Table 3.3, in the univariate tests, I present the mean values of the dependent variables and the change over time in the pre-event and post-event periods, and the differences in the change between connected and non-connected firms.

The univariate tests results presented in Panel A suggest that non-SOEs with political ties have a higher likelihood of appointing local small auditors than those without in both the pre-event and post-event periods. However, after the connections with corrupt bureaucrats are broken, politically connected non-SOEs are more likely to appoint large or non-local auditors, while there is no significant change in the auditor choice pattern for non-connected firms. The difference in the change of auditor choice patterns between the connected and non-connected firms indicates that the tendency for politically connected non-SOEs to hire local small auditors becomes significantly lower after the anti-corruption events, compared with the non-connected peers. By contrast, I find that politically connected SOEs are more likely to

appoint large or non-local auditors than the non-connected SOEs in the pre-event period. But after the anti-corruption cases, the auditor choice patterns of connected and non-connected SOEs do not differ significantly. The differences in the change in auditor choice patterns further suggest that, relative to the matching non-connected SOEs, connected SOEs are more likely to hire local small auditors in the post-event period. These results thus support hypotheses 2a and 2b.

The regression results presented in Panel B confirm the main findings above. Specifically, in column (1), the results for non-SOEs show that  $PCON*POST$  is significantly and negatively associated with  $LOCALSMALL$  (the coefficient of  $PCON *POST$  is -0.933 and the T-value is -2.07). However, the regression results for SOEs reported in column (2) show a significantly positive relationship between  $PCON*POST$  and  $LOCALSMALL$ . Economically, the coefficients of  $PCON *POST$  suggest that the possibility that politically connected non-SOEs will appoint local small auditors has decreased by 16.8%, while connected SOEs have a 29.7% higher chance of hiring local small auditors in the post-event period, compared with their non-connected counterparts. These results indicate that after the benefits from government are lost, formerly connected non-SOEs are more likely to hire high-quality auditors as a substitute for political connections; while formerly connected SOEs suffer fewer agency problems and thus have a lower demand for a high-quality auditor. Hence hypotheses 2a and 2b are also confirmed. In addition, the empirical results also show that in the pre-event period, non-SOEs with political connections are more likely to appoint local small auditors, while politically connected SOEs are more likely to appoint large or non-local auditors than the non-connected matching firms.

With respect to control variables, I find that firms of larger size are more likely to appoint



high-quality auditors, which is consistent with prior studies (Wang et al., 2008; Guedhami et al., 2014). Moreover, I also document that the coefficients of *LSH* are significantly positive in the regression results for SOEs, which might suggest that having a larger proportion of state shares lowers SOEs' demand for a high-quality auditor (Wang et al., 2008).

Table 4.4 Empirical results for hypotheses 2a and 2b

Panel A Univariate tests

Non-SOEs	Connected Firms			Non-connected Firms			Difference		
	Pre-event (N=111)	Post-event (N=82)	Change	Pre-event (N=111)	Post-event (N=97)	Change	Pre-event	Post-event	Change
LOCALSMALL	0.757	0.610	-0.147**	0.405	0.454	0.049	0.352***	0.156**	0.196*

SOEs	Connected Firms			Non-connected Firms			Difference		
	Pre-event (N=97)	Post-event (N=93)	Change	Pre-event (N=104)	Post-event (N=92)	Change	Pre-event	Post-event	Change
LOCALSMALL	0.227	0.376	0.149**	0.481	0.315	-0.166**	-0.254**	0.061	0.315***

Panel B Regression results

	Non-SOEs		SOEs	
	LOCALSMALL		LOCALSMALL	
PCON	1.687***	(5.21)	-1.042***	(-3.09)
PCON*POST	-0.933**	(-2.07)	1.453***	(3.09)
POST	0.0810	(0.26)	-0.478	(-1.48)
SIZE	-0.196*	(-1.70)	-0.210***	(-2.69)
ROE	-0.376	(-0.82)	1.471**	(2.48)
LEV	-0.648*	(-1.86)	-0.128	(-0.28)
Q	-0.075	(-1.35)	0.0520	(0.92)
CR	0.003	(0.05)	0.0180	(0.33)
INVAR	0.898	(1.51)	0.690	(1.26)
BSHARE	-0.407	(-0.55)	-0.975**	(-1.99)
MKTIDX	-0.011	(-0.21)	-0.066	(-1.15)
LSH	0.002	(0.05)	0.012*	(1.90)
Cons	4.057*	(1.68)	4.120**	(2.57)
Year/Industry dummy	include			
Adj-R square	0.126		0.102	
N	401		386	

**Note:**

This table reports the empirical results for my hypotheses 2a and 2b. Panels A and B report the univariate tests and regression results, respectively. “Change” is measured as the mean value of the variable in the post-event period minus its mean value in the pre-event period. I drop the observations of corruption event years, and the sample firms which lose their political ties in 2014. I report the differences of each variable between the connected and non-connected firms in the pre-event period, post-event period and the change. Connected firms refer to the firms which are connected to corrupt government officers. Non-connected firms are matched with connected firms according to year, industry, ownership and closest assets. \*\*\*, \*\* and \* indicate two-tailed significance at the 1%, 5% and 10% level, respectively. The definitions of variables are presented in Appendix B.

### 4.5.3 Robustness Tests

#### 4.5.3.1 Alternative matching sample construction

In this section, I expand the previous analyses to test whether the core evidence is robust to the implementation of alternative matching techniques when constructing the control sample.

First, I adopt a Propensity Score Matching (PSM) procedure to reselect the non-connected control firms. In particular, I require the candidate non-connected firms to belong to the same industry and have the same owner type as politically connected firms in the years of the anti-corruption events, and use a logit model to calculate the propensity scores for the connected and non-connected firms based on the firm size (*SIZE*), return on equity (*ROE*), financial leverage (*LEV*), and the largest shareholder’s ownership stake (*LSH*) (Faccio et al., 2006; Chaney et al., 2011; Guedhami et al., 2014). I then match, without replacement, each connected firm with a non-connected firm that has the closest propensity score. To validate the matching procedure, I conduct univariate difference comparisons between connected firms and matching firms. I report the test result in Panel A of Table 4.5, which indicates that there is no significant difference in the above firm characteristics between the connected and matched non-connected firms. I then collect financial and governance information for these newly selected non-connected firms around the anti-corruption events, and re-estimate the equations. Panels B and C of Table 4.5 present the regression results for

audit opinion and auditor choice patterns, respectively. I do not report the results of control variables in this and the following tests. The regression results in Table 4.5 are quantitatively similar to those presented in Table 4.3 and Table 4.4.

**Table 4.5 Regression results of the sample matched by propensity scores**

Panel A Differences of firm characteristics between connected and non-connected firms

	Connected Firms	N	Non-connected firms	N	Difference	T-value
<i>SIZE</i>	21.938	91	21.824	91	0.114	0.62
<i>ROE</i>	0.56	91	0.499	91	0.061	1.02
<i>LEV</i>	0.032	91	0.074	91	-0.042	-1.47
<i>LSH</i>	36.362	91	40.372	91	-4.01	-1.37

Panel B The impact of termination of political connections on auditor opinions

	<i>Non-SOEs</i>		<i>SOEs</i>	
	<i>MAOOD</i>	<i>MAO</i>	<i>MAOOD</i>	<i>MAO</i>
<i>PCON</i>	-0.769 (-1.33)	-1.480** (-2.29)	2.570** (2.09)	4.204* (1.74)
<i>PCON*EVENT</i>	2.254** (2.09)	2.120* (1.86)	-3.255* (-1.89)	-8.316** (-1.97)
<i>EVENT</i>	-0.867 (-0.98)	-1.172 (-1.30)	2.445* (1.71)	6.925* (1.72)
<i>Control Variables</i>	<i>include</i>			
<i>Adj-R square</i>	0.415	0.510	0.578	0.824
<i>N</i>	337	337	324	324

Panel C The impact of termination of political connections on the firms' auditor choice

	<i>Non-SOEs</i>	<i>SOEs</i>
	<i>LOCALSMALL</i>	<i>LOCALSMALL</i>
<i>PCON</i>	0.887*** (2.74)	-1.933*** (-5.16)
<i>PCON *POST</i>	-0.796* (-1.76)	2.487*** (4.88)
<i>POST</i>	-0.349 (-1.07)	-1.049*** (-3.01)
<i>Control Variables</i>	<i>include</i>	
<i>Adj-R square</i>	0.089	0.209
<i>N</i>	391	375

Note:

This table reports the regression results for the sample matched by propensity scores. Panel A reports the differences of firm characteristics between the connected and matching non-connected groups; Panel B reports the results of audit opinions, and Panel C presents those of auditor choice patterns of politically connected firms and non-connected firms, respectively. I match politically connected firms with the set of peer firms without political connections based on the closest propensity scores, which are calculated by firm size, return on equity, financial leverage, and the shareholding ratios of the controlling shareholders. I do not report the coefficients of control variables to save space. In the regression of audit opinion, the control variables include *SIZE*, *LEV*, *LOSS*, *Q*, *ROE*, *INVAR*, *AGE*, *LOCALSMALL*, *CR*, *BSHARE*, *MKTIDX*, and year and industry fixed effects. In the regression of auditor change, the control variables include *SIZE*, *ROE*, *LEV*, *Q*, *CR*, *INVAR*, *BSHARE*, *MKTIDX*, *LSH*, and year and industry fixed effects. Z statistics in parentheses are based on standard errors adjusted for clustering on client firms. \*\*\*, \*\* and \* indicate two-tailed significance at the 1%, 5% and 10% level, respectively. The definitions for the variables are outlined in Appendix B.

Secondly, it is argued that the characteristics and preferences of audit firms can influence their risk assessment, so that different audit firms may react to the anti-corruption cases differently. For this reason, any observed variations in audit outcomes around anti-corruption cases between connected and non-connected matched firms could be due to the fact that they adopt different audit firms. To address this issue, I reconstruct the sample by further requiring the non-connected firms to share the same auditors as the connected ones. I then re-estimate equations (1) and (2) using this new matching sample.

Lastly, although the DID research approach helps to control for unobserved time-series changes in the economic environment commensurate with the anti-corruption cases (Angrist and Krueger, 1999; Athey and Imbens, 2006), a concern raised from this method is that anti-corruption cases may also cause variations in the behaviour of non-connected firms. I address this concern by focusing on the connected firms only, and check whether they are really influenced by the sudden termination of political connections.

