Transparency in Politically Connected Firms: Evidence from Private Sector Firms in China

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Abstract:

Using a sample of listed Chinese private sector firms, we show that politically connected firms are less likely to engage high-quality (big) auditors, less timely in recognizing losses, and exhibit higher discretionary accruals than similar non-connected firms. Together, these results suggest that politically connected private sector firms in China exhibit lower transparency than non-connected firms. We control for reverse causality by showing that firms which newly acquire political connections are more likely than non-connected firms to switch to small auditors. The results are also robust after controlling for endogeneity in a two-stage model. The likelihood of engaging big auditors is reduced further for politically connected firms in regions with weaker market institutions and in periods before enforcement action for corporate fraud. We also find that the post-listing performance of politically connected firms is superior to that of non-connected firms, resulting in a net benefit for minority shareholders. Out of all the potential benefits arising from political connections, our findings are consistent with rent-seeking being the dominant one.

1. Introduction

In this paper, we investigate whether listed private sector firms¹ that have political connection exhibit higher or lower reporting transparency than similar non-connected firms in China. The important role of China as a global economic player and the increasing share of the private sector within China's politically controlled economy render a study of the consequences of political connection important in its own right. Further, understanding the consequences of political connections and government influence has become globally important in informing the prevailing debate about the desirability of state capitalism and government influence in private sector.² Political rent-seeking through connections has been alleged even in free market economies such as US and Canada.³ Political connections might diminish in the presence of greater transparency. Furthermore, investors in advanced economies continue to increase their investment in China and other fast-growing emerging economies which have extensive state control over resources. Their interests demand a better understanding of the

¹ By Private Sector firms, we mean firms that are listed in Chinese stock exchanges but do not have state ownership. Consistent with Fan et al. (2007), we define a firm in the private sector as politically connected if an ex-government official serves as its CEO. We use this measure because it is publicly available and to the extent that other forms of political connection exist, it works against our finding significant results.

² Real world capitalism has been described in terms of a continuum of market spectrum with state capitalism comprising one half of the spectrum and free-market capitalism constituting the other half with countries moving from across this spectrum, often from one form to the other (Bremmer, 2010, pages 44-45).

³ The political connection of Goldman Sachs with the US ex-treasury secretary, Henry Paulson, is alleged to have played a role in the bailing out of AIG to which Goldman Sachs had a \$20 billion exposure (Financal Times, Oct. 14, 2008). Writing a column in Dow Jones Factiva Postmedia News on March 09, 2011, Tobi Cohen reports that former Canadian MP, Rahim Jaffer provided testimony regarding allegations of illegal lobbying and influence peddling on behalf of his company, Green Power Generation. The Government operations and estimates committee suggested that his testimony suggests an abuse of parliamentary privilege. Further, Ramanna et al. (2010) show that political connections in the US influence discretionary accruals.

interplay between transparent reporting and returns in these countries within the context of political connections and government influence in business.⁴

We examine in this study the firms that operate in the private sector as listed companies in China. In this regard, we differ from Fan et al. (2007) who focus on partially privatized firms in which the state still retained the controlling ownership stake after privatization.⁵ Unlike partially privatized firms, the private sector firms that we examine do not have any state ownership or control. Their choice of political connection, if any, is voluntary and not driven by state ownership. Therefore, our results are driven by non-state-based political connection established (or not established) voluntarily by the firms in question.

We find that politically connected private sector firms are less likely to engage big (higher quality) auditors and exhibit less informative accounting properties than similar non-connected firms.⁶ Together, the lower informativeness of earnings and the

⁴ Sternberg (2011) argues that investors in Hong Kong, including sophisticated foreign investors such as the American private equity firm the Carlyle Group (11% stake), bought shares of China Forestry Holdings Ltd. when it listed on the Hong Kong stock exchange (demand exceeded supply by 113 times for the retail tranche of the IPO in 2009) despite a short track record and *virtually no information about its business model*, mainly because of its political connections. "*In sum, investors were presented with a company possessing demonstrated skill at amassing a potentially valuable asset owing to its apparent good connections to the government and other industry insiders. Reading between the lines, such connections could also help in securing the logging permits the company would need on an ongoing basis to conduct what is supposed to its core business" (Italics added).*

⁵ The partial privatization process was officially called "corporatization" and prohibited the government from selling its controlling stake in the firms (non-tradable stocks) while issuing minority shares to individual investors that were traded on the Shanghai and Shenzhen stock exchanges.

⁶ There has been some debate on whether auditor size is an appropriate measure of audit quality in China. However, DeFond et al. (2000) document that larger auditors issue more modified opinions for similar firms relative to smaller auditors, and Wang et al. (2008) argue that large local auditors are more reputable and not as "acquiescing" as small auditors in China. Fan and Wong (2005) show that Big-4 auditors provide a corporate governance role in emerging Asian markets. Gul et al. (2010) show more stock price informativeness in firms audited by Big-4 auditors in China. Overall, there is considerable support in the literature for big auditors providing higher audit quality in China.

choice of lower quality auditors reflect lower transparency.⁷ The above result indicates that politically connected firms are less transparent. However, it could also be consistent with the argument that firms which engage lower quality auditors seek and obtain political connections. We conduct a change analysis which shows that firms that establish political connections are likely to switch to smaller auditors and become less transparent. Further, we show the association between political connections and low transparency in a two-stage analysis in which we predict political connections in the first stage and use the predicted connections in the second stage. Together the results from these two tests support the first argument that politically connected firms in China engage in political rent-seeking and avoid scrutiny by becoming less transparent and choosing lower quality auditors.⁸

As a large economy that is rapidly changing its focus from the state to the private sector within a state-controlled business environment, China presents an excellent natural experimental ground for studying issues of political connection and state influence in the private sector. Political connections in China can benefit a private sector firm in several ways.⁹ First, they can reduce the transaction costs involved in searching for and complying with regulatory and licensing procedures with the expert help of connected

⁷ Both these results together indicate lower transparency. *Higher* informativeness of earnings and lower quality auditors might indicate that the connected firms have less need for high quality auditors and engage smaller auditors to save costs. On the other hand, lower informativeness of earnings and *higher* quality auditors could indicate an attempt by the firms to signal that they are transparent, i.e., have nothing to hide while the lower earnings informativeness could arise because of inherent factors beyond their control. However, when both these results are present, it strongly indicates a lack of transparency.

⁸ We describe political rent-seeking later in the paper. In short, it involves seeking favors from political and government officials that result in abnormal returns to the business – rents.

⁹ Acquiring political connections and enjoying the benefits require the firm to adequately compensate the connected official and protect his or her reputation. All private sector firms cannot attract such connections and some find it prohibitively costly to do so. This explains the equilibrium wherein firms whose expected net benefits from connections are positive (negative) choose to (not to) acquire political connections.

officials. Second, the connected official could bring in superior professional management expertise, particularly in China where there is a longer tradition of management in stateowned enterprises (SOEs) than in private sector firms. The aforementioned benefits are sustainable and could even be higher in a transparent environment. In contrast, politically connected firms could benefit from political favors dispensed by the government. Such political rent-seeking (and dispensation of favors) involves self-interested opaque dealings with government officials with the objective of gaining preferential treatment in government contract awards and loans from state-owned banks, among other things. Political rent-seeking requires an implicit quid pro quo in which the official (providing the government connection) helps the firm in gaining political favors and the firm "protects" the official by hiding scrutiny facilitating information. The official is likely to fear exposure and loss of face in transparent environments, and is thus inhibited from dispensing political favors.¹⁰ Based on this reasoning, if connected firms derive benefits mainly from political rent-seeking, they are likely to be less transparent than similar nonconnected firms. Moreover, firms that acquire political connections are likely to become less transparent after that.

Although a growing body of research examines the role of political and economic institutions in the incentives of managers—particularly corporate insiders—to report transparently (Shleifer and Vishny 1994; Johnson and Mitton 2003; Bushman et al. 2004; Gul 2006; Faccio 2006; Leuz and Oberholzer-Gee 2006; Srinidhi et al. 2009), the

¹⁰ It is possible for a firm to decrease transparency while technically complying with the accounting standards – without committing fraud – but choose accounting policies that defer bad news (which attracts greater scrutiny) and make estimates that hide poor performance (for elaboration, see the vast literature on earnings management). They can also engage more acquiescent auditors who allow such policies and estimates to be practiced. In effect, these actions are manifested as lower conservatism, lower earnings quality, and a higher likelihood of low quality auditors – the variables that we examine.

findings are mixed with regard to reporting transparency. Chaney et al. (2011) find lower earnings quality among politically connected firms using non-Chinese data from Faccio's (2006) database on political connections in 47 countries. In an unpublished working paper, Guedhami et al. (2010) use the same database but find that politically connected firms are *more likely* to choose big auditors.^{11 12}

Similar to Miller (2004) and Gul (2006), we argue that the diversity of institutional features and differences in ownership structures could make the interpretation of the findings in cross-country studies more difficult. We focus instead on one country, China, which provides a common institutional environment and ownership structure for all of the firms in our sample.¹³ China is a large economy where much economic activity is still controlled by the government or SOEs and political connections are widespread in the private sector. The success of private sector firms is predicated on the awarding of government contracts and other government favors in this environment more than in environments where the government does not exercise as much control over resources. Further, in China the commercial banking system is dominated by state-owned

¹¹ Guedhami et al. (2010) use a signaling argument in support of the choice of big auditors. However, the strength of this signal could diverge significantly across the countries in their sample. Our finding of the preference for small auditors by politically connected firms in China is consistent with the need for safeguarding the benefits of rent-seeking dominating over the benefits of signaling through big-auditor choice. Moreover, Guedhami et al. (2010) use a multi-country sample and focus only on the Big-4 international auditors. In that respect, our paper and its results are not comparable with theirs.

¹² Although the two studies use the same database, their samples are not identical due to the need to match political connection information with, respectively, earnings and auditor information.

