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Published in:
Pacific Accounting Review

DOI:
[10.1108/PAR-04-2016-0047](https://doi.org/10.1108/PAR-04-2016-0047)

Published: 07/08/2017

[Link to publication](#)

Citation for published version (APA):
Hu, F., Stewart, J., & TAN, W. (2017). CEO's political connections, institutions and audit opinions. *Pacific Accounting Review*, 29(3), 283-306. <https://doi.org/10.1108/PAR-04-2016-0047>

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CEO's Political Connections, Institutions and Audit Opinions

Abstract

Purpose – The purpose of this paper is to investigate whether audit opinions of listed firms in China vary systematically with the political connections of the firm's chief executive officer (CEO). Prior literature only shows the importance of political influence to auditor choice and audit quality.

Design/methodology/approach –A politically connected firm is defined as a firm in which the CEO has a political background. We use a “difference-in-difference” model to control for self-selection problems.

Findings – We find that the likelihood of receiving a favourable opinion in the subsequent period is positively associated with a CEO's political connections. This positive association is stronger with CEOs connected to local government within the same region. We further find that the CEO's political connections have more influence on favourable audit opinions in non-state owned enterprises (non-SOEs), in a less developed and lower investor protection region. The influence is also less significant in the regions where there are more non-state owned or foreign banks and where there are greater penalties for political corruption and relationship-based contracting.

Originality/value – The study complements and extends the existing literature on the role of political connections in the economy by providing evidence on the effect of a CEO's political connections on audit opinions. We extend the research on auditing in emerging markets by explicitly accounting for unique institutional and market factors in China. We explore audit quality by observing how audit opinions are directly shaped by political and institutional factors.

Keywords Political connections, Audit Opinions, State-owned enterprises (SOE), China

Paper type Research paper

1. Introduction

In this paper we investigate whether audit opinions of listed firms in China vary systematically with the political connections of the firm's chief executive officer (CEO). Although recent research analyses the importance of political influence to auditor choice and audit quality (Chan *et al.*, 2006; Chan *et al.*, 2012; Gul, 2006; Wang *et al.*, 2008; Guedhami *et al.*, 2009; and Guedhami *et al.*, 2014), there is a lack of direct evidence on how political connections affect audit opinions and whether the effect is confounded by other institutional characteristics.

A number of studies have demonstrated that auditor choice and quality are shaped by political influence in China's state-owned enterprises (SOEs). For example, Chan *et al.* (2006), Chan *et al.* (2012) and Wang *et al.* (2008) find that SOEs, especially local SOEs, have a strong tendency to hire small local auditors or switch from a non-local auditor to a local auditor in pursuit of desirable opinions. These studies assume that small local auditors in China are subject to greater political pressure or have more reliance on local governments so that they will issue more favorable opinions. Based on this assumption, they typically examine the impact of political influence on auditor choice from the demand side, which accordingly affects the quality of audit opinions. While these studies emphasize the interaction of managers, auditors and government under political influence, they overlook institutional differences. Moreover, it is unclear whether political influence varies with features of the market and institutional factors. We fill this gap in the literature by empirically examining and answering the following questions: (1) Do a CEO's political connections affect audit opinions? (2) Does this effect vary with institutional features such as the existence of government ownership and other market characteristics?

We analyse all companies listed on the domestic stock exchanges in China during the period 2005 to 2010. The descriptive data show that firms with politically connected CEOs receive 11 per cent more favourable opinions than firms without political connected CEOs. We find that the likelihood of receiving a favourable opinion in the subsequent period is positively associated with a CEO's political connections[1]. This positive association is stronger with CEOs connected to local government within the same region. Our results are robust when we use a "difference-in-difference" model to control for self-selection problems.

We interpret these results from two perspectives. On the demand side, we argue that politically-connected CEOs will actively seek unqualified audit opinions. This is because insiders with political connections wish to suppress information on actual economic performance to ensure that their discretionary practices, largely stemming from political cronyism and corruption, are kept hidden. On the supply side, auditors have incentives to lower the threshold for issuing an unqualified opinion to clients with political connections. This is because auditors have greater economic dependence on political connections in China's political and legal environment (Chan *et al.*, 2006) and they may fear losing the specific rents from politically connected clients if they issue a qualified opinion. Alternatively, auditors may perceive that firms with political connections, especially those connected to local government, have less litigation risk than other firms, thus raising the level of acceptable errors.