The empirical results for the above two robustness tests are reported in Table 4.6. Panels A and B present the results for audit opinion and auditor choice decisions, respectively. Consistent with the main findings, I document that, compared with the non-connected ones, connected SOEs (non-SOEs) receive more (less) favourable audit opinions in the years of anti-corruption cases, and have a higher (lower) possibility of appointing local small auditors in later years. Thus, the main findings are robust after employing alternative matching samples.

**Table 4.6 Regression results of using alternative matching samples**

**Panel A The impact of termination of political connections on audit opinions**

	<i>Matching with same auditors</i>				<i>Only connected firms</i>			
	<i>Non-SOEs</i>		<i>SOEs</i>		<i>Non-SOEs</i>		<i>SOEs</i>	
	<i>MAOOD</i>	<i>MAO</i>	<i>MAOOD</i>	<i>MAO</i>	<i>MAOOD</i>	<i>MAO</i>	<i>MAOOD</i>	<i>MAO</i>
<i>PCON</i>	-1.374 (-1.30)	-1.817 (-1.63)	0.507 (0.77)	-0.0180 (-0.03)				
<i>PCON*EVENT</i>	1.194 (0.90)	3.208*** (2.76)	-3.759** (-1.97)	-4.914* (-1.86)				
<i>EVENT</i>	0.364 (0.29)	0.243 (0.21)	-1.165 (-0.93)	0.377 (0.45)	1.524* (1.92)	1.144* (1.72)	-4.337** (-2.03)	-5.064* (-1.88)
<i>Control Variables</i>	<i>include</i>							
<i>Adj-R square</i>	0.359	0.473	0.461	0.478	0.390	0.490	0.719	0.884
<i>N</i>	184	184	253	253	172	172	163	163

**Panel B The impact of termination of political connections on the firms' auditor choice patterns**

	<i>Only connected firms</i>	
	<i>Non-SOEs</i>	<i>SOEs</i>
	<i>LOCALSMALL</i>	<i>LOCALSMALL</i>
<i>POST</i>	-1.137*** (-2.62)	1.041*** (2.61)
<i>Control Variables</i>	<i>include</i>	
<i>Adj-R square</i>	0.128	0.193
<i>N</i>	193	190

Note:

This table reports the results of the robustness test by using different non-connected matching samples. Panel A reports the results of audit opinions, and Panel B presents those of auditor choice patterns of politically connected firms and non-connected firms, respectively. I match the connected and non-connected firms according to industry, ownership, closet assets and auditor; I further drop the non-connected firms and focus on the connected ones only. I do not report the coefficients of control variables to save space. In the regression of audit opinion, the control variables include *SIZE*, *LEV*, *LOSS*, *Q*, *ROE*, *INVAR*, *AGE*, *LOCALSMALL*, *CR*, *BSHARE*, *MKTIDX*, and year and industry fixed effects. In the regression of auditor change, the control variables include *SIZE*, *ROE*, *LEV*, *Q*, *CR*, *INVAR*, *BSHARE*, *MKTIDX*, *LSH*, and year and industry fixed effects. Z statistics in parentheses are based on standard errors adjusted for clustering on client firms. \*\*\*, \*\* and \* indicate two-tailed significance at the 1%, 5% and 10% level, respectively. The definitions of the variables are outlined in Appendix B.



#### 4.5.3.2 Alternative treatment sample construction

In this section, I also reclassify the politically connected firms to examine whether the core findings still stand.

First, in previous analyses, I employ the Chinese high-level anti-corruption cases to examine how the sudden termination of political ties influences the audit risk and auditor choice decisions of connected firms. I build this natural experiment because high-level anti-corruption cases in China are mainly driven by political factors and not directly caused by the connected firms (Fan et al., 2008). However, the managements of connected firms may be prosecuted or fired because of corruption scandals, which affects firms' accounting practices and corporate governance. If this is the case, the confounding effect caused by firm management turnover/prosecution is likely to contaminate my interpretation of the consequences of sudden termination of corporate political connections. I collect the information of firm management turnover and find that the management turnover ratio for connected firms has increased slightly from 0.52 (126/244) in the pre-event years to 0.56 (148/266) in the event and post-event years, compared with a decrease from 0.42 (104/249) to 0.40 (113/280) in the same period for the non-connected control firms<sup>34</sup>. However, the difference in the changes of turnover ratio between connected and non-connected firms is not significant at conventional levels. I further search for the reason behind each case of management turnover in connected firms after the anti-corruption events, and find that the most common reason is job transfer, followed by end of tenure and personal reasons; yet involvement in lawsuits accounts for only one case<sup>35</sup>. I also divide the connected firms into

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<sup>34</sup> The management turnover ratio is defined as the average number of instances of management turnover for each firm in each year. The descriptive statistics and the test results in this part, which are not presented, will be provided upon request.

<sup>35</sup> Of the 148 cases of management turnover of connected firms after the anti-corruption events, 60 were due to job transfer; 50 due to end of tenure; 15 due to personal reasons; 12 due to resignation; 5 due to retirement; 1 due to improvement of corporate governance; 1 due to involvement in lawsuits, and the remaining 4 did not disclose the reasons.

those directly involved in bribery activities (bribing firms), and those whose executives are family members of the corrupt bureaucrats (affiliated firms), but again fail to find significant evidence that either the bribing or affiliated firms are subject to more severe management turnover after the ousters of corrupt bureaucrats, relatively to their non-connected counterparts. These test results may suggest that neither turnover nor prosecution of firm management can explain my empirical findings. Nonetheless, the insignificance could also be attributed to the relatively short examining period, and/or the opaque judicial system in China (He et al., 2015). Since direct involvement in corruption cases could damage a firm's reputation, and influence their audit risk and auditor choices, I exclude bribing firms and re-estimate the equations using the sample of affiliated firms and their non-connected matching firms.

Secondly, in the main analyses, I examine the impact of the termination of political connections on audit opinions between the three-year pre-event period and the event year. I also argue that Chinese listed firms are required to make their decisions on the appointment of external auditors at the beginning of the fiscal year and seldom switch auditors during the course of the year. Therefore, any change of auditor by connected firms occurring in the event year is unlikely to be attributable to the sudden termination of political connections, i.e., anti-corruption events cannot influence auditor choices made by firms in the same year. However, I do find that some firms change auditors in the years of anti-corruption events, and this may contaminate the empirical findings (DeFond and Zhang, 2014; Lennox, et al., 2014). I therefore exclude any firm that switched its auditor in the event year to test the robustness of my findings.

Thirdly, the jurisdictions of corrupt bureaucrats in the sample are not static, i.e., these

bureaucrats may be promoted or demoted, or be transferred to another government department at the equivalent level during the research period<sup>36</sup>. Thus, one could argue that the connections with corrupt bureaucrats will be lost or become weaker after the corrupt bureaucrats have left, and the termination of political connections therefore may have no or little effect on firms connected to them. I therefore perform a robustness test by requiring connected firms to be located in the jurisdictions of corrupt bureaucrats. Specifically, if the bureaucrat works in a local government, then the connected firms are required to be located in the same province as the official. If the bureaucrat works in the central government, I identify a connected firm from all publicly listed firms because officials in the central government can exert their influence across all provinces.

Finally, I found that the impact of anti-corruption cases on the audit risk and auditor switch in connected firms varies between SOEs and non-SOEs, and attributed these variations to the interplay between corporate political connections and firm ownership structures. However, it is possible that the findings are actually driven by the interplay of industry and political connections. For example, non-SOEs are likely to sit in industries which are more competitive than those of SOEs. As a result, political connections may be more valuable to non-SOEs than to SOEs. To rule out this possibility and validate my main arguments, based on the previous full sample, I further match each connected SOE (non-SOE) to one connected non-SOE (SOE) in the same industry.

The results of imposing these alternative requirements on the sample constructions are reported in Table 4.7. From Table 4.7, I still find that connected SOEs (non-SOEs) receive more (less) favourable audit opinions compared with their non-connected counterparts in the

event year, and are more (less) likely to appoint local small auditors in post-event years. Thus, even when I employ a different classification of politically connected firms, the core findings are still robust.

**Table 4.7 Regression results of re-classifying the politically connected firms**

Panel A The impact of termination of political connections on audit opinions

	<i>Excluding Bribing firms</i>				<i>Excluding firms changing auditors in the event years</i>			
	<i>Non-SOEs</i>		<i>SOEs</i>		<i>Non-SOEs</i>		<i>SOEs</i>	
	<i>MAOOD</i>	<i>MAO</i>	<i>MAOOD</i>	<i>MAO</i>	<i>MAOOD</i>	<i>MAO</i>	<i>MAOOD</i>	<i>MAO</i>
<i>PCON</i>	-0.549 (-0.63)	-0.339 (-0.42)	2.656** (2.51)	2.950* (1.90)	-0.280 (-0.31)	-2.212 (-1.62)	5.311*** (2.86)	0.651 (1.31)
<i>PCON*EVENT</i>	1.445* (1.81)	1.076 (1.37)	-3.607** (-2.36)	-3.773* (-1.77)	2.356* (1.91)	4.141* (1.92)	-5.007** (-2.46)	-1.630* (-1.74)
<i>EVENT</i>	0.463 (0.88)	0.848 (1.55)	2.339* (1.83)	2.043 (1.26)	-0.366 (-0.39)	-1.460 (-0.87)	4.596** (2.29)	1.130 (1.59)
<i>Control Variables</i>	<i>include</i>							
<i>Adj-R square</i>	0.308	0.418	0.615	0.760	0.467	0.713	0.466	0.554
<i>N</i>	157	157	161	161	284	284	287	287

Panel B The impact of termination of political connections on the firms' auditor choice patterns

	<i>Excluding Bribing firms</i>		<i>Located in the justifications of corrupt bureaucrats</i>		<i>Matching same industry between connected SOEs and connected non-SOEs</i>	
	<i>Non-SOEs</i>	<i>SOEs</i>	<i>Non-SOEs</i>	<i>SOEs</i>	<i>Non-SOEs</i>	<i>SOEs</i>
	<i>LOCALSMALL</i>	<i>LOCALSMALL</i>	<i>LOCALSMALL</i>	<i>LOCALSMALL</i>	<i>LOCALSMALL</i>	<i>LOCALSMALL</i>
<i>PCON</i>	1.807*** (4.89)	-0.237 (-0.61)	1.225*** (3.07)	-1.273*** (-4.27)	1.642*** (4.08)	-0.396 (-1.10)
<i>PCON</i>	-0.979** (-2.37)	1.423*** (2.74)	-1.148** (-2.44)	1.153*** (3.20)	-1.082* (-1.91)	2.247*** (4.12)
<i>*POST</i>						

<i>POST</i>	0.428 (1.31)	-0.226 (-0.68)	0.284 (0.73)	-0.833** (-2.06)	0.480 (1.34)	-0.826** (-2.13)
<i>Control Variables</i>	<i>include</i>					
<i>Adj-R square</i>	0.262	0.191	0.148	0.224	0.248	0.325
<i>N</i>	199	205	342	328	308	337

Note:

This table reports the regression results by reclassifying the politically connected firms. Panel A reports the results of audit opinions, and Panel B presents those of auditor choice patterns of politically connected firms and non-connected firms, respectively. I perform the robustness tests by excluding the bribing firms, excluding those firms which switched their auditors in the event years, and requiring identical industry distributions between connected SOEs and connected non-SOEs. I do not report the coefficients of control variables to save space. In the regression of audit opinion, the control variables include *SIZE*, *LEV*, *LOSS*, *Q*, *ROE*, *INVAR*, *AGE*, *LOCALSMALL*, *CR*, *BSHARE*, *MKTID*, and year and industry fixed effects. In the regression of auditor change, the control variables include *SIZE*, *ROE*, *LEV*, *Q*, *CR*, *INVAR*, *BSHARE*, *MKTIDX*, *LSH*, and year and industry fixed effects. Z statistics in parentheses are based on standard errors adjusted for clustering on client firms. \*\*\*, \*\* and \* indicate two-tailed significance at the 1%, 5% and 10% level, respectively. The definitions of the variables are outlined in Appendix B.