¹³ Governmental and regulatory institutions, the legal system including the enforcement of the laws and regulations, and extra-legal institutions such as the press are all part of the institutional environment referred to here. Although the strength of these institutions could vary across China, there is no variation in the law itself, and in any case the institutions across China are more homogenous than for an international sample chosen across different countries. Moreover, almost all of the politically connected firms in China are family owned, which provides a nearly homogenous ownership structure to the firms in our sample.

banks that provide much of the required capital. Therefore, political connections can arguably confer more benefits over a longer time in China than in most other countries.

Recent evidence from the U.S. and other non-Chinese countries suggests that politically connected firms exhibit lower earnings quality (Chaney et al. 2011), lower stock price informativeness (Kusnadi and Srinidhi 2010), and worse performance (Faccio et al. 2006) compared to similar non-connected firms. Our result showing lower earnings quality for politically connected firms in China is consistent with that of Chaney et al. (2011), but our result that politically connected firms shun high-quality auditors is inconsistent with the Guedhami et al. (2010) result. Guedhami et al. argue that higher quality (big) auditors are chosen by politically connected firms to signal to outside investors that political connections are not used to divert corporate resources away from them. However, the need to protect the (rent-procuring) connected official from scrutiny and exposure is perhaps higher, and the benefits of signaling to outside investors lower, in China compared to the countries covered by Faccio (2006).

We find that politically connected firms are significantly less likely to engage higher quality (big) auditors than non-connected firms, and in fact are likely to switch to small auditors when they acquire political connections. We confirm this result in a twostage analysis in which we predict political connections using loans from banks as an instrumental variable. The predicted political connections are negatively associated with the engagement of big auditors in the second stage.

We find that the likelihood of engaging big auditors is even lower for politically connected firms when the benefit of opacity is higher, as is the case for regions of China that have weaker legal institutions and greater government intervention or for periods before enforcement action for corporate fraud. Further, we find that politically connected firms are less timely in recognizing losses and exhibit smaller changes in reported earnings and higher discretionary accruals. Together, these results show that politically connected firms derive benefit primarily from rent-seeking and are less transparent than similar non-connected firms.

Another characteristic of private sector firms in China is that they are invariably controlled by dominant shareholders such as individuals or families. Political connections in these firms are sought and obtained by the controlling shareholders. The controlling insiders can "tunnel" the benefits of political connection away from the outside shareholders. It is an empirical question as to whether the effect of tunneling is small enough for non-controlling outside shareholders to still obtain residual benefits or large enough to limit the benefits of political connection to the insiders. We find that both the post-listing accounting returns (measured by return on assets and return on sales) and market returns (measured by cumulative abnormal returns) of politically connected firms exceed the returns of similar non-connected firms.¹⁴ This result shows that the residual rent-seeking benefits to non-controlling shareholders outweigh the tunneling effect.

This study contributes to the growing literature on the consequences of political connectedness of firms in different contexts, such as in free market economies including the U.S. (Goldman et al. 2009) or emerging economies like Malaysia (Gul 2006). To the best of our knowledge, ours is the first study to examine the consequences of political

¹⁴ We note that these results for private sector firms are different from the results for partially privatized firms studied by Fan et al. (2007). We argue that private sector firms in our sample choose to have political connection because it is beneficial whereas partially privatized firms might still be influenced by government policy and might not be able to exercise their choice regarding political connection. Therefore, the partially privatized firms might not derive benefits from political connection that exceed the cost of such connection.

connections on transparency for the private sector firms in China. We extend research in China beyond the shrinking SOE sector to the growing private sector. Private sector firms in China need to attract domestic and foreign investors for capital within a business framework largely defined by the government, making political connections an important means of doing so.

Our study also extends the recent accounting literature on the role of accounting properties such as accounting conservatism (e.g. Ball et al. 2000; Ball 2001; Ball et al. 2003; Ball and Shivakumar 2005) to a different context in which private sector firms operate in a politically controlled business framework. Taken together, our result that politically connected private sector firms do not demand high-quality audits and the result of Wang et al. (2008) that SOEs do not demand high-quality audits point to the overall lack of demand for high-quality audits in China. In effect, we offer a complimentary but non-policy-related explanation for the limited demand for high-quality auditors (despite the much improved supply) in China's current stage of economic development¹⁵.

More generally, we are able to obtain internally consistent results with regard to earnings quality and audit quality that support the political rent-seeking explanation for lower reporting transparency. In so doing, we show that in addition to the legal system (common vs. civil (Ball et al. (2000)), cultural tradition (Western vs. East Asian (Ball et al.2003)), ownership structure (SOEs vs. family-owned firms (Wang et al. (2008)), and listing status (listed vs. non-listed (Ball and Shivakumar (2005)), political connection is another factor affecting reporting transparency.

¹⁵ While Wang et al. (2008) tell a mainly government intervention story of using SOEs to achieve policy objectives (e.g. employment or social stability), ours is a political rent-seeking story in which the rent sought is solely for the benefit of the firms in the private sector.

The rest of the paper is organized as follows. Section 2 provides background information on the relationships between political connections, rent-seeking, transparency, auditing, and firm performance in China. Based on this background, we develop and state our hypotheses. Section 3 describes the data used in the study. Section 4 presents the empirical results. Section 5 presents our concluding remarks.

2. Description of the Background and Hypotheses

2.1 Private sector firms in China

The privatization policy initiated in 1990 resulted in the partial privatization of some state owned enterprises in China. More importantly, it also spawned the growth of entrepreneurial firms that were never state owned. As a consequence, the share of publicly listed non-state-owned enterprises has steadily increased in China.¹⁶ Amit et al. (2009) report that state-owned firms (including partially privatized firms with state ownership) constituted 62% of the 1,453 publicly listed firms as of 2007. The remaining firms have no state ownership and operate in the private sector. These firms are characterized by dominant shareholders who could be an individual, a family, or a team of co-founders or their families (Amit et al. 2009). According to the National Bureau of Statistics, the private sector in 2006 accounted for about 65% of China's GDP and 70% of its annual growth¹⁷. Out of these private sector firms, nearly 20% had political connections.

¹⁶ From 1999 to 2008, the share of SOEs declined from 68 percent to 44 percent in terms of assets, based on the industrial enterprise survey data released by China's National Statistical Bureau, covering all SOEs and other enterprises with annual sales larger than RMB5 million in the industrial sectors.

¹⁷ The importance of this sector is further illustrated by the relative size of the Chinese economy. China is larger (both in GDP and population) than the sum of 83 countries in Eastern Europe, the former Soviet Union, and all of Africa (Maddison, 2003).

2.2 Political connections and rent-seeking in Chinese private sector firms

As a result of the legacy of a command economy coupled with the strategy of gradual economic reform, the Chinese government remains in control of virtually all aspects of the economy, such as accesses to markets, finance, raw materials, and investment opportunities (e.g. Fan et al. 2008). We posit that in the Chinese context where access to capital and other resources are controlled by government, the primary benefit of political connections arises from gaining better access to these resources compared to other benefits arising from the technical, management, and regulatory expertise of the connected official. In free market environments where private investors and institutions control most resources, firms need to reassure outside investors that their invested resources are employed in a way that benefits investors. Such reassurance requires transparency. In contrast, in the Chinese economy where the government effectively controls the resources, private firms are likely to seek access to resources through political connections rather than transparent reporting. The protection of the connected official requires *less* rather than more transparency to reduce the chance of exposing the connected official to charges of influence peddling and exposing the government to charges of lack of objectivity in allocating resources.¹⁸ In effect, political rent-seeking becomes the primary determinant of (lack of) transparency in reporting.

Political rent-seeking can be described as a process of self-interested opaque dealings between government officials and private businesses (Morck and Yeung 2003; Krueger 1974) to invite the "helping hand" and stay the "grabbing hand" of government.

¹⁸ Gaining political favors to either secure the helping hand or stay the grabbing hand of the government can be costly to the connected official if he or she is exposed. In the past ten years, 17 entrepreneurs on the Rich List compiled by Forbes have been sent to jail, and one of those received a life sentence. The communist party chief of Shanghai was sentenced to 20 years in prison on corruption charges.

The dealings might include but are not limited to activities such as lobbying politicians, influencing judges, and cultivating relationships with bureaucrats to gain favorable treatment for the business such as obtaining government contracts, laxity in applying standards and the flexibility to bend rules. In so far as these favors are bestowed on one set of businesses but not others, they create a rent for the former and a barrier for the latter. Such rent-seeking arises if the business is connected with politicians or government officials (Faccio 2006; Morck and Yeung 2003).

While the government is the source of rent, the actual rent is channeled to the firm through trading "favors" with government officials (Fisman 2001; Faccio and Parsley 2009), who need to be paid off for using their influence and taking on the risk of exposure. Such payoffs are rarely explicit. The connected firms keep the payoff hidden to protect the government officials concerned. Disclosure of too much detail has the potential of alerting analysts and sophisticated investors about the implicit payoffs and thereby attracting scrutiny. Hence, firms seeking political rent have the incentive to be less transparent.

Political rent-seeking in China is characterized by several factors. 1) Private economic activities are relationship-based (Allen et al. 2005)¹⁹. Relationships are important to private businesses where legal institutions do not effectively protect the firm's interests by enforcing contracts (Rajan and Zingales, 1998; Morck et al. 2000; Yu and Zhang 2008). A relationship-intensive economy coupled with strong government influence implies that political connections—relationships with the government—are

¹⁹ In fact, "alternative...corporate governance mechanisms, such as those based on reputation and relationships...support the growth of the Private Sector." (Allen et al.,2005, p. 59).

arguably the most valuable relationship for private sector firms in China²⁰. 2) There are no opposition parties in China, and thus all political connections are with government officials from the communist party. 3) Some, if not all, rent-seeking activities are irregular or extra-legal. 4) The cost of transparency is likely to be higher in China than in most other countries because unlike in countries with multi-party political systems with free media, official favors can be bestowed on connected firms without being challenged by opposition or scrutinized by the media in China, and unnecessary disclosures could invite undesirable scrutiny and the risk of very severe penalties. 5) As the government in China has a much higher influence and ability to affect private sector firms' operating and investment decisions than in most countries, they are less dependent on external auditors for firm-level information, and this is more so for politically connected firms.