Next, we analyse how the impact of a CEO's political connections on audit opinions is shaped by institutional factors. First, we find that the CEO's political connections have more influence on favourable audit opinions in non-state owned enterprises (non-SOEs) than in state owned enterprises (SOEs). We then examine the CEO's political connections interacted with institutional characteristics based on regions in China. We find the impact of a CEO's political connections on audit opinions is less pronounced in regions where the market is

more developed and there is a higher level of investor protection[2]. The influence is also less significant in the regions where there are more non-state owned or foreign banks and where there are greater penalties for political corruption and relationship-based contracting. As additional tests, the results show that the influence of political connections on audit opinions is not related to auditor size and auditor locality and only persists in the firms that do not switch their auditors.

This paper contributes to previous research in two ways. First, the study complements and extends the existing literature on the role of political connections in the economy (Bliss and Gul, 2012; Claessens *et al.*, 2008; Fan *et al.*, 2007; Guedhami *et al.*, 2014; Li *et al.*, 2008). Prior studies mostly investigate political influence embedded in state ownership. For instance, Wang *et al.* (2008) demonstrate that auditor choice in SOEs in China is subject to political influence. We attempt to provide evidence on the effect of a CEO's political connections on this issue.

Second, we extend the research on auditing in emerging markets (Chan *et al.*, 2006; Chan *et al.*, 2012; DeFond *et al.*, 2000; Wang *et al.*, 2008) by explicitly accounting for unique institutional and market factors in China. In this single emerging market, we avoid the possibility of contamination due to omitted variables resulting from country differences (Faccio, 2006). Moreover, the Chinese market has a high level of government intervention, with various layers of government and differences across regions. In contrast to prior studies that focus on how auditor choice affects the pursuit of audit opinions (Chan *et al.*, 2006; Chan *et al.*, 2012; DeFond *et al.*, 2000; Wang *et al.*, 2008), we explore audit quality by observing how audit opinions are directly shaped by political and institutional factors.

The remainder of this paper is organised as follows. Section 2 provides the background to the study and develops the hypotheses. Section 3 describes the research method including the sample, the regression models and variables. Section 4 outlines our data and summarises

the descriptive statistics on the regression variables. Sections 5 and 6 report the results of the multivariate analysis and the robustness tests respectively. Section 7 discusses the policy implications of our results while Section 8 contains some concluding comments.

2. Background and hypotheses development

2.1 Political influence, audit profession and auditor quality in China

Chinese certified public accounting (CPA) firms were initially established and owned by government bodies. Chan et al. (2006) suggest that this affiliation between audit firms and local government led to a lack of independence as well as to regional protectionism. Between 1995 and 2000, the Chinese government launched a series of audit market reforms to improve the independence of the auditing profession. These included (1) the adoption of international auditing standards; (2) the separation of audit firms from government control; and (3) the facilitation of mergers of small audit firms (Wang *et al.*, 2008)[3].

Despite the reforms, political influence still affects the economic dependence of audit firms in China (Chan *et al.*, 2006). From the competition perspective, audit firms can gain advantage by maintaining close relationships with government bureaucrats (Chan and Mo, 2002; Hofstede, 2001). For instance, auditors have more knowledge of government procedures and regulations because of their close relationship with government (Yang, 2013). Thus, they are better able to retain existing clients or find new clients. From the risk perspective, auditors might encounter lower litigation risk given a connection to government as the Chinese government strongly influences business activities (Fan *et al.*, 2007; Chen *et al.*, 2011). This in turn impacts the quality and independence of audit firms (or individual auditors). For example, many local auditors may have strong incentives to issue favourable audit reports in order to maintain existing connections (Chan *et al.*, 2006). Furthermore, clients are unlikely to switch from auditors they perceive as lenient.

Based on the assumption that certain types of audit firms, such as small and local auditors, are subject to more political influence, previous studies find that SOEs might select or switch to these auditors in order to obtain desirable audit opinions. For example, using a sample of Chinese listed firms for the period 1996–2002, Chan *et al.* (2006) find that local government-owned companies switched from a non-local auditor to a local auditor following receipt of a qualified opinion. Wang *et al.* (2008) find that SOEs have a stronger tendency to hire small local auditors than non-state firms because governments may use political pressure to coerce small local auditors to issue more favourable opinions to their SOEs. Chan *et al.* (2012) provide further evidence that local government-controlled companies choose local auditors to obtain more favourable audit opinions when they face the need for new equity financing or the threat of exchange delisting.