#### 4.5.3.3 Test for the Parallel-Paths Assumption

The credibility of DID estimation relies on the core assumption of “Parallel Paths”, that is, without treatment, the average change for the treated firms should be equal to the average change for controls (Angrist and Krueger, 1999; Athey and Imbens, 2006). In this section, I test whether the connected and non-connected firms exhibit parallel trends in audit risk and auditor choice patterns before the ousters of corrupt bureaucrats. I perform the tests by including the interaction terms  $PCON*PRE(-1)$  and  $PCON*PRE(-2)$  in the empirical models (Mora and Reggio, 2012; Berkowitz et al., 2015). Both  $PRE(-1)$  and  $PRE(-2)$  are dummy variables, representing the one and two years ahead of the anti-corruption cases, respectively. The interaction term  $PCON*PRE(-1)$  ( $PCON*PRE(-2)$ ) thus captures the differences between connected and non-connected firms in the one year (two years) ahead of the anti-corruption events, compared to their differences in the three years ahead. If the pre-event trends of connected and non-connected matched firms are parallel, the coefficients of  $PCON*PRE(-1)$  and  $PCON*PRE(-2)$ , and the difference between the two coefficients, are all expected to be insignificantly different from zero. In Table 8 I report the regression results, which confirm my expectation and suggest there is no significant difference in the pre-event trends of connected and non-connected firms in both SOE and non-SOE groups.

**Table 4.8 Test for the Parallel Path Assumption**

Panel A The impact of termination of political connections on audit opinions

	<i>Non-SOEs</i>		<i>SOEs</i>	
	<i>MAOOD</i>	<i>MAO</i>	<i>MAOOD</i>	<i>MAO</i>
<i>PCON</i>	-0.861 (-0.97)	-1.529 (-1.40)	3.063*** (2.72)	3.814** (2.09)
<i>PCON *PRE(-2)</i>	-0.457 (-0.88)	-0.494 (-0.78)	0.300 (0.54)	1.378 (1.19)
<i>PCON *PRE(-1)</i>	-0.781 (-0.74)	-0.741 (-0.57)	0.716 (0.70)	-0.303 (-0.13)
<i>PCON *EVENT</i>	2.976** (2.42)	2.958** (2.02)	-4.318** (-2.51)	-5.473** (-2.03)
<i>Control Variables include</i>				
<i>Adj-R square</i>	0.352	0.578	0.591	0.801
<i>N</i>	343	343	332	332
<i>Testing for PCON *PRE(-2) = PCON *PRE(-1)</i>				
$\chi^2$	0.15	0.06	0.19	0.66

Panel B The impact of termination of political connections on auditor choice patterns

	<i>Non-SOE firms</i>	<i>SOEs</i>
	<i>LOCALSMALL</i>	<i>LOCALSMALL</i>
<i>PCON</i>	1.714*** (3.60)	-1.038** (-2.06)
<i>PCON *PRE(-2)</i>	0.098 (0.35)	0.044 (0.14)
<i>PCON *PRE(-1)</i>	-0.026 (-0.04)	0.337 (0.50)
<i>PCON*POST</i>	-0.959* (-1.68)	1.414** (2.36)
<i>Control Variables include</i>		
<i>Adj-R square</i>	0.140	0.108
<i>N</i>	401	386
<i>Testing for PCON *PRE(-2) = PCON *PRE(-1)</i>		
$\chi^2$	0.05	0.25

**Note:**

This table reports the test results for the Parallel Path Assumption between the connected and non-connected firms. Panels A and B report the results for audit opinion and auditor choice, respectively. I match politically connected firms with the set of peer firms without political connections based on the same industry, same ownership, and closest assets in the anti-corruption event years. *PRE(-2)* and *PRE(-1)* stand for two years and one year ahead of corruption cases. I do not report the coefficients of control variables to save space. The control variables in the regressions of audit fees include *SIZE*, *LEV*, *LOSS*, *Q*, *ROE*, *INVAR*, *AGE*, *LOCALSMALL*, *CR*, *BSHARE*, *MKTIDX*, and year and industry fixed effects; Those in the regressions of redefined *LOCALSMALL* include *SIZE*, *ROE*, *LEV*, *Q*, *CR*, *INVAR*, *BSHARE*, *MKTIDX*, *LSH*,



and year and industry fixed effects.  $Z(\chi^2)$  statistics in parentheses are based on standard errors adjusted for clustering on client firms. \*\*\*, \*\* and \* indicate two-tailed significance at the 1%, 5% and 10% level, respectively. The definitions of the variables are outlined in Appendix A.

#### 4.5.3.4 Alternative measurements of dependent variables

In the above analyses, I use the propensity for auditors to issue unfavourable opinions to proxy for audit risk. However, highen audit risk could also drive auditors to exert additional effort, which raises the audit fees (Simunic and Stein, 1996; Defond and Zhang, 2014). I therefore employ audit fees to proxy for audit risk and examine whether anti-corruption events influence the audit fees<sup>37</sup>. I also redefine an audit firm as a local small firm if (1) it is not one of the Big 4 auditors, (2) it is located in the same jurisdiction as the client firms, and (3) more than half of the total number of its clients come from the same jurisdiction (Chan et al., 2012)<sup>38</sup>. I then estimate above equations using the audit fees and the redefined local small audit firms, and present the results in Table 4.8. This evidence echoes the main findings and indicates that after the termination of political connections, SOEs pay lower audit fees and are more likely to appoint local small auditors; whereas non-SOEs pay higher audit fees and are less likely to retain local small auditors.

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<sup>37</sup> In China, as with the change of auditor, audit fee contracts normally take place at the beginning of the fiscal year and have few adjustments during the course of the year (Liu et al., 2012). For this reason, I do not examine the change in firms' audit fees between the pre-event ( $t-3$  to  $t-1$ ) and event ( $t$ ) years, but rather between the pre-event period ( $t-3$  and  $t-1$ ) and the year after the ousters of corrupt bureaucrats ( $t+1$ ). To get a clearer interpretation, I exclude any sample firms which have switched auditors in the year following anti-corruption cases.

<sup>38</sup> As each audit firm in the sample has multiple offices, I further require the number of clients, measured as the combined number of local clients of each office, to be more than half of the total clients of the entire audit firm (regardless of the distribution of client firm numbers in any office).

**Table 4.9 Alternative definitions for dependent variables****Panel A The impact of termination of political connections on audit fees**

	<i>Non-SOEs</i>	<i>SOEs</i>
	<i>FEE</i>	<i>FEE</i>
<i>PCON</i>	-0.232** (-2.19)	0.133 (0.79)
<i>PCON *POSTI</i>	0.186* (1.97)	-0.332* (-1.71)
<i>POSTI</i>	-0.064 (-0.88)	-0.062 (-0.44)
<i>Control Variables</i>	<i>include</i>	
<i>Adj-R square</i>	0.771	0.838
<i>N</i>	203	195

**Panel B Results on the redefined *LOCALSMALL***

	<i>Non-SOE firms</i>	<i>SOEs</i>
	<i>LOCALSMALL</i>	<i>LOCALSMALL</i>
<i>PCON</i>	1.521*** (3.86)	-0.943*** (-2.76)
<i>PCON*POST</i>	-0.968* (-1.68)	0.936** (1.99)
<i>POST</i>	0.400 (1.10)	-0.800** (-2.28)
<i>Control Variables</i>	<i>include</i>	
<i>Adj-R square</i>	0.135	0.168
<i>N</i>	401	386

**Note:**

This table reports the regression results after I redefine the dependent variables. Panel A and B report the results for audit fees and the redefined *LOCALSMALL*, respectively. I match politically connected firms with the set of peer firms without political connections based on the same industry, same ownership, and closest assets in the anti-corruption event years. *POSTI* stands for the year immediately after the anti-corruption case. *POSTI* equals one if the observation falls in the year after an anti-corruption case, and zero otherwise. I do not report the coefficients of control variables to save space. The control variables in the regressions of audit fees include *SIZE*, *LEV*, *LOSS*, *Q*, *ROE*, *INVAR*, *AGE*, *LOCALSMALL*, *CR*, *BSHARE*, *MKTIDX*, and year and industry fixed effects; Those in the regressions of redefined *LOCALSMALL* include *SIZE*, *ROE*, *LEV*, *Q*, *CR*, *INVAR*, *BSHARE*, *MKTIDX*, *LSH*, and year and industry fixed effects. T (Z) statistics in parentheses are based on standard errors adjusted for clustering on client firms. \*\*\*, \*\* and \* indicate two-tailed significance at the 1%, 5% and 10% level, respectively. The definitions of the variables are reported in Appendix B.

#### 4.5.4 Further evidence

##### 4.5.4.1 Does the termination of political connections have more influence after the recent anti-corruption campaign in 2012?

After the 18th Congress Conference in 2012 when President Xi formally took office, China launched an anti-corruption campaign. In this context, firms find it even harder to rebuild their political connections once the connected corrupt bureaucrats are ousted. Hence, I predict that the effect of the termination of political connections on audit opinions and firms' choice of auditor will be even more pronounced after the recent anti-corruption campaign. To test this prediction, I focus on the connected firms and check whether the influence of the termination of political connections is more pronounced after the initiation of the recent anti-corruption campaign.