Lower transparency also enables the controlling shareholder and other insiders of the firm to divert ("tunnel") resources away from the firm to their private coffers. Such tunneling involves the diversion of corporate resources to private use and reduces the residual value of the firm available to small shareholders.²¹ Political connections and consequent rent-seeking can still benefit outside shareholders if their share of the incremental rent is higher than the loss of value because of tunneling. To assess the combined effects of political rents and the tunneling associated with information opacity for small shareholders, we investigate the post-listing performance of politically connected firms relative to that of non-connected firms.

2.3 Information Opacity, Auditor Choice and Earnings Quality

²⁰ A variety of devices are available to the government (e.g. legislation, licensing requirements, repudiation of commitments, re-nationalization) to "shut down a business, kick it out of its premises, or even refuse to allow it to start" (Shleifer, 1994, p. 97).

²¹ Small shareholders emerge as a group distinct from the controlling shareholders after listing.

The need to hide the benefits of political connections induces the insidermanagers of politically connected firms to curtail informative reporting and avoid unnecessary scrutiny of the reports by effective independent third-party auditors. Managers can hide these benefits by using their discretion in estimating accruals to make reported earnings less informative (Leuz et al. 2003). Further, bad news attracts greater scrutiny, which these firms seek to avoid. Hence, we expect that the reported earnings of politically connected firms are less likely to be conservative and are more likely to have larger uninformative discretionary accruals.

Big auditors are likely to push managers to reduce uninformative discretionary accruals (Teoh and Wong 1993; Khurana and Raman 2004; Becker et al. 1998) because they face higher audit risk when losses are not disclosed promptly (Abbott et al. 2006; Francis and Krishnan 1999; Krishnan 2005; Ball and Shivakumar 2005). In order to indulge in rent-seeking activities, politically connected firms are likely to shun big auditors and high-quality audits. They are more likely to favor smaller auditors who are dependent on a few clients for their survival. DeFond et al. (2000) document a similar flight from audit quality in the face of more stringent audit standards in China and attribute it to the incentives of state-owned enterprises (SOEs) to hide their performance. Wang et al. (2008) confirm that SOEs demand lower audit quality than private firms in China. They attribute the difference in auditor choice to the SOEs' incentives for a lower demand for audit quality than private firms. Leuz and Oberholzer-Gee (2006) show that Indonesian firms with political connections are less likely to list abroad and argue that the connected firms are reluctant to subject themselves to greater financial scrutiny than non-connected firms.

The demand-based explanation of auditor choice is consistent with the arguments of Ball and Shivakumar (2005) in their study of listed and non-listed U.K. firms. They argue that the demand for information quality in non-listed firms is lower than that in comparable listed firms, even though both face equivalent reporting requirements, regulations, and tax laws. The large number of small shareholders and bondholders in listed firms demand public disclosure (transparency), whereas larger but fewer shareholders, creditors, and suppliers of non-listed firms demand less public disclosure but substitute it with private communication. All of these studies suggest that improved information transparency and high-quality audit are costly for politically connected firms because they could damage political ties and eliminate the benefits of political connections.²²

Chinese firms enjoy considerable choice in selecting auditors. The Chinese audit market is highly competitive and less concentrated than that in the U.S. By the end of 2005 there were 5, 639 approved audit firms operating in China and the Big 4/5 auditors' market share has remained at about 10% in the last ten years (Chen et al. 2008). While international auditors (the Big 4/5) and top-ten domestic auditors (as measured by the domestic market share of assets audited) are available to provide high-quality service because of their expertise, reputation, and independence, there are also many small (i.e. non-top-10) domestic auditors who provide relatively low-quality service. As the supply

²² In a related paper, Fishman (2001) concludes that in Indonesia, a large portion of a politically connected firm's value comes from political ties (or rent-seeking activities).

of auditors is the same for all firms in our single-country setting²³, a difference in auditor choice between firms is explained by demand factors.

Apart from choosing lower quality audits, we also expect politically connected firms to exhibit less propensity to promptly recognize losses. Further, after controlling for this lack of conservatism, we expect those firms to exhibit higher uninformative discretionary accruals. We state these expectations formally as hypotheses in the next section.

2.4 Hypotheses

Our primary auditor choice hypothesis is stated as follows:

Hypothesis 1: Politically connected private sector firms are less likely to choose highquality auditors than non-connected firms, other things being equal.

We base our primary auditor choice hypothesis on the expectation that political connections yield benefits mainly from rent-seeking. Political rent-seeking is more likely in jurisdictions where the institutions that restrain such behavior are weaker. There are large regional variations in institutional development across China. The hinterland regions have weaker market-supporting institutions and exhibit stronger government intervention in resource allocation than the coastal regions. In regions with weaker institutions, unencumbered by market forces, political rent-seeking is likely to be more effective and arguably more "irregular". Consequently, politically connected firms from these regions are likely to exhibit more information opacity than politically connected firms from other regions. Thus, our second auditor choice hypothesis is as follows:

²³ We recognize that very small audit firms cannot audit large clients because of resource constraints. However, we compare politically connected family firms with the non-connected family firms that are similar. These two sets are similar in the supply of auditors.

Hypothesis 2: The likelihood of choosing high-quality auditors is further reduced for politically connected firms in regions of weaker institutions, other things being equal.

Firms facing legal or regulatory enforcement action for corporate fraud are on average more likely to have undertaken irregular actions and violated rules and norms than firms not facing such action.²⁴ In particular, politically connected firms facing such enforcement action are likely to find the withholding of information more beneficial in the period before enforcement action than in other periods. Our third auditor choice hypothesis can be stated as follows:

Hypothesis 3: The likelihood of selecting high-quality auditors is further reduced for politically connected firms in the period before enforcement action for corporate fraud, other things equal.

Our results on auditor choice are based on the rationale that politically connected firms are less likely than their peers to be transparent. Consistent with the accounting literature, we use the timely loss recognition (Basu, 1997; Ball et al. 2003) or conservatism in reporting—the willingness of a firm to recognize bad news more promptly than good news in its financial statement—as a measure of transparency. Politically connected private sector firms that demand lower audit quality are likely to exhibit less conservative reporting than their peers. Further, we expect politically connected firms to exhibit higher discretionary accruals after controlling for the lack of conservatism and after controlling for a performance measure such as cash flows. We state this expectation formally as follows:

²⁴ We define corporate fraud to be irregular corporate activities that result in legal or regulatory enforcement actions.

Hypothesis 4: Politically connected firms exhibit lower accounting conservatism in reporting than non-connected firms. Politically connected firms also exhibit higher absolute discretionary accruals after controlling for the lack of conservatism and operating cash flow.

2.5 Post-listing Performance and Valuation

Almost all the private sector firms in China are controlled by dominant shareholders. The controlling insiders make the auditor (audit quality) choice. The political rent-seeking argument suggests that the controlling insiders seek rents from political connection and choose lower quality auditors to shield the rent-seeking transactions. However, the reduced transparency in insider-controlled firms enables insiders to "tunnel" the firm's corporate resources away from the outside shareholders. Although political rent-seeking could increase the overall firm value because of the rent (or favors) received through political connections, the tunneling of the firm value by the controlling shareholders reduces the part of firm value available to the minority outside shareholders (Johnson et al. 2000; Jiang et al. 2010). After public listing, the share price denotes the value placed on the firm by minority shareholders. Therefore, the post-listing performance across firms reflects the net effect for minority shareholders. If the positive effect of political rent-seeking dominates the negative effect of tunneling, the net effect should be a post-listing performance premium in politically connected firms. On the other hand, if the negative effect of tunneling dominates the positive effect of political rentseeking, the net effect should be a post-listing performance discount in politically connected firms. We examine the post-listing performance to explore the net effect of political connections on the outside shareholders.

3. Data and Sample Description

We test the hypotheses using a sample of private sector firms in China. Ultimate control of a firm is identified through its published annual report. Listed firms are subject to the mandatory requirement of reporting the ultimate controlling owner in annual reports since 2001. As our study covers the period from 1999 to 2007, we treat the ultimate owner of a firm in 1999 and 2000 to be the same as in 2001 unless there is a change in the controlling owner. In the latter case, we use information from annual reports before the change along with information from the financial press to ascertain ultimate ownership. We exclude the few firms under the control of foreign owners because the business models of such firms are likely to differ significantly from those of their domestic counterparts. Our selection criteria produced a sample of 2,774 firm-year observations.

Following the convention in the literature (Fisman 2001; Faccio 2006), the proxy for political connections is based on what can be commonly observed. Political Connections is set to one if the CEO of a firm is an ex-government official and zero otherwise (see footnote 1). Both the names and employment histories of CEOs in our sample were obtained manually from the company annual reports, and the financial and business press in China. The non-availability of data on CEO backgrounds reduced our sample to 2,681 firm-year observations.

Consistent with the literature, we use auditor size as a proxy for audit quality (Teoh and Wong 1993; Khurana and Raman 2004; Becker et al. 1998). The variable "*Big Auditor1*" is set to one if an audit firm is an international Big 4/5 or domestic top-10

auditor (based on the market share of total assets audited) in the fiscal year in which the auditor was engaged and zero otherwise. A second variable "*Big Auditor2*" is defined as the domestic top-10 auditor.^{25 26} We manually collected the information on mergers and splits of audit firms in our sample period to control for their effects on market share. The auditor data was obtained from China Securities Market and Accounting Research (CSMAR) and from documents published by the China Securities Regulatory Commission (CSRC). Other financial and market related data used in the paper is also obtained from CSMAR. Missing auditor and financial information reduces our sample further to a final 2,446 firm-year observations.