2.2 Hypothesis development

2.2.1 Political connections and audit opinions

According to agency theory, external auditing provides a monitoring role to minimise financial reporting bias stemming from managerial incentives. Prior literature documents that political connections provide incentives to distort financial reports and reduce accounting transparency. Bushman *et al.* (2004) report that higher government share ownership is negatively associated with financial transparency while Bushman and Piotroski (2006) find that earnings are less conservative in firms operating in countries with higher state involvement in the economy. Chaney *et al.* (2007) find a negative association between politically-connected firms and earnings quality. According to Leuz and Oberholzer-Gee (2006: 416), “...high levels of transparency and public attention might expose political favors of questionable legality. For instance, firms in weakly regulated markets are often free to engage in undisclosed related-party transactions benefiting controlling insiders and political

backers.” Those politically connected insiders could exploit their position to siphon corporate resources that they later conceal by distorting the financial statements (Shleifer and Vishny, 1994; La Porta *et al.*, 1998; Dyck and Zingales, 2004). Piotroski *et al.* (2008) find that politically connected firms are particularly eager to suppress information about poor economic outcomes since these firms have incentives to conceal from minority shareholders expropriation-related activities stemming from political cronyism and corruption. To mitigate the agency costs arising from political connections, it could be argued that external auditors are more likely to issue qualified or modified audit opinions when the CEO is politically connected. However, this argument assumes a strong regime of audit independence, where audit firms do not have incentives to develop their own connections to government.

In contrast to agency theory, the resource dependence theory of the firm recognises the value of a CEO’s political connections because these connections help firms obtain favourable resources and thereby increase their negotiation power in contracting. As discussed above, audit firms in China are economically dependent on political connections to do business (Chan *et al.*, 2006; Yang, 2013). As a result, auditors are expected to actively lower the threshold of issuing unqualified opinions and be more lenient to politically connected firms because (1) they can retain existing clients where politically connected insiders might have more power to dismiss or appoint an auditor; (2) they can rely on their political ties or relationships with governments to get more clients; and (3) they can reduce auditing risk by maintaining close political ties as they can obtain insight into the regulatory process and lobby for more favourable regulatory decisions (Yang, 2013). In particular, auditors may perceive that firms with political connections, especially those connected to local government, have less litigation risk than other firms and thus they may raise the level of acceptable errors. Because China’s audit market is heavily influenced by political

relationships, resource dependence arguments are more relevant than agency theory arguments in explaining auditor behaviour. We therefore develop the following hypothesis:

H1: *Politically connected firms in China are more likely to obtain a favourable audit opinion than firms without political connections.*

2.2.2 CEO's political connections, audit opinions and institutional factors

Institutional factors, such as legal, political, financial, regulatory and cultural institutions, exert strong pressures on economic agents' incentives and behaviours. We therefore identify a number of key institutional factors that may influence the relation between a CEO's political connections and audit opinions in China.

(i) Existence of government ownership

A unique feature of China's market is the dominance of government ownership and high state control of business. The CEO's political connections might be mixed with the natural political connections driven by government ownerships. Agency arguments suggest that politically connected CEOs are appointed by the government owners in SOEs to align firm goals with government objectives such as reducing unemployment. Hence, the impact of politically connected CEOs in SOEs on external auditors may be diluted by government ownerships[4]. Among non-SOEs (or privately owned firms) that lack ties with government but operate in a relationship-based environment, having politically-connected managers helps them to obtain favourable treatment and overcome market and institutional barriers (Li *et al.*, 2008). In accordance with resource dependency theory, CEO's political connections can be more advantageous for non-SOEs especially in emerging economies, which typically lack property rights protection and the market-supporting institutions needed by private firms (McMillan, 1995). In particular, non-SOEs lack political connections by nature of their ownership. Therefore, when political connections are established by CEOs in non-SOEs,

audit firms may seek advantage by colluding with these clients as a way of maintaining close relationships with government. These arguments lead to the following hypothesis:

H2: *The effect of a CEO's political connections on audit opinions is more pronounced in non-SOEs than in SOEs.*