I construct a new dummy variable, *CAMPAIGN*, which equals 1 for the observations of firms which lost their connections after the 18th Congress Conference, and zero otherwise<sup>39</sup>. The interaction term between *EVENT (POST)* and *CAMPAIGN* is constructed to capture the differences in the change in auditor reporting behaviour (auditor choice decisions) before and after the anti-corruption campaign.

The regression results are reported in Table 4.9. Consistent with the previous results, connected non-SOEs (SOEs) are more (less) likely to receive unfavourable audit opinions, and less (more) likely to appoint local small auditors after the termination of political connections. More importantly, I find that these results become even more pronounced after the recent anti-corruption campaign. This finding confirms the above prediction and suggests

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<sup>39</sup> Consistent with the official report by the CCDI, the anti-corruption case which involved the former party vice-secretary of Sichuan Province, Mr Li Chuncheng, identifies him as the first high-level corrupt officer after the recent anti-corruption campaign.

that the effect of the termination of political connections becomes more pronounced after the 18th Congress Conference.

**Table 4.10 Regression results for politically connected firms after the recent anti-corruption campaign, for the sample of connected firms**

Panel A The impact of termination of political connections on audit opinions

	<i>Non-SOEs</i>		<i>SOEs</i>	
	<i>MAOOD</i>	<i>MAO</i>	<i>MAOOD</i>	<i>MAO</i>
<i>CAMPAIGN</i>	-5.214** (-2.50)	-4.509* (-1.89)	-2.725** (-2.49)	-2.220** (-2.30)
<i>CAMPAIGN *EVENT</i>	9.388** (2.09)	6.233** (2.46)	-2.643* (-1.80)	-2.682* (-1.68)
<i>EVENT</i>	2.192** (2.03)	2.444** (1.98)	-4.497* (-1.87)	-4.133** (-2.34)
<i>Control Variables include</i>				
<i>Adj-R square</i>	0.394	0.443	0.724	0.887
<i>N</i>	172	172	163	163

Panel B Impact of termination of political connections on the firms' auditor choice patterns

	<i>Non-SOEs</i>	<i>SOEs</i>
	<i>LOCALSMALL</i>	<i>LOCALSMALL</i>
<i>POST</i>	-1.067** (-2.07)	0.853** (2.04)
<i>CAMPAIGN *POST</i>	-1.567* (-1.79)	1.923* (1.84)
<i>CAMPAIGN</i>	-0.435 (-0.75)	-0.407 (-0.75)
<i>Control Variables include</i>		
<i>Adj-R square</i>	0.158	0.209
<i>N</i>	193	190

**Note:**

This table reports the regression results for the sample of connected firms around the recent anti-corruption campaign. Panel A reports the results of audit opinions, and Panel B presents those of auditor choice patterns of politically connected firms. *CAMPAIGN* is a dummy variable: if firm observations fall in the post-period of the anti-corruption campaign launched by Present Xi, it equals 1, 0 otherwise. I do not report the coefficients of control variables to save space. In the regression of audit opinion, the control variables include *SIZE*, *LEV*, *LOSS*, *Q*, *ROE*, *INVAR*, *AGE*, *LOCALSMALL*, *CR*, *BSHARE*, *MKTIDX*, and year and industry fixed effects. In the regression of auditor switch, the control variables include *SIZE*, *ROE*, *LEV*, *Q*, *CR*, *INVAR*, *BSHARE*, *MKTIDX*, *LSH*, and year and industry fixed effects. Z statistics in parentheses are based on standard errors adjusted for clustering on client firms. \*\*\*, \*\* and \* indicate two-tailed significance at the 1%, 5% and 10% level, respectively. The definitions of the variables are presented in Appendix B.

#### 4.5.4.2 How does the termination of political connections impact firms' earnings management?

The previous analyses suggest that lower (higher) audit risk in connected SOEs (non-SOEs) results in a lower (higher) probability of receiving MAOs after the termination of political connections. In this section I take a further step by investigating the association between anti-corruption cases and earnings management in connected firms. I argue that political connections lower the incentive of non-SOEs to engage in earnings management by enhancing their firm's value and accounting performance, whereas they exacerbate the agency problems in SOEs and motivate them to become involved in more severe earnings management. If this argument is true, I can then expect that termination of political connections will be associated with a higher (lower) level of earnings management in connected non-SOEs (SOEs). I employ both the unsigned discretionary accruals ( $/DA/$ ) and the presence of small profits ( $SP$ ) to capture clients' earnings management by following prior studies (Chen et al., 2011b; Gul et al., 2013)<sup>40</sup>. In particular, discretionary accruals are estimated using the cross-sectional Jones (1991) model for each industry-year, which requires at least 10 observations, and the presence of small profits is a dummy variable which equals 1 if the ROE of a certain company is between 0 and 0.01, and 0 otherwise. I replace the dependent variable  $MAO/MAOOD$  in the eq. (1) to  $/DA/SP$  to examine the joint impact of termination of political connections and ownership structures on earnings management during anti-corruption events.

The regression results presented in Table 4.10 show that the key experimental variable,

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<sup>40</sup> The commonly used proxies for earnings management include discretionary accruals, the presence of small profits and below-the-line items. The large number of missing values in calculating the below-the-line items prohibits me from running a regression with economic meaning. I therefore do not employ below-the-line items as another proxy for earnings management in this study.

*PCON\*EVENT*, is significantly positive with both */DA/* and *SP* in the non-SOE group, which is reported in the last two columns, but negative with */DA/* in the SOE group. This finding suggests that compared with their non-connected peers, connected SOEs are less likely to engage in earnings management, while the earnings management in connected non-SOEs becomes substantially more severe, once their political ties are broken. Thus, my underlying arguments have been confirmed.

**Table 4.11 The impact of termination of political connections on firm earnings management**

	<i>SOEs</i>		<i>Non-SOEs</i>	
	<i>/DA/</i>	<i>SP</i>	<i>/DA/</i>	<i>SP</i>
<i>PCON</i>	0.046 (1.30)	2.362** (2.52)	-0.071** (-2.13)	0.238 (0.35)
<i>PCON*EVENT</i>	-0.077* (-1.76)	-1.843 (-1.47)	0.095** (1.99)	1.839* (1.78)
<i>EVENT</i>	0.015 (0.42)	0.0920 (0.11)	-0.046 (-1.38)	-1.001 (-1.13)
<i>Control Variables</i>		<i>include</i>		
<i>Adj-R square</i>	0.118	0.376	0.331	0.236
<i>N</i>	320	332	315	343

**Note:**

This table reports the regression results for earnings management. *|DA|* and *SP* represent discretionary accruals and small profits, respectively. I match politically connected firms with the set of peer firms without political connections based on the same industry, same ownership, and closest assets in the anti-corruption event years. I do not report the coefficients of control variables to save space. The control variables include *SIZE*, *LEV*, *LOSS*, *Q*, *ROE*, *INVAR*, *AGE*, *LOCALSMALL*, *CR*, *BSHARE*, *MKTIDX* and year and industry fixed effects. T and Z statistics in parentheses are based on standard errors adjusted for clustering on client firms. \*\*\*, \*\* and \* indicate two-tailed significance at the 1%, 5% and 10% level, respectively. The definitions of the variables are outlined in Appendix B.

4.5.4.3 Are connected non-SOEs with severe earnings management in the anti- corruption event years more likely to retain local small auditors?

The previous results suggest that connected non-SOEs are more likely to engage in earnings management, and to be assessed as of higher audit risk once their connections with

the corrupt bureaucrats are terminated. I also find that these firms tend to switch from local small auditors to other auditors of high quality after the corruption events, with an aim to convey a positive signal to the market. However, looking at it from the of auditors' point of view, the high-quality auditors, who are more concerned about their reputation and litigation risk, have an incentive to shed the risky firms from their client portfolios (Laux and Newman, 2010; Hsieh and Lin, 2016). Thus, if those connected non-SOEs engage in severe earnings management in the anti-corruption event years, they could be more likely to retain local small auditors in following years.

I test the argument by focusing on the connected non-SOE sample only. I follow Caramanis and Lennox (2008) and classify a firm as having severe earnings management if (1) its ROE is between 0 and 0.01 and (2) its discretionary accruals are positive. A dummy SEVERE, which equals 1 if a certain firm engages in severe earnings management in the corruption event years, is built and the interaction term, SEVERE \*POST, is added to examine whether severe earnings management prevents firms from appointing high-quality auditors. The results in Table 12 show a significantly positive association between LOCALSMALL and SEVERE \*POST, which confirms my argument.

**Table 4.12 Severe earnings management and auditor choice in connected non-SOEs**

<i>LOCALSMALL</i>		
	<i>COEFFICIENT</i>	<i>T-Value</i>
<i>POST</i>	-1.876***	-3.29
<i>SEVERE *POST</i>	1.579*	1.68
<i>Control Variables</i>	<i>include</i>	
<i>Adj-R square</i>	0.258	
<i>N</i>	175	

**Note:**

This table reports the regression results for the relationship between severe earnings management and auditor choice patterns of connected non-SOEs. *SEVERE* is a dummy variable: it equals 1 if a firm's ROE is between 0 and 0.01 and its discretionary accruals are positive, 0 otherwise. I do not report the coefficients of control variables to save space. In the regression, the control variables include *SIZE*, *ROE*, *LEV*, *Q*, *CR*, *INVAR*, *BSHARE*, *MKTIDX*, *LSH*, and year and industry fixed effects. Z statistics in parentheses are based on standard errors adjusted for clustering on client firms. \*\*\*, \*\* and \* indicate two-tailed significance at the 1%, 5% and 10% level, respectively. The definitions of the variables are outlined in Appendix A.

4.5.4.4 How does the termination of political connections impact firm performance and market reactions?

I further investigate how the termination of political connections influences the market value and performance of connected firms. The results in the Table 2 and 3 in Appendix C suggest that, compared with their non-connected counterparts, connected SOEs experience an improvement in firm value and accounting performance, while non-SOEs with political ties suffer a decline in firm value and performance after the anti-corruption events. I also perform an event study to examine the reactions of investors when the arrest of corrupt bureaucrats first becomes known. I find a significantly positive market reaction towards the termination of political connections for SOEs, but a substantially negative reaction for non-SOEs. Such findings further confirm the different effect of political connections in SOEs and non-SOEs, and might also indicate that investors are able to assess the value of corporate political connections correctly. I further examine whether the central and local connected SOEs will



respond differently to the breaking of political ties, yet fail to find corresponding evidence. Lastly, I investigate the agency problem in connected SOEs and find that the perks in connected SOEs decrease significantly once they are no longer tied to corrupt bureaucrats, which is consistent with recent findings in Chen et al. (2015).