Panel A of Table 1 reports the sample distribution by year. The number of private sector firms increased steadily from 83 in 1999 to 435 in 2007. The more than 500% increase attests to the growing influence of the private sector and, perhaps more importantly, to the changing character of the corporate sector in China (less "state" and more "market"). Panel B of Table 1 reports the sample distribution by industry. While the majority of the firms (56%) are engaged in manufacturing, several also appear in tightly

 $^{^{25}}$ The audit market in China has experienced some merger activity during the sample period which results in an audit firm that is small in an earlier year might have merged with a bigger auditor and therefore might be categorized as a big auditor in the subsequent years. Our choice of the variables to reflect big auditors is conservative. Even if a client chooses and retains an auditor who moves into the "Big auditor" category in at a later period, we still treat the choice of that auditor in the earlier year as the choice of a small auditor. Underlying this choice is the argument that the audit quality improves when a small auditor merges with a big one – an argument that is supported in the literature.

²⁶ We also find consistent results when we use auditor locality as a proxy for audit quality (local auditors as lower quality) but the results lack significance. A plausible reason for the lack of significance may be that although non-local auditors might exhibit greater independence, they might be less informed about the client than local auditors.

regulated industries such as mining, finance and public utilities. About 20% of the firms in our sample are politically connected²⁷.

Insert Table 1 here

Panel C of Table 1 describes the choice of auditor (big or small) in the sample stratified by political connection. We further divide the sample of politically connected firms into local and non-local samples. A firm with local political connection has a CEO who is an ex-government official in the local jurisdiction where the firm is registered. A firm with non-local political connection has a CEO who is an ex-government official for the central government or a local government outside the jurisdiction where the firm is registered.

If *Big Auditor* is defined as either international or domestic top-10 (*Big Auditor 1*), 32% of the firms during 1999-2007 chose big auditors. However, only 25% of the politically connected firms (18% of the locally connected firms) chose big auditors during this period while 34% of non-connected firms did so. When *Big Auditor* is defined as domestic top-10 (*Big Auditor 2*), 29% of the firms chose big auditors during this period. Only 22% of the politically connected firms (17% of locally connected firms) chose big auditors whereas 31% of the non-connected firms did so. Two patterns can be seen here. First, there are substantially more non-connected firms choosing big auditors than politically connected firms²⁸. If we leave out 1999-2000, when the sample size for locally connected firms is very small, we find that locally connected firms consistently

²⁷ It should be noted that there are more politically connected firms in the Electric, Gas, and Sanitary Services sector, which might require less intensive auditing than other sectors. In other words, both connected and non-connected firms may prefer small auditors. This potential selection problem biases against finding results in favor of our hypotheses.

²⁸ We note that this trend weakened somewhat in the latter years. This may have occurred because more small firms, which tend to use small auditors, have been able to list since the establishment of the SME board.

chose fewer big auditors compared to the full sample of politically connected firms or the sample of non-connected firms. These patterns suggest that the negative effect of political connections on transparency is most acute when the connections are with local officials.

Table 2 presents descriptive statistics of the variables used in this paper. The average ownership of the largest controlling shareholders given in Panel A of Table 2 is about 30% with the minimum at 10% and the maximum at 60%, suggesting effective control by the largest shareholder in our sample of firms. There is no discernable difference in ownership between politically connected firms and non-connected firms (Panel B, Table 2). There is also no discernable difference in size between connected and non-connected firms. However, politically connected firms tend to have more bank loans and locate in regions with weaker legal institutions.

Insert Table 2 here

Panels A and B of Table 3 present the Pearson and Spearman correlations of the variables, respectively. In both panels, political connections are negatively and significantly correlated to the choice of a big auditor.

Insert Table 3 here

4. Results

4.1. Political Connections and Auditor Choice

4.1.1 Baseline Model

We first examine the impact of political connections on auditor choice in the baseline model. The logistic regression results are presented in Table 4. The coefficient of Political Connections is negative and statistically significant in Models 1 and 3. These

results suggest that politically connected firms are negatively associated with the choice of big auditors. This result is consistent with Hypothesis 1.

Insert Table 4 here

As political rent-seeking (and the ability to bestow political favors) is likely to be greater when the connected official is influential in the jurisdiction where the firm is located, we expect local political connections to have a stronger impact on auditor choice than non-local political connections. Accordingly, we divide the sample of politically connected firms into sub-samples with local and non-local political connections and examine their effect on auditor choice in Models 2 and 4. While the coefficient of Local Political Connections is negative and statistically significant (at the 1% level) in both Models 2 and 4, the coefficient of Non-local Political Connections is not significant. In effect, our evidence shows that only local political connections significantly affect the connected firm's auditor choice.

The Size coefficient is positive and statistically significant, suggesting that larger firms are more likely to select big auditors. The coefficient of ROA is significantly positive, implying that better performing firms are also more likely to select big auditors.

4.1.2. Control for Endogeneity

The foregoing results could support two possibilities. The first is that politically connected firms choose small auditors, and the second is that firms which choose small auditors seek political connection.²⁹ We address this endogeneity problem by conducting two tests: (i) a "change analysis" to determine whether the acquisition of political

²⁹ Another possible explanation is that politically connected firms choose politically connected auditors, not necessarily differentiating on quality. However, a brief search revealed that the big auditors are more connected than the small ones. As such, the explanation based on the political connections of auditors does not have any support.

connections is associated with a switch in auditors; and (ii) a two-stage analysis where we predict political connections in the first stage and use the predicted connections in the second stage.

4.1.2.1 Change Analysis

Panel A of Table 5 shows that out of the 77 firms which acquired new political connections during our sample period, 27 firms or 35% changed auditors and the majority (21 firms or 27%) switched to small auditors. In contrast, out of the firms that did not acquire political connection, only 17% changed auditors and 11% switched to small auditors. These differences between the group in which new political connections were established and the no-change group are statistically significant. Panel B of Table 5 shows the descriptive statistics of the variables used in the auditor switch analysis.

Insert Table 5 here

The foregoing univariate results are confirmed by the multivariate results in Panel C of Table 5. The acquisition of political connections is positively associated with the likelihood of switching auditors (Model 1, Panel C in Table 5). Moreover, the result in Model 1 is largely driven by the significant likelihood of a switch to a small auditor as the firm acquires political connections (Model 2, Panel C in Table 5). There is no evidence that a firm would switch to a large auditor after acquiring political connections (Model 3, Panel C in Table 5). These results lend support to the argument that the results in Table 4 support Hypothesis 1: i.e., politically connected firms choose smaller auditors.

4.1.2.2 Two-stage analysis

Panel D of Table 5 shows the results of the two-stage analysis using an indicator variable for the presence of outstanding loans from commercial banks at the end of the

fiscal year (Loans) as the instrument variable. A valid instrumental variable should be correlated with political connection (the endogenous regressor) but must be uncorrelated with the error in the structural equation (Larcker and Rusticus, 2010). Most commercial banks in China are state-owned and thus it is likely that the need for loans from banks increases the demand for political connections. However, having a loan from a bank (as opposed to having no loan at all) is unlikely to induce lower transparency, i.e., make the firm choose a smaller auditor. A direct logistic regression with Big Auditor 1 and Big Auditor 2 as dependent variables and *Loans* as an explanatory variable shows no significant relation between *Loans* and transparency in both the politically non-connected and politically connected firms.³⁰

The results in Panel D of Table 5 show that in the first stage there is a strong positive relation between the presence of bank loans and political connections. We use the first stage to predict the presence of political connections, and in the second stage use the predicted political connections as the treatment variable. We find a significant negative association between the predicted political connections and the choice of higher quality auditors – both Big Auditor 1 and Big Auditor 2. These results also confirm that the results in Table 4 support the hypothesis that politically connected firms choose smaller auditors.

4.1.3. The Impact of Political Connection on Auditor Choice across Regions

Panel A of Table 6 presents the results of the differential effects of political connections on auditor choice in regions with different levels of institutional

³⁰ We run logistic regressions with Big Auditor 1 and Big Auditor 2 as dependent variables and the following explanatory variables: Loans, Ownership, Leverage, Return on Assets, Size, Fixed Assets, Market-to-book with year and industry dummies separately for politically connected and non-connected samples. The variable, *Loans* is not significant in any of the four regressions.

development (Hypothesis 2). This regional variation is captured by two widely adopted indexes compiled by Fan and Wang (2001): the index for legal environment and the index for government intervention in resource allocation for 31 regional jurisdictions across China. The legal index ranges from poor legal environment (low) to good legal environment (high). The government intervention index ranges from strong government intervention (low) to weak government intervention (high). We set the variable Strong-Legal to one for a region if its legal environment index is above the median of these regions, and zero otherwise. We also set the variable Weak-Govt-Intervention to one for a region if its index for government intervention in resource allocation is above the median of these regions, and zero otherwise. Both Strong-Legal and Weak-Govt-Intervention are designed to distinguish the regions with stronger institutions from those with weaker institutions.

The results show positive and statistically significant coefficients for Strong-Legal in Models 1 and 3, which show that private sector firms in regions with stronger legal environments are more likely to select big auditors. Weak-Govt-Intervention, however, is not significant in Models 2 and 4. The coefficient of Political Connections is negative and strongly significant in all 4 models. The Size (Return on Asset) coefficient is positive and statistically significant in all 4 models (Models 1, 2, and 4), suggesting that larger (more profitable) firms are more likely to choose big auditors. The average interaction effects of Political Connections*Strong-Legal are positive but insignificant in Models 1 and 3 and the average interaction effects of Political Connections*Weak-Govt-Intervention are positive and significant in models 2 and 4³¹. This evidence suggests that

³¹ In all logistic regressions with interaction terms, our interpretation is based on the average interaction effect (see, e.g., Powers 2005).

1) politically connected firms remain on average less likely to choose big auditors than non-connected firms; and 2) this likelihood is lower (higher) for politically connected firms in regions with strong (weak) government intervention in resource allocation. These results are consistent with Hypotheses 2.

Insert Table 6 here

4.1.4. The Impact of Political Connections on Auditor Choice before Enforcement Action

To examine Hypothesis 3, we set Pre-Enforcement to one, for years before an enforcement action on a firm, and zero otherwise. Panel B of Table 6 shows the logistic regressions results.

The results in Panel B of Table 6 show that the politically connected firms remain significantly less likely to select big auditors in all periods, as shown by the negative and significant coefficients of Political Connections in both models. This likelihood is further reduced for the politically connected firms in the period before an enforcement action, as shown by the negative and significant average interaction effect of Pre-Enforcement*Political Connections in both regressions. This result is consistent with Hypothesis 3.