(ii) the level of investor protection and market development

The level of market development and the resultant information environment is a key institutional feature which shapes both financial reporting practices and monitoring mechanisms (Piotroski and Wong, 2011). In general, stronger investor protection generates higher quality financial reporting, i.e. less earnings management (e.g. Leuz *et al.*, 2003), more conservative reporting (e.g. Ball *et al.*, 2000; Ball *et al.*, 2003; Bushman and Piotroski, 2006) or higher earnings informativeness (e.g. DeFond *et al.*, 2007). In particular, Francis *et al.* (2005) find that a high quality (or more independent) auditor is used in the presence of strong institutions. In an environment encouraging greater investor protection and fewer relation-based contracts, the political connections or other relationships exert less pressure on economic agents' behaviour. For example, Faccio (2006) finds that the favourable treatment enjoyed by firms with political connections is more pronounced in countries with interventionist governments and weak protection of property rights. As such, we conjecture that in a more developed market with stronger investor protection, an audit opinion is more independent of political connections or more associated with information quality disclosed by firms. Hence we test the following hypothesis:

H3: *The effect of a CEO's political connections on audit opinions is more (less) pronounced in regions with lower (higher) level of market development.*

(iii) Demand for information in contracting

Institutional factors also influence the demand for information and monitoring mechanisms to ensure the quality of information in firms' managerial and debt contracts. The stronger the contractual demand for credible information, the higher is the quality of disciplinary mechanisms, such as the independence of external auditors, to ensure the reporting of high quality information to all contractual parties (Watts, 2006). Chinese firms overwhelmingly rely on banks for financing and this increases the demand for information quality. Chen *et al.* (2010) suggest that state-owned banks have weaker demand for information quality as they adopt less accounting-based covenants than non-state owned banks (including foreign banks). Hence, we propose that audit opinions are less influenced by political connections in markets with stronger contractual demand for credible information. This leads to the following hypothesis:

H4: *The effect of a CEO's political connections on audit opinions is more (less) pronounced in regions with more (less) state-owned banks.*

(iv) Penalties for accounting scandals and relationship-based contracting

How the market penalises misconduct is also a key feature to shape the incentives and behaviours of market participants. When firms are caught in accounting scandals, the reputation penalty is high. For example, studies show that a significant portion of a share price decline is associated with scandals; there is a loss of potential new contracts or increase in future contracting costs; the senior officers involved in scandals are dismissed and have difficulty in finding comparable positions in the future (Karpoff *et al.*, 2004; Karpoff *et al.*, 2008a, b). In China's market, Hung *et al.* (2009) find that the share prices of the firms with senior officers caught in political corruption charges and accounting scandals dropped more significantly than those that were only involved in accounting scandals alone. After the corruption charges, those firms find it hard to get bank loans and suffer from significant

board changes. These unfavourable economic consequences also have spillover effects on auditors' litigation risks. Hence, we conjecture that auditors are less likely to compromise their opinions when a region has more severe penalties for managers' and auditors' misconduct based on relationships. We therefore test the following hypothesis:

H5: *The effect of a CEO's political connections on audit opinions is more (less) pronounced in regions with less (more) penalties for accounting scandals and relationship-based contracting.*

3. Research design

3.1 Measures

3.1.1 Political connections

A politically connected firm is defined as a firm in which the CEO has a political background. Given the dual presence of the Chinese Communist Party (CCP) and government organs at each level of China's political hierarchy (Whiting, 2001), a CEO is identified as having a political background if (1) he or she has worked in government entities (including the military); or (2) has held one of three main CCP positions – Party Secretary, Central Committee Member, or Representative of the National People's Congress.

In addition, given the importance of locality in China's economy, we also classify the political connections as local and non-local connections. A CEO with local political connections is defined as a CEO who has a political background within the same region (based on province in China).

3.1.2 Audit opinion

Auditors in China issue five types of audit opinion. These are unqualified, unqualified with an explanatory paragraph, qualified, disclaimer, and adverse opinions. Prior studies of the

Chinese audit market define all opinions other than completely unqualified opinions as “qualified” or “unfavourable” opinions (Chen *et al.*, 2000; Chen *et al.*, 2001; DeFond *et al.*, 2000; Chan *et al.*, 2006)[5]. This is because unqualified opinions with an explanatory paragraph are used by auditors in China as an alternative to qualified opinions in order to retain clients (Chen *et al.*, 2000). Therefore, this type of opinion is treated the same as a qualified opinion by the China Securities Regulatory Commission (CSRC, 2001b)[6]. We therefore follow these other studies and include unqualified opinions with an explanatory paragraph as unfavourable opinions.