#### **4.6 Conclusion**

This study examines the reactions of the auditors and management of politically connected firms towards the sudden termination of political ties in the Chinese market. Based on 84 anti-corruption cases and 91 connected firms in China from 2004 to 2014, I find that compared with non-connected firms, connected non-SOEs are likely to receive more severe audit opinions, while connected SOEs receive more favourable audit opinions once the ties between firms and corrupt officials are terminated. These findings suggest that auditors may assess the termination of political connections as an increase in audit risk for connected non-SOEs, but as a decrease in audit risk for connected SOEs. Moreover, I also find that relative to non-connected firms, connected non-SOEs are likely to appoint reputable auditors, whereas connected SOEs tend to hire local small auditors after the ouster of corrupt officials. These results indicate that, after political connections are broken, connected non-SOEs suffer a higher business risk and tend to hire high-quality auditors as a positive signal, but connected SOEs enjoy milder agency problems and are less likely to appoint high-quality auditors as a monitoring mechanism. In summary, the findings suggest the relationship between corporate political connections and the behaviours of auditors and firm executives is subject to firm ownership structures. I also document a significant decrease in the earnings management of connected SOEs, but a substantial increase in that of connected non-SOEs after their political

connections are broken. This finding is in accordance with my underlying argument and suggests political connections benefit non-SOEs, but may be value-destroying to SOEs.

My single-country setting and the time-serial empirical design provide robust evidence that is subject to fewer problems of endogeneity and omitted variables. The empirical results of this study should help investors to assess the value of firms with political connections and alternative ownership structures. Policy makers and other participants in financial markets could also benefit from this study when gauging the importance of corporate political connections. The evidence from China should also provide a useful example for other emerging markets plagued with similar institutional environments.

This research also contains several unavoidable caveats. First, although direct and explicit, the definition of political connections could be too narrow. Therefore, this study may suffer a small sample bias and it may not be possible to draw generalizations from the empirical evidence. Nonetheless, this study casts light on reconciling the existing mixed evidence on the relationship between corporate political connections and the behaviours of auditors and firm executives. In addition, the politically connected firms in this study may have multiple ties with government officials. In other words, even if the arrest of corrupt officials removes one of their political ties, they may still be connected to other officials. Moreover, this study only focuses on the high-level anti-corruption cases, but ignores those cases that involve bureaucrats from lower levels. Both caveats lead to an underestimation of the effect of political connections and could substantially bias the empirical tests. However, I was still able to find significant evidence, which suggests that the impact of terminating corporate political connections will be even more pronounced.

## **Chapter 5: Conclusion**

This thesis examined how legal liability, the relationship between auditors and government, and corporate political connections influence auditor behaviours. By employing the mandatory reform which required all Chinese audit firms to transform from an LLC to an LLP structure, this thesis first examined whether auditors exert more audit effort and charge additional audit fees when their liability exposure increased. This thesis then used the rent-seeking theoretical framework to capture the complex economic implications of auditors' political connections, and examined whether politically connected auditors and government are likely to seek rents from each other and whether these rent seeking activities impair audit quality. Finally, this thesis adopted the Chinese high-level corruption cases as a natural experiment, and investigated whether auditors re-assess audit risk and if clients re-appoint auditors once the clients' political connections are suddenly broken due to the ousters of corrupt bureaucrats. Moreover, this thesis also examined whether the reactions of auditors and clients toward the sudden termination of corporate political connections are influenced by clients' ownership structures. The findings of this thesis are as follows:

### **5.1 Legal liability, government intervention, and auditor behaviour**

Chapter 2 examines whether LLP adoption has a positive effect on audit quality and audit fees. Since LLP adoption exposes the personal wealth of negligent auditors into the threat of litigation, this thesis conjectures that auditors will face a higher total audit cost and exert more audit effort after their audit firms transform to an LLP structure. Thus, LLP adoption is expected to lead to a superior audit quality and higher audit fees. This thesis proxies audit quality using both the propensity that auditors will issue MAOs/GCOs and the magnitude of

earnings management in client firms. By using 3,396 audits in the Chinese market between 2008 and 2013, this thesis documents that after LLP adoption, (1) auditors issue significantly more MAOs/GCOs; (2) client firms have significantly lower earnings management; and (3) auditors charge substantially more audit fees. These findings thus confirm the above expectations and suggest that enlarging auditors' liability exposures can effectively improve audit quality and increase audit fees in China.

Chapter 2 further investigates whether the effect of LLP adoption is more pronounced when auditors are subject to heavier government intervention. Auditors who receive intervention are likely to issue more unwarranted clean opinions, and thus have a higher chance to encounter audit failures and litigations. This research demonstrates that the audit quality and audit fees of these auditors increase even more after audit firms transform to an LLP structure. Based on prior studies, this thesis assumes that auditors are likely to receive government intervention when they are from local small audit firms and their clients are local SOEs. The empirical findings show that the effect of LLP adoption is indeed more pronounced when auditors suffer heavier government intervention.

As LLP adoption increases both audit quality and audit fees, an interesting and important question arises in how investors react to LLP adoption. Improved audit quality benefits client companies by reducing information asymmetry and mitigating agency problems, yet on the other hand, increased audit fees also raise the clients' operating costs. Thus, whether investors perceive LLP adoption positively or negatively is *ex ante* unknown. This thesis examines the CARs in several windows around the announcement of "Interim Provision" and documents significantly positive results in most windows, which suggests that LLP adoption increases the overall value of auditing.

Overall, Chapter 2 demonstrates that enlarging auditors' liability exposures is able to effectively improve audit quality and audit fees in China. In addition, the effect of LLP adoption is more pronounced when auditors are subject to heavier government intervention. Moreover, LLP adoption increases the overall value of auditing.

## **5.2 The rent-seeking between government and auditors**

Chapter 3 examines how connections with government influence audit quality at the individual auditor level. Previous studies suggest that a close relationship with government will introduce heavy government intervention on auditors (Wang et al., 2008). Others also find that connections with government enable audit firms to earn a larger market share and more audit fees (Yang, 2013). However, both the "government intervention" and "prop-up" arguments alone may not be able to fully capture the complex economic implication of the auditor-government relationship. Instead, Chapter 3 employs the theoretical framework of "rent-seeking" to depict the interactivities between government and auditors who bear political connections.

Under the "rent-seeking" framework, connections with government not only introduce heavier intervention, but also grant connected auditors with the protection from sanctions. For the mutual rent-seeking to exist, connections with government must neither induce government intervention only, nor prop up the performance of audit firms only. Additionally, the rent-seeking activities of auditors outlined in Chapter 3 reflected in the chance of being sanctioned, which is imposed directly by regulators, rather than in the audit fees or market shares, which are subject to many other non-political factors. Moreover, since government intervention jeopardises auditor independence, and protection from sanctions impedes auditors from exercising due diligence, this thesis predicts that connections with government

ultimately drive a lower audit quality.

To test the above predictions, I employ a sample consisting of 5,851 audits in the Chinese market between 2008 and 2013. Of the entire sample, 1,386, or 28.6%, firm-year observations are engaged by politically connected auditors. After controlling for other influential factors and the audit firm fixed effect, I document that individual auditors' political connections are associated with a significantly lower frequency of non-clean audit opinions, which indicates that connections with government impair audit quality. I further find that the audit opinions issued by connected auditors are significantly less informative than those issued by non-connected auditors. These findings hold after several robustness tests. Further evidence suggests that the influence of individual auditors' political connections is stronger when: (1) audit firms are located in underdeveloped regions; and (2) other auditors in the same firms also are connected to government.

I further investigate the evidence on rent-seeking activities between government and politically connected auditors. I find that politically connected auditors issue even more clean opinions when they provide services to SOEs, which confirms that connected auditors receive more government interventions. In addition, I also find that connected auditors are significantly less likely to receive penalties than their non-connected peers.

Overall, Chapter 3 suggests that government are likely to exert interventions on the practices of politically connected auditors to seek favourable audit opinions for SOEs, and connected auditors also are likely to seek protections from government. Moreover, these rent-seeking activities finally drive a lower audit quality.

### **5.3 Political connections, audit opinions and auditor choice**

Chapter 4 attempts to reconcile the mixed evidence on how corporate political

connections influence auditors' risk assessments and clients' auditor choice patterns. Corporate political connections are well documented as an important factor which influences firms' governance mechanisms and accounting practices. Recent studies further suggest that the effect of corporate political connections is subject to firm ownership structures (Wu et al., 2012). Specifically, political connections help non-SOEs to overcome market failures, but tend to elaborate agency problems in SOEs. Based on these findings, I thus examine whether the effect of corporate political connections on auditors' risk assessments and clients' auditor choice patterns is influenced by clients' ownership structures.

To mitigate the potential endogeneity problem, I take advantage of the Chinese setting and employ the high-level corruption cases as natural experiment. I then collect a set of firms which are connected to the corrupt bureaucrats through bribing and family affiliations, and examine how auditors and firms react to the sudden break in political connections. Since corporate political connections benefit non-SOEs and elaborate the agency problem in SOEs, I predict that auditors are likely to perceive the termination of corporate political connections as an increase of audit risk for non-SOEs, but a decrease of audit risk for SOEs. Furthermore, after the connections with corrupt bureaucrats are lost, non-SOEs will no longer receive the favourable treatment from local small auditors, yet SASACs may have little incentive to appoint high quality auditors to monitor the connected management in SOEs. Therefore, I further expect that connected non-SOEs will re-appoint high quality auditors, and connected SOEs will switch to local small auditors after the corruption cases.

To test the above predications, I collect 84 corruption cases between 2004 and 2014, and identify 91 listed firms connected to these corrupt bureaucrats. To make sure that the empirical findings are not spuriously attributed to firm features other than political

connections, a set of non-connected firms, which have the closest total assets with the connected ones, are further collected as a control group. By employing DID empirical approach, I find that compared with the non-connected matched firms, the connected non-SOEs receive significantly more/more serious MAOs in the corruption event years, and tend to switch their auditors from the local small ones to others. However, connected SOEs get more favourable audit opinions once their connections with corrupt bureaucrats are terminated, and are more likely to reappoint local small auditors in following years. These findings still hold after re-identifying the connected firms, re-constructing the non-connected control firms using alternative matching approaches and using other dependent variables. Furthermore, I also find that (1) the effect of sudden termination of political connections is more significant after the anti-corruption campaign launched by President Xi in 2012; and (2) connected non-SOEs engage more earnings management, but the earnings management in connected SOEs becomes weaker after the corruption cases.