The two tests above, one based on regional variation in institutional development and the other on whether the period is before an enforcement action for corporate fraud, are effectively difference-in-difference tests. They are more direct in evaluating the impact of political connections on auditor choice because they evaluate the impact of political connections (the first difference) on a firm's auditor choice in regions or periods (the second difference) in which the benefit of information opacity is likely to be greater.

4.2 Earnings Quality

Table 7 gives the results of the association between political connections and accounting conservatism. Panel A of Table 7 gives the descriptive statistics of net income, market return, and proportion of losses in politically connected and non-connected firms. The results from the earnings-returns model (Basu 1997) for the whole sample and the sub-samples of firms choosing big auditors and small auditors are shown in Panel B of Table 7. These results show that politically connected firms are significantly less timely in recognizing losses (as shown by the negative coefficient of Political Connections*RD*Return in Model 1). In particular, politically connected firms with small auditors show a strong and significant tendency for less timely loss recognition. Less timely loss recognition is also consistent with the (non-transparency-based) argument that politically connected firms might face less bad news than unconnected firms and therefore has less need to be conservative. However, this is not likely because the interaction term Political Connections*RD is not significant, which indicates that there is no significant difference in bad news between connected and non-connected firms.

Panel C of Table 7 shows results from the income persistence model (Basu 1997). Those results also show stronger income persistence for politically connected firms regardless of whether or not they are audited by big auditors.

Insert Table 7 here

In addition to timely loss recognition, we also use the Ball and Shivakumar (2006) model (which controls for the lack of accounting conservatism and for current cash flow) to test the level of unsigned discretionary accruals of the firms in our sample. The absolute value of discretionary accruals has often been used to test the quality of earnings under the assumption that these accruals could be used by managers opportunistically to alter income (Fan and Wong, 2002; Haw et al. 2004). The results of our tests are given in Table 8. The univariate results in Panel A of Table 8 show that the mean absolute discretionary accrual of the politically connected firms is significantly higher than that of the non-connected firms. Multivariate results including control variables given in Panel B of Table 8 also show that the level of unsigned discretionary accruals is significantly higher for politically connected firms. Taking the results of timely loss recognition and discretionary accruals together, the evidence suggests politically connected firms, which are more likely to select low audit quality than non-connected firms, also exhibit lower earnings quality than non-connected firms. These results support Hypothesis 4.

Insert Table 8 here

4.3. Post-listing Performance

To assess the overall effects of political connection, including the benefits of political rents and costs such as low transparency in accounting reports and low audit quality for small shareholders in politically connected insider-dominated firms, we compare the post-listing performance of political connected insider-dominated firms with that of non-connected insider-dominated firms. We use three measures of performance: two accounting measures—the changes in return on assets (ROA) and return on sales (ROS) from two years before to two years after listing—and one market measure—CAR, the cumulative monthly abnormal return (firm-return minus market return) in the two years after listing.³² The results are presented in Table 9.

³² Admittedly, there might be earnings management, especially in the pre-listing period which introduces noise in the measure of changes in ROA and ROS. However, we have no reason to suspect any bias that can only result from politically connected firms engaging in systematically different earnings management

Insert Table 9 here

The results of the univariate analysis (Panel A, Table 9) show that the post-listing performance measured as a change in ROA or ROS is significantly higher for politically connected insider-dominated firms. CAR is also higher for politically connected insider-dominated firms but the difference in CAR between the two types of firms is not significant. Multivariate results (Panel B, Table 9) also show that the post-listing changes in ROA and ROS as well as CAR are all significantly higher for politically connected firms. Furthermore, there was no change in the results when we adjusted the ROA and ROS measures for discretionary accruals and used the modified ROA and ROS in the analysis. We interpret these results as meaning that political connections generate a net benefit in terms of improved performance for minority shareholders. The benefits to outside shareholders from rent-seeking appear to dominate the costs of tunnelling. In effect, acquiring political connections seems to be beneficial to insider-dominated private sector firms in China—both to insiders and to external minority shareholders. We conjecture that non-connected firms remain non-connected only because they are not able to gain the political connections they desire.

5. Concluding Remarks

The private sector in China has become an important part of her economy and continues to increase in size, making a study of these firms worthwhile and important in its own right. Moreover, these firms operate in a business environment in which the government exerts control over their access to capital and other resources. In such an

compared to non-connected firms. However, such noise will be rationally expected by the market and therefore, we supplement our accounting measures with CAR, which is a market measure.

environment, acquiring political connection could be viewed as one way of gaining preferential access to resources. Such political rent-seeking engenders lower transparency to shield rent-seeking activities from public scrutiny. This is in contrast to firms that operate in environments where resources are mostly controlled by free-market institutions and investors demand greater transparency to choose the stocks to invest in. This fundamental difference between the listed firms in the free market economies of the West and private sector firms in China encourages more transparency and less political rentseeking in the former but more political rent-seeking and lower transparency in China.

In this paper, we examined the impact of political connections on the transparency of reporting in publicly listed private sector firms in China. We use the properties of earnings report as well as the auditor choice as joint measures of transparency. This is arguably the first study to examine the consequences of political connections for transparency in the private sector listed firms operating in the context of governmentcontrolled access to resources. China presents a natural experimental ground for studying this issue. Further, unlike an international study encompassing a multitude of countries with different institutional structures, legal and political systems and reporting and auditing capabilities, a focused study of China such as this one can yield specific insights into how government influence and political connections affect reporting and auditing decisions.

An understanding of the relation between political connections and reporting transparency is important for three reasons. First, China and other emerging economies where the governments exert control over capital and infrastructure resources now constitute a significant part of the portfolios of investors in the US and other advanced economies. Second, there is increasing government intervention in business even in western economies and therefore, it is important for capital market participants in those countries to understand how such intervention might affect transparency. Third, since rent-seeking behavior tends to result from government control of resources (wherever this exists), its impact on reporting transparency is likely to be general rather than country-specific.

We find that politically connected private sector firms in China are significantly less transparent (less timely in recognizing losses and lower in earnings quality) and are less likely to choose high quality auditors than non-connected firms. This likelihood is further reduced for politically connected firms in situations where the benefit of opacity is higher, such as in regions with weaker institutions or in periods before enforcement action for corporate fraud. In addition, we find that the acquisition of political connections in private sector firms is positively associated with the likelihood of switching to small auditors. The post-listing performance is better for firms with political connections (despite their relative information opacity) than for non-connected firms.

Our finding of lower quality of accounting information is internally consistent with our second finding - a "race to the bottom"—the choice of lower quality auditors in Chinese private sector firms. This contrasts with the findings in multi-country settings where the earnings quality of politically connected firms has been shown to be lower but the connected firms seem to choose big auditors.

Collectively, our results suggest that 1) political rent-seeking is associated with lower earnings quality and lower audit quality but 2) the net effect of political rentseeking appears to be positive for small shareholders of politically connected insiderdominated private sector firms in the relationship-intensive and politically sensitive business context of China. More generally, our results imply that political rent-seeking through connections is associated with government control of capital and infrastructure resources, particularly in relationship-intensive economies with a single-party political system. Further, the cost of information transparency for politically connected firms is likely to exceed the benefits.

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Table 1 SamplePanel A: By year

This panel presents the sample distribution by year of the full sample and the sample of politically connected firms of which CEOs are ex-bureaucrats. The percentages of politically connected firms are also reported.

		Politically connected firms				
Year	Full sample		As percentage of			
		Ν	full sample			
1999	83	9	10.84%			
2000	115	20	17.39%			
2001	146	30	20.55%			
2002	246	53	21.54%			
2003	295	76	25.76%			
2004	354	78	22.03%			
2005	372	68	18.28%			
2006	400	69	17.25%			
2007	435	71	16.32%			
Total	2,446	474	19.38%			

Panel B: By Industry

This panel presents the sample distribution by industry of the full sample and the sample of politically connected firms of which CEO are ex-bureaucrats. The percentages of politically connected firms are also reported.

		Politically connected firms			
Industry	Full sample		As percentage of		
		Ν	full sample		
Agriculture, Forestry, and Fishing	85	21	24.71%		
Mining	4	0	0.00%		
Manufacturing	1,391	245	17.61%		
Electric, Gas, and Sanitary Services	25	8	32.00%		
Construction	43	6	13.95%		
Transportation	32	10	31.25%		
Communication	240	28	11.67%		
Wholesale and Retail Trade	133	40	30.08%		
Finance	19	4	21.05%		
Real Estate	147	38	25.85%		
Public Utility	36	4	11.11%		
Culture, Sport and Entertainment	27	3	11.11%		
Conglomerate	264	67	25.38%		
Total	2,446	474	19.38%		

Table 1 (continued)Panel C: By Auditor Choice

This panel presents the sample distribution by auditor choice and political connection. A local politically collected client is a firm with a CEO who is an ex-bureaucrat in a local/regional jurisdiction where the firm is registered, and zero otherwise. Big Auditor 1 equals one if the auditor firm is an international Big 4/5 auditor or domestic top-ten auditor ranked by the market share of total assets audited, and zero otherwise. Big Auditor 2 equals one if the auditor firm is a non-top-ten domestic auditor.