3.2 Models

We first test the relationship between political connections and the likelihood of favourable opinions. Since we focus our attention on the post-connection period to see if firms successfully obtain a favourable opinion in the subsequent period after they establish political connections, we follow Chan *et al.* (2006) in using a LOGIT model as follows:

$$\begin{aligned}
 & \text{Logit}(\text{Opinion}_{it+1}) \\
 &= \alpha + \beta_1 PC_{it} (\text{or } Local_PC_{it}) + \beta_2 Size_{it} + \beta_3 ROE_{it} + \beta_4 Debt_Ratio_{it} \\
 &+ \beta_5 Current_Ratio_{it} + \beta_6 Receivable_{it} + \beta_7 Inventory_{it} + \beta_8 Loss_{it} \\
 &+ \beta_9 Ownership_{it} + \beta_{10} Age_{it} + \beta_{11} Audit_Fee_{it} + \beta_{12} Bshare_{it} \\
 &+ Year_Dummy + Industry_Dummy + \varepsilon_{it}
 \end{aligned}$$

Model (1)

where

$Opinion_{it+1} = 1$ if audit opinion in the subsequent period is favourable as explained earlier, and 0 if it is unfavourable;

$PC_{it} = 1$ if the firm's CEO is politically connected as explained earlier, and 0 otherwise.

$Local_PC_{it} = 1$ if the firm's CEO is politically connected within the same region, and 0 otherwise.

Following prior studies (Chen *et al.*, 2001; DeFond *et al.*, 2000; Chan *et al.*, 2006), we include a number of control variables as follows:

$Size_{it}$ is measured as the natural log of the client's total assets. Chan *et al.* (2006) argue that larger companies are more financially stable than smaller companies and hence $Size_{it}$ is expected to be positively associated with the likelihood of receiving an unqualified opinion. ROE_{it} measures profitability by dividing net income by total equity. As prior studies indicate that poorly performing companies are more likely to manage earnings opportunistically than profitable companies (Chan *et al.*, 2006; Chen *et al.*, 2001; Schwartz and Menon, 1985), we expect ROE_{it} to be positively associated with the probability of receiving an unqualified opinion.

$Debt_Ratio_{it}$ (debt-to-total assets ratio) measures the level of leverage. Prior studies indicate that companies with higher leverage ratios are more likely to receive modified reports (Chan *et al.*, 2006; DeFond *et al.*, 2000; Wilkins, 1997). We therefore expect $Debt_Ratio_{it}$ to be negatively associated with the receipt of an unqualified audit opinion.

$Current_Ratio_{it}$ (the ratio of current assets to current liabilities) measures the financial liquidity of companies. Prior studies indicate that companies with lower current ratios are more likely to receive modified reports (Chan *et al.*, 2006; DeFond *et al.*, 2000; Wilkins, 1997). $Current_Ratio_{it}$ is therefore expected to be positively associated with such an opinion.

$Receivable_{it}$ (accounts receivable divided by total assets) and $Inventory_{it}$, (inventory divided

by total assets) are included to control for audit risk (Hay *et al.*, 2006). We expect these two variables to be negatively associated with the receipt of an unqualified opinion.

$Loss_{it}$ (a dummy variable for a firm making a loss) is included because companies that have reported losses are more likely to manage earnings upwards to avoid delisting[7]. Similar to our arguments relating to ROE_{it} , companies that manipulate earnings are more likely to receive a qualified audit opinion (Chan *et al.*, 2006; Chen *et al.*, 2001).

$Ownership_{it}$ is the ratio of the number of shares held by the largest shareholder over the number of total shares of the firm. In the context of audit fee models, Hay *et al.* (2006: 171) argue that “the existence of a dominant shareholder could indicate higher agency costs or stronger control”, with either a positive or negative effect on audit fees. Similarly, the effect of a dominant shareholder on the likelihood of receiving a qualified audit opinion may be positive or negative. Hence we expect $Ownership_{it}$ to be associated with the likelihood of receiving an unqualified opinion but do not predict a direction.

Age_{it} is defined as the firm’s age at period t. Chen *et al.* (2001) find that companies listed for some years will manipulate earnings to avoid delisting (see endnote [7]). We therefore expect Age_{it} to be negatively associated with the receipt of an unqualified opinion.