In summary, Chapter 4 suggests that the relationship between corporate political connections and the behaviours of auditors and firm executives is subject to firm ownership structures.

## **5.4 Summary and Conclusion**

External auditing is essential for reducing information risk and improving the efficiency of recourse allocation. Thus, understanding what factors and how they influence auditor behaviour has profound meaning in both theory and practice. This thesis focuses on the Chinese market and examines the influence of legal liability, the relationship between auditors and government and corporate political connections on auditor behaviours.

I first examine that whether enlarging auditors' liability exposures can motivate them to



improve audit quality and charge more audit fees by employing the Chinese reform which took place at 2010 and required audit firms to transfer from LLC to LLP structure. The results suggest that after the LLP adoption, auditors issue significantly more MAOs/GCOs and constrained clients' earnings management to a substantially lower degree, which suggests that exerting unlimited legal liability on negligent auditors is able to enhance audit quality. In addition, I also document that auditors charge significantly more audit fees after their audit firms transform to an LLP structure. Moreover, the effect of LLP adoption is more pronounced for auditors who suffer heavier government interventions. Further evidence shows that the market reaction towards LLP adoption is significantly positive, which may also suggest that LLP adoption increases the overall value of auditing.

I then examine how auditors' political connections influence their audit quality at the individual auditor level. The results of this thesis indicate that auditors with political connections issue significantly less MAOs. Additionally, the audit opinions issued by politically connected auditors are also significantly less informative than those issued by other auditors. Thus, connections with government are documented to impair audit quality. I further explore the underlying reasons and finds that connected auditors are even more likely to issue favourable opinions to SOEs, and these auditors are less likely to be sanctioned. These findings further suggest that connections with government on one hand introduce heavier government interventions, but on the other hand also protect auditors from sanctions. Nevertheless, political connections drive a lower audit quality.

Lastly, I examine whether the effect of corporate political connections on auditors' risk assessments and firms' auditor choice patterns is subject to firms' ownership structures. I adopt the Chinese high-level corruption cases as a natural experiment, and collects a set of

firms which are connected to these corrupt bureaucrats. The findings suggest that once their connections are terminated, politically connected non-SOEs receive more unfavourable audit opinions, but connected SOEs get more favourable ones. In addition, in the following years of corruption cases, connected non-SOEs are likely to switch their auditors from the local small ones to others, yet connected SOEs tend to change their auditors from the high quality ones to local small auditors. Moreover, I also find that connected non-SOEs engage more earnings management, whereas connected SOEs engage less earnings management in the years of corruption cases.

The findings reported in this thesis represent clearer evidence on how legal liability, corporate political connections and the relationship between auditors and government influence audit quality. These findings suggest that at least in the Chinese market: (1) enlarging auditors' liability exposures is able to effectively improve audit quality, and also motivate them to charge more audit fees; (2) connections with government impair audit quality by bringing auditors with more interventions and protecting them from sanctions; and (3) the impact of corporate political connections on auditors' risk assessments and firms' auditor choice patterns is dependent on firm ownership structures.

These findings have several implications in both theory and practice. Firstly, the findings reported in this thesis support the argument that larger liability is associated with higher audit quality (Simunic and Stein, 1995; Liu and Wang, 2006; Choi et al., 2008; Mo et al., 2015). In addition, these findings also provide support to the position that drawing unlimited legal liability only on the negligent auditors, rather than all auditors, is able to effectively motivate them to exert more efforts. Combined with the argument that excessive liability exposures can drive wealthy auditors to quit from the existing market and ultimately destroy the auditing

profession (Napier, 1998; Doralt et al.; 2008), the findings reported in this thesis suggest that LLP is the most effective structure for auditors to organise their audit firms. Moreover, this thesis further notes that the effect of legal liability is more pronounced in the presence of government intervention. Thus, the findings reported in this thesis would be of great interest to policy-makers and the accounting professions, especially those in emerging economics, in selecting the structural forms for audit firms.

Secondly, this thesis extends prior studies which examine the strategic interactions between government and audit firms (Wang et al., 2008; Chan et al., 2012). Unlike previous studies which only focus on government intervention on auditors, I employ the rent-seeking framework to better capture the economic implications of the auditor-government relationship. Under the rent-seeking framework, connections with government not only introduce heavy interventions, but also provide auditors with protection from sanctions. In addition, this thesis also pushes down the analysis level from audit firms to individual auditors, and the findings suggest that connections with government drive down the service quality of individual auditors. Moreover, the results of this study further indicate that the behaviours of individual auditors are influenced by their colleagues. These findings benefit both policy makers and other participants in financial markets. In particular, the recently amendments proposed by the PCAOB required auditors to identify themselves in the audit report, whereas auditors opposed this by arguing that audit quality reflects the collaborative effort of the entire firm rather than any particular individual. The results reported in this thesis lend some initial support to the view that disclosing the identity of auditors could benefit audit quality.

Finally, The results reported in this thesis help to interpret the mixed evidence on how corporate political connections influence firms' auditor choice decisions and auditors' risk

assessments. This research shows that non-SOEs with political connections are more likely to select local small auditors and be assessed as of lower audit risk, whereas politically connected SOEs tend to be viewed as of higher audit risk, and appoint high quality auditors. Moreover, by employing the high-level corruption cases as a natural experiment, this research suffers less from endogeneity concerns, and is able to provide clearer evidence on the effect of corporate political connections. The empirical results should help investors to assess the value of firms with political connections and alternative ownership structures. Policy makers and other participants in financial markets could also benefit from this study when gauging the importance of corporate political connections.

### **5.5 Limitations and suggestions for future studies**

Although great effort has been made in conducting these studies, this research has several limitations. Firstly, as this research has focused on the Chinese market, its conclusions and implications may not be applied to other countries or jurisdictions. In other word, the findings reported in this thesis could be significantly different if other empirical settings are chosen. Future research can conduct investigations in other settings or use cross-country samples.

Secondly, this research adopts high-level corruption cases to investigate how auditors and firms react to the sudden termination of corporate political connections. Although the high-level corruption cases are unlikely to be expected by the market, they may induce other economic consequences, such as management turnovers and litigations, which can attribute to the findings. In addition, the politically connected firms in this study may have multiple ties with government officials. Thus, even if the arrest of corrupt officials removes one of their political ties, they may still be connected to other officials. Future research should adopt a more rigorous research design to explore the consequences of sudden termination of corporate

political connections.

Finally, this research argues that government exerts interventions on politically connected auditors, yet at the same provides them with protection from sanctions. However, to shop for favourable audit opinions, government may grant connected auditors other benefits, such as more SOE clients and higher audit fees. I have not investigated this possibility because larger market shares and higher audit fees may attribute to either the connections with government, or the superior audit quality. Future studies examining the effect of auditors' political connections could try to address this problem.

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## Appendix A

Case 1: *Hua Lun* audit firm was sued by its client's minority shareholders

In 2002, three minority shareholders of *Lan Tian Gu Fen* (stock code: 600709) initiated litigation against the company's external audit firm, *Hua Lun*, for negligence. In June 2006, the court announced that *Lan Tian Gu Fen*, and the *Hua Lun* audit firm together should make compensation, which amounted to almost RMB 157,000, for the investors' losses<sup>41</sup>.

Case 2: *Tian Zhi Guo Ji* audit firm was sued by its client's minority shareholders

In September 2007, 46 minority shareholders of *Tian Yi technology* (stock code: 000908, a local SOE), sued the company's audit firm, *Tian Zhi Guo Ji*, for not exerting due care during the auditing process. In 2009, the court adjudicated that the audit firm was liable for the financial losses of these minority shareholders, which amounted to RMB 23,000<sup>42</sup>.

Case 3: *KPMG* was sued by its client's controlling shareholder

In 2008, the company *Xin Hua Engineering* was sued by its controlling shareholder for making inappropriate retroactive adjustments in the annual report of 2005. The audit firm, *KPMG*, was also listed as a defendant due to issuing inappropriate audit opinions. In 2009 the court adjudicated that both *Xin Hua Engineering* and *KPMG* should make compensation to the controlling shareholder<sup>43</sup>.

Case 4: *Rui Hua* audit firm was sued by its client's minority shareholders

In 2014, a number of shareholders of *Lv Da Di* (stock code: 002200) initiated litigation against the LLP audit firm *Rui Hua*, which was formed in 2013 by a merger between *Shenzhen Peng Cheng*, *Zhong Rui Yue Hua*, and *Guo Fu Hao Hua* audit firms. Before the merger, *Shenzhen Peng Cheng* audit firm issued inappropriate audit opinions to the false financial statements of *Lv Da Di*. In 2013, the CSRC imposed a fine of RMB 1.2 million on *Shenzhen Peng Cheng* audit firm and revoked its special licence to audit listed companies. Moreover, the negligent auditors were fined RMB 100,000 and forbidden from practising in

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<sup>41</sup> Source access: <http://finance.sina.com.cn/stock/t/20070629/08181506670.shtml>

<sup>42</sup> Source access: [http://news.changsha.cn/hn/3/200910/t20091022\\_1021904.htm](http://news.changsha.cn/hn/3/200910/t20091022_1021904.htm)

<sup>43</sup> Source access: <http://finance.sina.com.cn/g/20080831/13595255667.shtml>

the capital market for a life, which made these negligent auditors suffer from severe damage to their careers and reputation. Unlike all prior civil cases, the *Rui Hua* audit firm was listed as the first-mentioned defendant, who is expected to bear the largest proportion of liability. However, due to short period that the case has been under investigation, there has been no relevant judgment as yet<sup>44</sup>.