	1999	2000	2001	2002	2003	2004	2005	2006	2007	Total
Big Auditor 1 measured as internationa	al audito	r or top ten	domesti	c auditor	[.] with reg	ards to n	narket s	hare		
Pooled Sample										
Total number of clients	83	115	146	246	295	354	372	400	435	2,446
Percentage of clients hiring big auditor	29%	34%	38%	35%	31%	32%	29%	32%	32%	32%
Politically connected sample										
Total number of clients	9	20	30	53	76	78	68	69	71	474
Percentage of clients hiring big auditor	11%	10%	40%	36%	18%	22%	19%	29%	28%	25%
Local politically connected clients										
Total number of clients	5	8	15	29	44	42	40	43	38	264
Percentage of clients hiring big auditor	20%	25%	20%	24%	14%	12%	15%	26%	18%	18%
Non-connected sample										
Total number of clients	74	95	116	193	219	276	304	331	364	1,972
Percentage of clients hiring big auditor	31%	39%	37%	35%	35%	36%	31%	33%	32%	34%
Big Auditor 2 measured as domestic to	p ten aud	litor								
Pooled Sample	-									
Total number of clients	81	110	139	231	281	339	356	389	423	2,349
Percentage of clients hiring big auditor	27%	31%	35%	31%	27%	29%	26%	30%	30%	29%
Politically connected sample										
Total number of clients	9	19	28	50	74	74	65	67	69	455
Percentage of clients hiring big auditor	11%	5%	36%	32%	16%	18%	15%	27%	26%	22%
Local politically connected clients										
Total number of clients	5	7	14	29	44	41	39	42	38	259
Percentage of clients hiring big auditor	20%	14%	14%	24%	14%	10%	13%	24%	18%	17%
Non-connected sample										
Total number of clients	72	91	111	181	207	265	291	322	354	1,894
Percentage of clients hiring big auditor	29%	36%	34%	30%	31%	33%	28%	31%	31%	31%

Table 2 Descriptive Statistics

This table presents descriptive statistics of the variables used in the analysis. Big Auditor 1 equals one if the auditor firm is an international Big 4/5 auditor or a domestic top ten auditor ranked by the market share of total client assets audited, and zero otherwise. Big Auditor 2 equals one if the auditor firm is a domestic top-ten auditor, and zero if the auditor firm is a non-top-ten domestic auditor. Politically Connections equals one if a firm's CEO is an ex-bureaucrat, and zero otherwise. Strong-Legal equals 1 if the index for legal environment (high for strong, low for weak) of the region from Fan and Wang (2001) is above the median of 31 jurisdictions, and zero otherwise. Weak-Govt-Intervention equals one if a year is before a legal- or regulatory-enforcement action on a firm for corporate fraud, and zero otherwise. Ownership is the percentage of voting rights owned by the controlling shareholder in the company. Leverage is the ratio of total liabilities to total assets. Return on assets is the ratio of net income to total assets. Fixed Assets is the ratio of the net value of property, plant and equipment to total assets. Size is the logarithm of total assets. Market-to-book is the market-to-book equity ratio. Loans equals one if a firm has loans from a state-owned bank, and zero otherwise. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels for t-tests and Wilcoxon for mean and median, respectively.

Variable	Ν	Mean	Median	Std. Dev.	Min.	Max.
Big Auditor 1	2446	0.32	0.00	0.47	0.00	1.00
Big Auditor 2	2349	0.29	0.00	0.45	0.00	1.00
Strong-Legal	2417	0.69	1.00	0.46	0.00	1.00
Weak-Govt-Intervention	2417	0.71	1.00	0.45	0.00	1.00
Pre-Enforcement	2446	0.09	0.00	0.29	0.00	1.00
Political Connections	2446	0.19	0.00	0.40	0.00	1.00
Ownership	2446	30.38	28.58	12.27	10.00	60.00
Leverage	2446	0.57	0.53	0.34	0.13	2.04
Return on Assets	2446	0.00	0.03	0.12	-0.50	0.16
Size	2446	20.74	20.71	0.89	18.81	22.72
Fixed Assets	2446	0.25	0.23	0.15	0.01	0.62
Market-to-book	2446	4.26	2.99	4.52	-3.25	21.37
Loans	2446	0.373	0	0.48	0.00	1.00

Panel A: Pooled sample

Variable	Poli	tically Conne	ected Firms		Non-politically Connected Firms				
				Std.				Std.	
	Ν	Mean	Median	Dev.	Ν	Mean	Median	Dev.	
Big Auditor 1	474	0.25***	0.00	0.43	1972	0.34	0.00	0.47	
Big Auditor 2	455	0.22***	0.00	0.41	1894	0.31	0.00	0.46	
Strong-Legal	468	0.65***	1.00	0.48	1949	0.70	1.00	0.46	
Weak-Govt-Intervention	468	0.74	1.00	0.44	1949	0.70	1.00	0.46	
Pre-Enforcement	474	0.07	0.00	0.26	1972	0.10	0.00	0.29	
Ownership	474	30.11	28.39	12.48	1972	30.45	28.61	12.23	
Leverage	474	0.58	0.55	0.35	1972	0.57	0.53	0.34	
Return on Assets	474	0.00*	0.02***	0.13	1972	0.01	0.03	0.12	
Size	474	20.72	20.78	0.88	1972	20.74	20.70	0.89	
Fixed Assets	474	0.25	0.22	0.17	1972	0.25	0.23	0.15	
Market-to-book	474	4.27	2.79	4.77	1972	4.25	3.01	4.45	
Loans	474	0.46***	0.00***	0.50	1972	0.35	0.00	0.48	

Table 2 (continued)Panel B: By Political Connection Type

Table 3 Correlation matrix

This table presents the correlation matrix of all variables defined in Table 2. The values in italics are p-values.

Panel A: Pearson

		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
(1)	Big Auditor 1	1.00			2 /	2 6				~ /			
(2)	Big Auditor 2	1.00	1.00										
		0.00											
(3)	Political Connections	-0.07	-0.08	1.00									
		0.00	0.00										
(4)	Strong-Legal	0.19	0.17	-0.04	1.00								
		0.00	0.00	0.05									
(5)	Weak-Govt-Intervention	-0.02	-0.01	0.03	0.09	1.00							
		0.24	0.65	0.20	0.00								
(6)	Enforcement	0.04	0.04	-0.03	-0.06	-0.05	1.00						
		0.04	0.07	0.14	0.00	0.02							
(7)	Ownership	0.05	0.04	-0.01	0.08	0.10	-0.04	1.00					
		0.01	0.05	0.58	0.00	0.00	0.08						
(8)	Leverage	-0.04	-0.04	0.02	-0.04	-0.03	0.06	-0.16	1.00				
		0.05	0.09	0.38	0.04	0.20	0.01	0.00					
(9)	ROA	0.09	0.07	-0.03	0.07	0.02	-0.06	0.14	-0.52	1.00			
		0.00	0.00	0.13	0.00	0.44	0.00	0.00	0.00				
(10)	Size	0.15	0.10	-0.01	0.05	0.05	-0.03	0.07	-0.02	0.23	1.00		
		0.00	0.00	0.62	0.02	0.02	0.09	0.00	0.27	0.00			
(11)	Fixed Assets	-0.04	-0.04	-0.02	-0.02	0.05	-0.07	-0.07	0.04	-0.09	-0.01	1.00	
		0.04	0.06	0.36	0.22	0.01	0.00	0.00	0.04	0.00	0.66		
(12)	Market-to-book	0.01	0.02	-0.01	-0.02	-0.09	0.09	0.01	-0.02	0.13	-0.25	-0.09	1.00
		0.72	0.30	0.71	0.22	0.00	0.00	0.51	0.23	0.00	0.00	0.00	
(13)	Loans	-0.08	-0.07	0.09	-0.15	-0.06	0.07	-0.03	0.24	-0.16	-0.07	0.00	0.05
		0.00	0.00	0.00	0.00	0.00	0.00	0.10	0.00	0.00	0.00	0.88	0.01

Panel B: Spearman

		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
(1)	Big Auditor 1	1.00											
(2)	Big Auditor 2	1.00	1.00										
(2)	Political Connections	0.07	0.08	1.00									
(3)	r ontical Connections	-0.07	-0.08	1.00									
(4)	Strong-Legal	0.00	0.17	-0.04	1.00								
(.)	Suong Loga	0.00	0.00	0.05	1.00								
(5)	Weak-Govt-Intervention	-0.02	-0.01	0.03	0.09	1.00							
()		0.24	0.65	0.20	0.00								
(6)	Enforcement	0.04	0.04	-0.03	-0.06	-0.05	1.00						
		0.04	0.07	0.14	0.00	0.02							
(7)	Ownership	0.04	0.03	-0.02	0.09	0.10	-0.03	1.00					
		0.03	0.09	0.37	0.00	0.00	0.13						
(8)	Leverage	-0.03	-0.02	0.02	-0.04	-0.02	0.08	-0.15	1.00				
		0.21	0.31	0.32	0.06	0.28	0.00	0.00					
(9)	ROA	0.08	0.07	-0.05	0.08	0.03	-0.09	0.17	-0.44	1.00			
		0.00	0.00	0.01	0.00	0.11	0.00	0.00	0.00				
(10)	Size	0.14	0.10	0.00	0.04	0.05	-0.04	0.04	0.09	0.12	1.00		
		0.00	0.00	0.91	0.04	0.02	0.07	0.03	0.00	0.00			
(11)	Fixed Assets	-0.04	-0.04	-0.03	-0.03	0.06	-0.07	-0.04	0.01	-0.06	0.00	1.00	
		0.06	0.09	0.14	0.18	0.01	0.00	0.04	0.69	0.00	0.88		
(12)	Market-to-book	0.04	0.05	-0.01	0.00	-0.08	0.09	0.04	-0.06	0.27	-0.22	-0.14	1.00
		0.05	0.01	0.70	0.99	0.00	0.00	0.03	0.00	0.00	0.00	0.00	
(13)	Loans	-0.08	-0.07	0.09	-0.15	-0.06	0.07	-0.03	0.21	-0.13	-0.06	-0.01	0.02
		0.00	0.00	0.00	0.00	0.00	0.00	0.09	0.00	0.00	0.00	0.75	0.26

Table 4 Political Connections and Auditor Choice

This table presents the effect of political connections on auditor choice. Dependent variables Big Auditor 1 and Big Auditor 2 are as defined in Table 2. Local Political Connection equals one if a firm's CEO is an ex-bureaucrat in a local/regional jurisdiction where the firm is registered, and zero otherwise. Non-local political connections equals one if a firm's CEO is an ex-bureaucrat from the central government or local government outside the jurisdiction where the firm is registered, and zero otherwise. Other variables are as defined in Table 2. Logit regression with standard error clustered by firm is applied. Absolute values of z are reported in parenthesis. ***, ***, and *denote statistical significance at the 1%, 5%, and 10% levels, respectively.

rallel A: Dasellile Mouel				
	Big Aı	iditor 1	Big Au	ditor 2
	Model (1)	Model (2)	Model (3)	Model (4)
Political connections	-0.411		-0.463	
	(2.14)**		(2.38)**	
Local political				
connections		-0.801		-0.792
		(2.67)***		(2.61)***
Non-local political connect	ions	-0.010		-0.106
-		(0.04)		(0.44)
Ownership	0.007	0.007	0.006	0.006
-	(1.13)	(1.10)	(0.94)	(0.93)
Leverage	-0.260	-0.253	-0.248	-0.248
-	(0.66)	(0.64)	(0.63)	(0.63)
Return on assets	1.479	1.580	1.133	1.222
	(1.71)*	(1.82)*	(1.35)	(1.46)
Size	0.430	0.437	0.316	0.322
	(4.15)***	(4.22)***	(3.00)***	(3.05)***
Fixed assets	0.002	0.041	-0.040	-0.006
	(0.00)	(0.08)	(0.07)	(0.01)
Market-to-book	0.027	0.026	0.027	0.026
	(1.34)	(1.26)	(1.33)	(1.27)
Constant	-10.090	-10.293	-7.673	-7.841
	(4.66)***	(4.75)***	(3.46)***	(3.53)***
Year dummies	Yes	Yes	Yes	Yes
Industry dummies	Yes	Yes	Yes	Yes
-				
Dep.Var.=1	783	783	686	686
Observations	2446	2446	2349	2349
Pseudo R ²	0.055	0.059	0.040	0.043

Panel A: Baseline Model

Table 5 Auditor Switch and Instrumental Variable Tests

Panel A: Univariate Test on Auditor Switch

This panel presents the univariate results of the effect of political connection acquisition on auditor switch. All refers to the number of firms with/without the acquisition of new political connections. N refers to the number of firms with auditor switch. % refers to the percentage of N in All. *** denotes the statistical significance of 1% for the proportion test between firms with and without change in political connections.

Change in Political Connections Audited			tor Switch	Switc A	ch to Big uditor		
	All	Ν	%	Ν	%	Ν	%
Acquisition of new PC	77	27	35%***	21	27%***	6	8%
No acquisition of new PC	1858	283	15%	201	11%	82	5%

Panel B: Descriptive statistics

This panel presents descriptive statistics of the variables used in auditor switch analysis. Modified Opinion equals one if the company received a modified auditing opinion in year t-1, and zero otherwise. Loss equals one if company realized a net loss in year t-1, and zero otherwise. Δ Ownership is the change in ownership. Δ ROA is change in ROA. Δ Size is change in Size. Δ Leverage is the change in Leverage. Δ MB is the change in market-to-book equity ratio. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

		Acquis	ition of new	PC	No acquisition of new PC				
				Std.					
Variable	Ν	Mean	Median	Dev.	N	Mean	Median	Std. Dev.	
Modified Opinion _{t-1}	77	0.10	0.00	0.31	1858	0.08	0.00	0.27	
Loss _{t-1}	77	0.29^{***}	0.00	0.45	1858	0.18	0.00	0.38	
ΔOwnership	77	-0.47	0.00	4.55	1858	-0.59	0.00	4.43	
ΔROA	77	-0.01	0.00	0.14	1858	-0.01	0.00	0.13	
ΔSize	77	0.02**	0.07*	0.31	1858	0.09	0.09	0.26	
ΔLeverage	77	0.03	0.02	0.15	1858	0.04	0.02	0.14	
ΔMB	77	-0.13	-0.65***	4.64	1858	0.59	-0.05	3.94	

Table 5 (continued)

Panel C: Multivariate Analysis on Auditor Switch

This panel presents the effects of the acquisition of political connections on auditor switch. The dependent variable is Auditor Switch, which equals one if the company switches auditors in a year, and zero otherwise in Model (1), equals one if the company switches to a small auditor in a year, and zero otherwise in Model (2), and equals one if the company switches to a big auditor (international or domestic top-10) in a year, and zero otherwise in Model (3). ΔPC (Acquisition of Political Connections) equals one if the new CEO with political connections is appointed and the original CEO did not have political connections, and zero otherwise. All controlling variables are as defined in Panel B. Logit regression with standard error clustered by firm is applied. Absolute values of z are reported in parenthesis. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

	Model (1)	Model (2)	Model (3)
		Switch to small	Switch to big
	Auditor Switch	auditor	auditor
ΔΡС	0.998	0.971	0.624
	(3.91)***	(3.47)***	(1.29)
Modified Opinion _{t-1}	0.374	0.169	0.775
	(1.58)	(0.67)	(1.73)*
Loss _{t-1}	0.536	0.715	-0.169
	(2.85)***	(3.32)***	(0.45)
ΔOwnership	0.005	0.017	-0.013
	(0.36)	(0.94)	(0.50)
ΔROA	-0.172	-0.125	-0.167
	(0.32)	(0.21)	(0.18)
ΔSize	-0.517	-0.671	0.026
	(1.77)*	(2.10)**	(0.05)
ΔLeverage	0.681	0.646	0.580
	(1.43)	(1.23)	(0.64)
ΔΜΒ	0.025	0.034	-0.016
	(1.44)	(1.85)*	(0.42)
Constant	-2.484	-3.195	-3.113
	(4.60)***	(4.73)***	(3.97)***
Year dummies	Yes	Yes	Yes
Industry dummies	Yes	Yes	Yes
Observations	1935	1935	1935
Pseudo R ²	0.056	0.061	0.079

Panel D: Two-Stage Instrumental Variable Analysis

This panel presents the two-stage regression of political connections on auditor choice. In the first stage, Loans, which equals one if the company has outstanding loans from state-owned bank(s) at the end of the fiscal year and zero otherwise, serves as the instrument variable. Predicted Political Connections used in the second stage is the predicted probability from the first stage. Other variables are as defined in Table 2. Year and industry fixed effects are controlled but not reported. Logit regression with standard error clustered by firm is applied in both stages. Absolute values of z are reported in parenthesis. ***, **, and *denote statistical significance at the 1%, 5%, and 10% levels, respectively.

	(1)	(2)	(3)
	First-stage	Secon	d-stage
	Political		
	Connection	Big Auditor 1	Big Auditor 2
Loans	0.477		
	(4.29)***		
Predicted Political Connections		-3.099	-2.967
		(1.83)*	(1.72)*
Ownership	-0.001	0.007	0.006
	(0.22)	(1.06)	(0.86)
Leverage	-0.319	-0.290	-0.289
-	(1.13)	(0.75)	(0.75)
Return on assets	-0.590	1.193	0.877
	(0.75)	(1.39)	(1.05)
Size	-0.055	0.399	0.289
	(0.77)	(3.88)***	(2.76)***
Fixed assets	-0.492	-0.212	-0.255
	(1.30)	(0.38)	(0.45)
Market-to-book	0.003	0.027	0.027
	(0.17)	(1.35)	(1.34)
Constant	-0.693	-8.938	-6.619
	(0.45)	(4.09)***	(2.98)***
Year dummies	Yes	Yes	Yes
Industry dummies	Yes	Yes	Yes
Den Var –1	171	783	686
Observations	4/4	703 2446	2340
Pseudo \mathbf{R}^2	0.034	0.053	0.037
	0.004	0.055	0.037

Table 6: Effect of Institutions on the Association Between Political Connections and Auditor Choice

Panel A: The Impact of Political Connections on Auditor Choice across Regions

This panel presents the effect of cross-regional institutions on the association between political connections and auditor choice. The dependent variable is Big Auditor 1 in Model (1) and (2), and Big Auditor 2 in Model (3) and (4). Independent variables are defined in Table 2. Logit regression with standard error clustered by firm is applied. Absolute values of z are reported in parenthesis. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

	Big Au	uditor 1	Big Au	uditor 2
	Model (1)	Model (2)	Model (3)	Model (4)
Political Connections	-1.031	-0.983	-0.920	-1.061
	(2.57)**	(2.75)***	(2.30)**	(2.91)***
Strong-Legal	0.672		0.651	
	(3.27)***		(3.19)***	
Political connections	0.886		0.692	
Strong-Legal	(1.94)		(1.52)	
Weak-Govt-Intervention		-0.251		-0.184
		(1.18)		(0.84)
Political Connections		0.808		0.831
Weak-Govt-Intervention		(1.91)		(1.92)*
Ownership	0.005	0.008	0.004	0.006
	(0.78)	(1.13)	(0.56)	(0.89)
Leverage	-0.272	-0.317	-0.269	-0.300
-	(0.69)	(0.81)	(0.69)	(0.77)
Return on assets	1.449	1.737	1.143	1.386
	(1.66)*	(2.00)**	(1.35)	(1.65)*
Size	0.427	0.419	0.314	0.305
	(4.06)***	(4.07)***	(2.93)***	(2.91)***
Fixed assets	-0.036	0.011	-0.059	-0.047
	(0.07)	(0.02)	(0.11)	(0.09)
Market-to-book	0.028	0.022	0.028	0.023
	(1.33)	(1.08)	(1.33)	(1.09)
Constant	-10.487	-9.681	-8.067	-7.280
	(4.79)***	(4.50)***	(3.59)***	(3.30)***
Year dummies	Yes	Yes	Yes	Yes
Industry dummies	Yes	Yes	Yes	Yes
Average interaction				
effect	0.104	0.148	0.069	0.138
	(1.46)	(1.91)*	(1.02)	(1.87)*
Den Var =1	777	777	680	680
Observations	2417	2417	2320	2320
$\mathbf{D}_{\text{roudo}} \mathbf{D}^2$	0.077	0.059	0.050	0.042
rseudo K	0.077	0.038	0.039	0.043

Table 6 (continued)Panel B: The Impact of Political Connections on Auditor Choice before EnforcementAction for Corporate Fraud