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<sup>44</sup> Source access: <http://finance.sina.com.cn/stock/s/20140923/012220382541.shtml>;  
[http://www.csrc.gov.cn/pub/zjhpublic/G00306212/201307/t20130726\\_231847.htm](http://www.csrc.gov.cn/pub/zjhpublic/G00306212/201307/t20130726_231847.htm);  
[http://www.csrc.gov.cn/pub/zjhpublic/G00306212/201307/t20130726\\_231832.htm](http://www.csrc.gov.cn/pub/zjhpublic/G00306212/201307/t20130726_231832.htm);  
[http://finance.ifeng.com/a/20130726/10279264\\_0.shtml](http://finance.ifeng.com/a/20130726/10279264_0.shtml)

**Appendix B**

## Variable definitions

Dependent Variables	Definition
<i>MAO</i>	Indicator variable that equals 1 if the audit firm issued a modified audit opinion, and 0 otherwise
<i>GCO</i>	Indicator variable that equals 1 if the audit firm issued a going-concern audit opinion, and 0 otherwise
<i>MAOOD</i>	Indicator variable, taking values from 0 to 3 to represent clean opinions, unqualified opinions with explanatory notes, qualified opinions, and disclaimers, respectively
<i> DA </i>	Absolute value of discretionary accruals calculated by cross-sectional Jones (1991) model
<i>DA</i>	Discretionary accruals calculated by cross-sectional Jones (1991) model
<i>BL</i>	Below-the-line items, which are calculated as the sum of investment net income, profits from other operations, and non-operating net income, scaled by the total assets of the current fiscal year.
<i>LowRoa<sub>t+1</sub></i>	Indicator variable which equals 1 if the industry-adjusted ROA of a certain firm in the year $t + 1$ is in the lowest decile of the whole population of listed firms, 0 otherwise.
<i>Distress<sub>t+1</sub></i>	Indicator variable which equals 1 if either the working capital, net income or shareholder of a certain firm is negative in year $t + 1$ , 0 otherwise.
<i>PUNISH</i>	Indicator variable which equals 1 if the auditor has ever encountered a punishment from the regulators, 0 otherwise.
<i>PUNISHTIMES</i>	The number of punishments that a certain auditor has received from the regulators.
<i>LOCALSMALL</i>	Indicator variable that equals 1 if the audit firm is located in the same jurisdiction as the client and is not one of the Big 10 firms
<i>SP</i>	Indicator variable that equals 1 if the ROA of a certain client company is between 0 and 0.01, 0 otherwise.
<i>FEE</i>	Natural logarithm of audit fees
Independent Variables	Definition
<i>LLP</i>	Indicator variable that equals 1 if the audit firm is a limited liability partnership, and 0 otherwise
<i>MKTIDX</i>	Indicator variable that equals 1 if the marketization index of a certain region is in the top half of all regions, and 0 otherwise.
<i>CONNECTED</i>	Indicator variable that equals 1 if the individual auditor is connected to the government, 0 otherwise.
<i>PCON</i>	Indicator variable that equals 1 if a firm is politically connected to corrupt government officers, and 0 otherwise
<i>EVENT</i>	Indicator variable that equals 1 if the observation falls in the

	year of an anti-corruption event, and 0 if it falls in the three years before
<i>POST</i>	Indicator variable that equals 1 if the observation falls in the three years after the corruption event, and 0 if it falls in the three years before
<i>POST1</i>	Indicator variable that equals 1 if the observation falls in the first year after the anti-corruption case, and 0 if it falls in the three years before
<i>SIZE</i>	Natural logarithm of the total assets of the client company
<i>ROS</i>	The ratio of net income on the total sales of the client company
<i>ROE</i>	The ratio of net income on the net equity of the client company
<i>SOE</i>	Indicator variable that equals 1 if the client is ultimately controlled by central or local governments, and 0 otherwise
<i>INDDIR</i>	The percentage of the number of independent directors in board
<i>LOSS</i>	Indicator variable that equals 1 if the client experiences losses in the current fiscal year, and 0 otherwise
<i>DUAL</i>	Indicator variable that equals 1 if the chairman and CEO are the same person, and 0 otherwise
<i>AGE</i>	The number of years a company has been listed
<i>LEV</i>	The ratio of the long-term total liability to total assets of the client company
<i>BHSHARE</i>	Indicator variable that equals 1 if the company issues B or H shares, and 0 otherwise
<i>CI</i>	Client importance, the assets of a certain client to that of the total clients of auditors.
<i>BIG4</i>	Indicator variable that equals 1 if the auditor is one of the Big Four audit firms, and 0 otherwise
<i>EXIST</i>	Indicator variable which equals 1 if any of the other auditors in the same audit firm have political connections, 0 otherwise.
<i>PERCENTAGE</i>	The ratio of the other connected auditors over the total of other auditors.
<i>ACC-MAJOR</i>	Indicator variable which equals 1 if the auditor has majored in accounting, 0 otherwise.
<i>PARTNER</i>	Indicator variable which equals 1 if the auditor is a partner in the audit firms, 0 otherwise.
<i>MALE</i>	Indicator variable which equals 1 if the auditor is a male, 0 otherwise.
<i>FOREIGN-CPA</i>	Indicator variable which equals 1 if the auditor has a foreign qualification of CPA, 0 otherwise.
<i>UNDERGRADUATE</i>	Indicator variable which equals 1 if the auditor has a master's or doctor's degree, 0 otherwise.
<i>EPT</i>	Indicator variable that equals 1 if the observation falls in the period after 2010, and 0 otherwise
<i>INV</i>	The percentage of inventory over total assets of a client

	company
<i>REC</i>	The percentage of accounting receivables over total assets of a client company
<i>Q</i>	Tobin Q, the ratio of a client company's total market value to total book value
<i>GROWTH</i>	The growth rate of the client company's total sales
<i>LOCAL</i>	Indicator variable that equals 1 if the auditor is from a local audit firm, and 0 otherwise
<i>LSH</i>	The shareholding ratio of the largest stockholder
<i>LOCALSOE</i>	Indicator variable that equals 1 if the largest shareholder of client company is a local government entity that owns at least 20 percent of the shares
<i>LagMAO</i>	Indicator variable that equals 1 if the auditors issued MOAs to clients in the previous year, and 0 otherwise
<i>LagGCO</i>	Indicator variable that equals 1 if the auditors issued GCOs to clients in the previous year, and 0 otherwise

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## Appendix C

**Table 1** Summaries of the corruption cases

Province	Name	Position	Event Day	Sentence Day	Sentence
Hubei	Zhang Guoguang	Provincial Governor	25/02/2004	09/12/2004	11 years' imprisonment
Chongqing	Zhang Zonghai	Provincial Propaganda Minister	09/04/2004	18/5/2005	15 years' imprisonment
Hunan	Wu zhenhan	Provincial Chief Judge	19/05/2004	09/11/2006	Suspended death penalty
Heilongjiang	Han Guizhi	Provincial Chairman of the CPPCC	29/05/2004	15/12/2005	Suspended death penalty
Jiangxi	Ding Xinfu	Provincial Chief Procurator	30/07/2004	05/01/2006	17 years' imprisonment
Shanxi	Hou Wujie	Provincial Vice- Governor	09/12/2004	18/09/2006	11 years' imprisonment
Central	Lin Kongxing	Vice-Chairman of China Electricity Council	15/01/2004	01/04/2005	15 years' imprisonment
Central	Li Jianzhong	Dean of China Academy of Launch Vehicle Technology	21/04/2004	07/03/2006	Life imprisonment
Bank	Hu Chushou	Vice-Chairman of Agricultural Development Bank of China	01/06/2004	18/01/2006	Life imprisonment
Bank	Yu Dalu	Vice-Chairman of Agricultural Development Bank of China	01/06/2004	10/02/2006	Life imprisonment
Jiangsu	Xu guojian	Chairman of the Provincial Organization Department	05/06/2004	24/01/2006	Suspended death penalty
Bank	Zhang Enzhao	Chairman of China Construction Bank	10/03/2005	03/11/2006	15 years' imprisonment
Gansu	Zhu Zuoyong	Vice-Chairman of the Provincial CPPCC	09/12/2005	04/01/2007	12 years' imprisonment
Henan	Lv Debing	Provincial Vice-Governor	15/06/2005	30/09/2005	Death penalty
Sichuan	Li Dachang	Provincial Vice- Governor	14/01/2005	04/04/2006	7 years' imprisonment
Fujian	Jing Fusheng	Chairman of the Provincial Organization Department	11/10/2005	14/09/2007	Life imprisonment
Anhui	Wang Zhaoyao	Provincial Vice- Governor	02/07/2005	12/01/2007	Suspended death penalty
Henan	Wang Youjie	Deputy Director of the Provincial National People's	29/03/2005	19/01/2007	Suspended death penalty

Congress					
Shanghai	Chen Liangyu	Provincial Governor	24/09/2006	11/04/2008	18 years' imprisonment
Jiangsu	Wang Wulong	Director of the Provincial National People's Congress	13/07/2006	31/01/2008	Suspended death penalty
Shandong	Du Shicheng	Provincial Vice-Governor	12/23/2006	04/02/2008	Life imprisonment
Anhui	He Minxu	Provincial Vice-Governor	22/06/2006	27/12/2007	Suspended death penalty
Beijing	Liu Zhihua	Provincial Vice-Governor	09/06/2006	18/10/2008	Suspended death penalty
Central	Zheng Xiaoyu	Chairman of the State Food and Drug Administration	26/12/2006	29/05/2007	Death penalty
Tianjing	Li Jinbao	Provincial Chief Procurator	12/06/2006	19/12/2007	Suspended death penalty
Guangxi	Sun Yu	Vice-Chairman of the Provincial CPPCC	30/11/2007	31/08/2009	18 years' imprisonment
Guangdong	Liu Weiming	Provincial Vice-Governor	22/01/2007	22/01/2007	Dismissal from service and the CPC
Tianjing	Song Pingshun	Chairman of the Provincial CPPCC	03/06/2007	03/06/2007	Dismissal from service and the CPC
Shanxi	Pang Jiayu	Vice-Chairman of the Provincial CPPCC	18/01/2007	28/06/2008	12 years' imprisonment
Central	Chen Tonghai	Top Manager of Sinopec	22/06/2007	15/07/2009	Suspended death penalty
Henan	Sun Shanwu	Vice-Chairman of the Provincial CPPCC	29/12/2007	09/02/2010	Suspended death penalty
Tianjing	Pi Qiansheng	Municipal Standing Committee,	23/12/2008	12/08/2010	Suspended death penalty
Fujian	Chen Shaoyong	Secretary of Provincial Party Committee	02/12/2008	18/01/2010	Life imprisonment
Jilin	Mi Fengjun	Vice-Director of the Provincial National People's Congress	28/04/2008	28/05/2009	Suspended death penalty
Congress					
Bank	Wang Yi	Vice-Governor of National Development Bank	06/08/2008	15/04/2010	Suspended death penalty
Central	Huang Songyou	Vice-President of the Supreme Court	15/10/2008	07/05/2011	Suspended death penalty
Central	Zhu Zhigang	Director of the Budget Committee of National People's Congress	15/10/2008	10/05/2010	Life imprisonment
Congress					
Central	Zheng Shaodong	Assistant Minister of public security	12/01/2009	24/08/2010	Suspended death penalty
Ningxia	Li Tangtang	Provincial Vice-Governor	13/10/2009	08/04/2011	Life imprisonment
Niaoling	Song Yong	Vice-Director of the Provincial National People's Congress	13/10/2009	30/01/2011	Suspended death penalty
Congress					
Guizhou	Huang Yao	Chairman of the Provincial CPPCC	24/10/2009	09/12/2010	Suspended death penalty