This panel presents the association between political connections and auditor choice in the period before the enforcement action for corporate fraud. The dependent variable is Big Auditor 1 in Model (1), and Big Auditor 2 in Model (2). Independent variables are defined in Table 2. Logit regression with standard error clustered by firm is applied. Absolute values of z are reported in parenthesis. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

	Model (1)	Model (2)
	Big Auditor 1	Big Auditor 2
Pre-enforcement	0.381	0.408
	(1.52)	(1.56)
Political connections	-0.340	-0.361
	(1.69)*	(1.78)*
Pre-Enforcement*Political connections	-0.952	-1.370
	(1.48)	(2.18)**
Ownership	0.007	0.007
	(1.04)	(1.01)
Leverage	-0.261	-0.287
	(0.66)	(0.73)
Return on assets	1.347	1.111
	(1.56)	(1.32)
Size	0.428	0.318
	(4.16)***	(3.00)***
Fixed assets	-0.124	-0.033
	(0.24)	(0.06)
Market-to-book	0.026	0.025
	(1.29)	(1.23)
Constant	-9.919	-7.819
	(4.65)***	(3.52)***
Year dummies	Yes	Yes
Industry dummies	Yes	Yes
Average interaction effect	-0.175	-0.212
-	(1.74)*	(2.58)**
Dep.Var.=1	777	680
Observations	2446	2349
Pseudo R ²	0.051	0.043

Table 7 Effect of Political Connections on Timely Losses Recognition

Panel A: Descriptive Statistics

This panel presents descriptive statistics of variables used in timely loss recognition analysis. NI is net income scaled by market value at the beginning of fiscal year. Return is the annual stock return in the fiscal year. RD, an indicator for bad news, equals one if Return is negative and zero otherwise. ΔNI_t is the change in net income from year t-1 to year t scaled by the market value at the beginning of year t. ΔNI_{t-1} is one year lagged ΔNI_t . $D\Delta NI_{t-1}$, an indicator for decrease in net income, equals one if ΔNI_{t-1} is negative and zero otherwise.

Variable	Р	olitically Co	ically Connected Firms			Non-politically Connected Firms		
	Ν	Mean	Median	Std. Dev.	Ν	Mean	Median	Std. Dev.
NI	443	0.00	0.01	0.16	1820	0.00	0.02	0.17
Return	443	0.37	-0.13	1.22	1820	0.47	0.02	1.16
RD	443	0.57	1.00	0.50	1820	0.49	0.00	0.50
ΔNI_{t-1}	422	0.02	0.00	0.13	1692	0.01	0.00	0.12
ΔNI_t	422	0.01	0.00	0.10	1692	0.03	0.00	0.10
$D\Delta NI_{t-1}$	422	0.45	0.00	0.50	1692	0.47	0.00	0.50

Table 7 (Continued)Panel B: The Earnings-Return Model

This panel presents the effects of political connection on timely loss recognition. The dependent variable is NI, which is net income scaled by market value at the beginning of fiscal year. The independent variables are defined in Panel A of this table. Model (1) uses the pooled sample. Model (2) uses the sample of firms audited by big auditors, which are international auditors or domestic top ten auditors, and Model (3) uses the sample of firms audited by small auditors. OLS regression is applied. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively

	Model (1)	Model (2)	Model (3)
	Pooled	Big Auditor	Small Auditor
Return	0.023	0.026	0.022
	(5.63)***	(5.59)***	(3.81)***
RD	0.058	0.012	0.088
	(4.51)***	(0.83)	(4.82)***
Political Connections	-0.003	-0.010	0.001
	(0.20)	(0.39)	(0.06)
RD*Return	0.364	0.191	0.465
	(10.09)***	(4.71)***	(9.16)***
Political Connections*RD	-0.023	0.055	-0.061
	(0.76)	(1.32)	(1.59)
Political Connections*Return	0.003	0.004	0.004
	(0.36)	(0.26)	(0.34)
Political			
Connection*RD*Return	-0.137	0.161	-0.272
	(1.78)*	(1.40)	(2.76)***
Constant	0.007	0.022	-0.000
	(1.06)	(2.72)***	(0.04)
Observations	2263	716	1547
Adjusted R-squared	0.11	0.17	0.10

Table 7 (Continued)Panel C: Income Persistence

This panel presents the effects of political connections on income persistence. The dependent variable is ΔNI_t . All of the variables are as defined in Panel A of this table. Model (1) uses the pooled sample. Model (2) uses the sample of firms audited by big auditors, which are international auditors or domestic top ten auditors, and Model (3) uses the sample of firms audited by small auditors. OLS regression is applied. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively

	Model (1)	Model (2)	Model (3)
	Pooled	Big Auditor	Small Auditor
ΔNI_{t-1}	0.077	0.007	0.097
	(2.33)**	(0.12)	(2.41)**
$D\Delta NI_{t-1}$	-0.036	-0.024	-0.042
	(6.20)***	(2.76)***	(5.57)***
Political Connections	-0.011	-0.006	-0.013
	(1.52)	(0.53)	(1.42)
$\Delta NI_{t-1} * D\Delta NI_{t-1}$	-1.011	-0.766	-1.093
	(17.30)***	(7.48)***	(15.28)***
Political Connections*D Δ NI _{t-1}	0.041	0.024	0.048
	(3.29)***	(1.16)	(3.15)***
Political Connections* ΔNI_{t-1}	0.996	0.998	1.001
	(26.51)***	(15.62)***	(21.50)***
Political Connection* $D\Delta NI_{t}$.			
$_{1}*D\Delta NI_{t-1}$	0.929	0.757	0.996
	(7.79)***	(3.75)***	(6.78)***
Constant	0.006	0.006	0.007
	(1.60)	(1.01)	(1.34)
Observations	2254	705	1549
Adjusted R-squared	0.35	0.35	0.35

Table 8 Discretionary Accruals

Panel A Univariate test for unsigned discretionary accruals

This panel presents univariate results for the unsigned discretionary accruals of firms with and without political connection. The unsigned discretionary accruals are absolute values of residuals of the following model by Ball and Shivakumar (2006):

 $TA_{it}/ASSET_{it-1} = \beta_1 * 1/ASSET_{it-1} + \beta_2 CFO_{it}/ASSET_{it-1} + \beta_3 * (\Delta SALES_{it} - \Delta AR_{it})/ASSET_{it-1} + \beta_4 * PPE_{it}/ASSET_{it-1} + \beta_5 DCFO_{it} + \beta_6 DCFO_{it} * CFO_{it}/ASSET_{it-1} + \varepsilon_{it}$

Where TA_{it} is the total of accruals of firm t in year t; CFO_{it} is the cash flow from operation in year t³³; $DCFO_{it}$ equals one is CFO_{it} is negative, and zero otherwise. $ASSET_{it-1}$ is the total assets at the end of year t-1; $\Delta SALES_{it}$ is the change in sales from year t-1 to t; ΔAR_{it} is the change in account receivable fro year t-1 to t; PPE_{it} is the net value of plant property and equipment at the end of year t. ** and * stand for statistical significance at the 5%, and 10% levels for the

** and * stand for statistical significance at the 5%, and 10% levels for the difference in two samples.

	Ν	Mean	Median	Std. Dev
Politically Connected Firms	435	0.070*	0.045**	0.079
Non-politically Connected Firms	1768	0.062	0.040	0.071

³³ The result is similar if we use Return<0 as the proxy for bad news.

Table 8 (continued)

Panel B multivariate test for unsigned discretionary accruals

This panel presents the effects of political connections on unsigned discretionary accruals. The unsigned discretionary accruals, the absolute values of residuals of the model in Panel A, are used as the dependent variable. Big Auditor equals one if the auditor used is an international or domestic top-ten auditor, and zero otherwise. Other variables are as defined in Panel A of this table and Table 2. OLS regression is applied. *** and ** denote significance at the 1% and 5% levels, respectively.

	Unsigned Discretionary Accruals
Political Connections	0.009
	(2.01)**
Big Auditor	0.002
	(0.63)
Ownership	0.000
	(1.16)
Return on assets	-0.320
	(9.55)***
Size	-0.015
	(5.61)***
Leverage	0.036
	(3.16)***
Market-to-book	0.000
	(0.47)
Industry and Year dummies	Yes
Constant	0.383
	(7.21)***
Observations	2203
Adjusted R-squared	0.25

Table 9. Political Connections and Firm Performance

 \triangle ROA (\triangle ROS) is the change in Return on Assets (Return on Sales) from the two-year period before the listing of a firm to the two-year period after listing. CAR is the cumulated monthly abnormal return (firm return minus market return) in the two year period after listing. Other variables are as defined in Table 2. OLS regression is applied. Absolute values of t are reported in parenthesis. ***, **, and *denote statistical significance at the 1%, 5%, and 10% levels, respectively.

Panel A: Univariate statistics

Politically connected firms			Non-	politically	v connected	l firms		
		-	Media	Std.				Std.
Variable	Ν	Mean	n	Dev.	Ν	Mean	Median	Dev.
						-		
ΔROA	93	0.00	-0.01	0.09	359	0.02**	-0.02**	0.08
$\Delta \operatorname{ROS}$	93	0.04	-0.01	0.31	359	0.03**	-0.02	0.31
CAR	114	0.03	-0.06	0.45	438	-0.02	-0.07	0.42

Panel B: Multivariate Analysis

	Model (1)	Model (2)	Model (3)
	ΔROA	$\Delta \operatorname{ROS}$	CAR
Political			
connections	0.017	0.067	0.082
	(1.98)**	(1.93)*	(1.80)*
Size	-0.014	-0.089	0.068
	(2.45)**	(3.89)***	(2.46)**
Market-to-book	0.002	0.008	0.025
	(1.53)	(1.34)	(3.52)***
Leverage	0.126	0.327	-0.106
	(6.53)***	(4.28)***	(1.11)
Big Auditor	0.005	0.021	0.014
	(0.70)	(0.72)	(0.37)
Constant	0.226	1.709	-1.382
	(1.88)*	(3.58)***	(2.40)**
Year dummies	Yes	Yes	Yes
Industry dummies	Yes	Yes	Yes
Observations	452	452	552
Adjusted R-squared	0.22	0.16	0.06