Central	He Hongda	Director of the Political Department of the Ministry of Railways	11/03/2009	24/11/2009	14 years' imprisonment
Zhejiang	Wang Huayuan	Secretary of Provincial Inspection Commission	16/04/2009	24/09/2010	Suspended death penalty
Central	Zhang Chunjiang	Party Secretary of China Mobile	26/12/2009	12/07/2011	Suspended death penalty
Guangdong	Chen Shaoji	Chairman of the Provincial CPPCC	16/04/2009	23/07/2010	Suspended death penalty
Nei Monggu	Liu Zhuozhi	Vice-Chairman of the Provincial CPPCC	15/12/2010	02/07/2012	Life imprisonment
Central	Yu Renlu	Deputy Director of the Civil Aviation Administration of China	10/01/2010	23/12/2010	7 years' imprisonment
Central	Kang Rixin	Top manager of the CNNC	15/01/2010	19/11/2010	Life imprisonment
Zhejiang	Zhang Jiameng	Vice-Director of the Provincial National People's Congress	03/04/2010	20/12/2010	Life imprisonment
Central	Zhang Jingli	Vice-Chairman of the State Food and Drug Administration	04/06/2010	25/07/2012	17 years' imprisonment
Jiangxi	Song Chenguang	Vice-Chairman of the Provincial CPPCC	09/07/2010	27/04/2012	Suspended death penalty
Central	Li Yuan	Vice-Director of the Ministry of Land and Resources	09/06/2011	24/06/2011	Dismissal from service and the CPC
Central	Liu Zhijun	Minister of Railways	12/02/2011	09/06/2013	Suspended death penalty
Shandong	Huang Sheng	Provincial Vice-Governor	24/11/2011	03/05/2013	Life imprisonment
Jilin	Tian Xueren	Provincial Vice-Governor	05/11/2011	01/11/2013	Life imprisonment
Central	Lu Xiangdong	Vice-Manager of China Mobile	28/02/2012	15/11/2013	Life imprisonment
Chongqing	Wang Lijun	Provincial Vice-Governor	06/02/2012	24/09/2012	15 years' imprisonment
Chongqing	Bo Xilai	Provincial Governor	15/03/2012	22/09/2013	Life imprisonment
Guangdong	Zhou Zhenghong	Minister of the Provincial United Front Work Department	16/01/2012	10/04/2014	Suspended death penalty
Sichuan	Li Chuncheng	Provincial Vice-Governor	05/12/2012	29/04/2014	Dismissal from service and the CPC
Hunan	Tong Mingqian	Vice-Chairman of the Provincial CPPCC	18/12/2013	18/08/2014	5 years' imprisonment
Jiangxi	Chen Anzhong	Vice-Director of the Provincial National People's Congress	06/12/2013	19/06/2015	12 years' imprisonment



Hubei	Guo Youming	Provincial Vice-Governor	27/11/2013	N/A	N/A
Hubei	Chen Bohuai	Vice-Chairman of the Provincial CPPCC	19/09/2013	17/04/2015	17 years' imprisonment
Guizhou	Liao Shaohua	Member of Provincial Standing Committee	28/10/2013	09/04/2015	16 years' imprisonment
Central	Liu Tienan	Deputy director of development and Reform Commission	14/05/2103	10/12/2014	Life imprisonment
Guangxi	Li Daqiu	Vice-Chairman of the Provincial CPPCC	06/07/2013	13/10/2014	15 years' imprisonment
Central	Li Dongsheng	Vice Minister of Public Security	20/12/2013	25/12/2013	Dismissal from service and the CPC
Central	Wang Yongchun	Vice-Manager of Petrochina	26/08/2013	N/A	
Central	Jiang Jiemin	Director of SASAC	01/09/2013	30/06/2014	Dismissal from service and the CPC
Sichuan	Li Chongxi	Chairman of the Provincial CPPCC	29/12/2013	17/04/2015	Dismissal from service and the CPC
Neimenggu	Wang Suyi	Minister of the Provincial United Front Work Department	03/07/2013	17/07/2014	Life imprisonment
Sichuan	Guo Yongxiang	Provincial Vice-Governor	23/06/2013	14/01/2014	Dismissal from service and the CPC
Central	Yi Junqing	Director of the Central Compilation and Translation Bureau	17/01/2013	17/01/2013	Dismissal from service and the CPC
Hubei	Wu Yongwen	Vice-Director of the Provincial National People's Congress	15/01/2013	N/A	N/A
Central	Xu Jie	Director of the Bureau of letters and visits	28/11/2013	27/06/2014	Dismissal from service and the CPC
Heilongjiang	Fu Xiaoguang	Provincial Vice-Governor	17/12/2013	N/A	N/A
Anhui	Ni Fake	Provincial Vice-Governor	04/06/2013	28/02/2015	17 years' imprisonment
Hunan	Yang Baohua	Vice-Chairman of the Provincial CPPCC	27/05/2014	15/07/2014	Dismissal from service and the CPC
Chongqing	Tan Xiwei	Vice-Director of the Provincial National People's Congress	03/05/2014	02/09/2014	Dismissal from service and the CPC
Qinghai	Mao Xiaobing	Member of Provincial Standing Committee	24/04/2014	16/07/2014	Dismissal from service and the CPC
Central	Song Lin	Secretary of China Resources Group	17/04/2014	19/04/2014	Dismissal from service and the CPC
Central	ShenWeicheng	Secretary of China Association for Science and Technology	12/04/2014	22/12/2014	Dismissal from service and the CPC

Jiangxi	Yao Mugen	Provincial Vice-Governor	22/03/2014	11/04/2014	Dismissal from service and the CPC
Yunnan	Shen Peiping	Provincial Vice-Governor	09/03/2014	N/A	N/A
Shanxi	Jin Daoming	Provincial Vice-Governor	27/02/2014	N/A	N/A
Shanxi	Zhu Zuoli	Provincial Vice-Governor	19/02/2014	20/12/2014	Dismissal from service and the CPC
Hainan	Yi Wenlin	Provincial Vice-Governor	18/02/2014	02/07/2014	Dismissal from service and the CPC

Note: This table presents the summary of the Chinese high-level corruption cases during 2004 to 2014. We report the province, name, position, event day, sentence day, and the sentence for each corrupt government official. Event day is the first day on which the official was under investigation. Sentence day is the day on which the result of sentence is first publicly announced.

**Table 2** The impact of political connection termination on firm value and performance

	<i>Non-SOEs</i>		<i>SOEs</i>	
	<i>Q</i>	<i>ROE</i>	<i>Q</i>	<i>ROE</i>
<i>CONNECT</i>	0.239 (0.93)	-0.019 (-0.56)	0.142 (0.49)	-0.011 (-0.64)
<i>CONNECT*TERMIN</i>	-0.771**	-0.231**	1.002*	0.057**
<i>ATE</i>	(-2.01)	(-1.97)	(1.82)	(2.08)
<i>TERMINATE</i>	-0.218 (-0.82)	-0.016 (-0.19)	0.044 (0.11)	-0.055*** (-2.88)
<i>SIZE</i>	-1.138*** (-8.84)	0.002 (0.01)	-0.533*** (-6.74)	0.004 (0.88)
<i>LEV</i>	0.589** (2.11)	0.013 (0.30)	0.006 (0.02)	0.035** (2.49)
<i>CAPEX</i>	0.016 (0.04)	-0.001 (-0.01)	-0.144 (-0.24)	-0.066* (-1.76)
<i>LSH</i>	-0.020 (-0.52)	-0.005 (-0.59)	-0.034 (-1.16)	-0.001 (-0.51)
<i>LSH<sup>2</sup></i>	0.002 (0.30)	0.003 (0.68)	0.002 (1.50)	0.001 (1.24)
<i>MKTIDX</i>	0.182*** (4.28)	-0.002 (-0.20)	0.092 (1.46)	0.007* (1.66)
<i>Cons</i>	25.099*** (8.37)	0.176 (0.29)	12.927*** (7.14)	-0.074 (-0.72)
<i>Year/ Firm dummy</i>	<i>include</i>			
<i>Adj-R square</i>	0.448	0.034	0.215	0.082
<i>N</i>	343	343	332	332

Note:

This table reports the regression results for firm value and performance. T statistics in parentheses are based on standard errors adjusted for clustering on client firms. \*\*\*, \*\* and \* indicate two-tailed significance at the 1%, 5% and 10% level, respectively. The definitions for the variables are outlined in Appendix A.

**Table 3** Cumulative abnormal returns around the event date

<i>Event Windows</i>	<i>Non-SOEs</i>	<i>SOEs</i>
<i>(-10, 10)</i>	0.001 (0.79)	0.002* (1.67)
<i>(-5, 5)</i>	-0.001 (-1.30)	0.001** (1.96)
<i>(-2, 2)</i>	-0.003*** (-3.48)	0.002 (1.54)
<i>(-1, 1)</i>	-0.002* (-1.65)	0.002* (1.94)
<i>(-10, 0)</i>	-0.001 (-1.13)	0.001 (1.23)
<i>(-5, 0)</i>	-0.002** (-2.06)	0.001* (1.70)
<i>(-2, 0)</i>	-0.002*** (-3.00)	0.002** (2.38)
<i>(-1, 0)</i>	-0.002** (-2.09)	0.001** (2.23)
<i>(0)</i>	-0.001* (-1.75)	0.001* (1.68)
<i>(0, 1)</i>	-0.001* (-1.65)	0.002* (1.94)
<i>(0, 2)</i>	-0.002* (-1.89)	0.002 (1.54)
<i>(0,5)</i>	-0.001 (-1.16)	0.002 (1.58)
<i>(0,10)</i>	0.001 (0.21)	0.003** (2.49)

**Note:**

This table reports mean cumulative abnormal returns (CARs) over the corruption events. Difference in the mean CAR and zero are also reported. Column (1) reports the result for non-SOE firms and column (2) presents that of SOEs. CARs are estimated by cumulating daily abnormal stock returns within various event windows ranging from 10 days before to 10 days after the corruption event day.