$Audit_Fee_{it}$ is expected to be positively associated with the issue of a qualified opinion as problems in completing the audit increase both the amount of audit work needed and audit risk (Simunic, 1980; Hay *et al.*, 2006) We measure $Audit_Fee_{it}$ as the natural log of audit fees in period t.

B_share_{it} is a dummy variable equal to 1 if the client firm issues B shares and 0 otherwise. In China, B shares are eligible for foreign investors and are traded in foreign currencies. For instance, B shares are traded in U.S. dollars on the Shanghai Stock Exchange, and traded in Hong Kong dollars on the Shenzhen Stock Exchange. This variable controls for the effect of foreign investors having a greater demand for high quality financial information.

In addition to compliance with generally accepted accounting principles in China, companies with B shares are required to present financial statements in accordance with International Accounting Standards. They are also required to hire one domestically licensed auditor as well as an international audit firm to audit financial reports (Chan *et al.*, 2006). Hence, companies with foreign ownership are expected to be more likely to receive unqualified audit opinions (Chan *et al.*, 2006; Chen *et al.*, 2001; DeFond *et al.*, 2000). We therefore expect B_share_{it} to be positively associated with the receipt of an unqualified opinion.

We also include year and industry dummy variables to control for any year effects and industry effects.

We then test H2 to H5 using an extended model as follows, examining how the likelihood of favourable opinions is affected by political connections interacted with the various institutional factors.

$$\begin{aligned}
 &Logit(Opinion_{it+1}) \\
 &= \alpha + \beta_1 PC_{it} + \beta_2 PC_{it} * Institutions_{it} + \beta_3 Size_{it} + \beta_4 ROE_{it} \\
 &+ \beta_5 Debt_Ratio_{it} + \beta_6 Current_Ratop_{it} + \beta_7 Receivable_{it} \\
 &+ \beta_8 Inventory_{it} + \beta_9 Loss_{it} + \beta_{10} Ownership_{it} + \beta_{11} Age_{it} \\
 &+ \beta_{12} Audit_Fee_{it} + \beta_{13} Bshare_{it} + Year_Dummy \\
 &+ Industry_Dummy + \varepsilon_{it}
 \end{aligned}$$

Model (2)

To test H2, the institutional factor is:

$NSOE = 1$ if a firm is a non-SOE (its ultimate owner is not a government-related organisation), and 0 otherwise;

To test H3, the institutional factor is:

MINDEX = the regional marketisation index reported by Fan *et al.* (2011), widely used in prior studies to measure the level of investor protection and market development across regions in China.

To test H4, the institutional factor is:

NSB = the number of non-state owned banks (including foreign banks) in a region (based on provinces) of China.

To test H5, the institutional factor is:

Penalty = the number of firms caught in political corruption charges and accounting scandals by the China Securities Regulatory Commission (CSRC) in a region (based on provinces) of China.

The other variables are as defined in model (1).

4. Data and sample

4.1 Data

The financial data of all listed Chinese firms from 2005 to 2010 are obtained from the *China Securities Markets and Accounting Research* (CSMAR) database. Information on the backgrounds of board chairs, CEOs, and companies is collected by reading annual reports or summaries of top management resumés in annual reports that are issued on the finance website[8]. We choose the time period starting from 2005 because Chinese listed firms were not required to disclose the directors' and managers' employment history and compensation in the annual report prior to this year. Before 2005, the data is very limited as few firms voluntarily disclosed this information. The CSMAR database serves as the primary source for

the audit data such as audit opinion, audit fee and auditor details. The institutional factors such as the nature and number of banks in China and firms violating regulation caught and penalised by CSRC are also extracted from the CSMAR database.

Firms lacking financial or audit information and financial institutions (1-digit SIC code: I) are excluded[9]. The final sample consists of 1875 listed enterprises in China from 2005 to 2010. As data for some firms are not available in all years, the total number of firm years is 8617.

4.2 Sample description

Panel A of Table 1 reports details of the audit opinions partitioned by politically connected (PC) firms and non-politically connected (NPC) firms during the period 2005 to 2010. It shows that 2,273 firm year observations (26 per cent of the sample) are politically-connected where the CEO has a political background. Consistent with prior studies (Chan *et al.*, 2006), most firm-year observations in China receive favourable opinions (86 per cent of firms in the sample receive a favourable opinion). A greater percentage of PC firms (94 per cent) receive a favourable opinion compared to NPC firms (83 per cent).

Panel B of Table 1 reports the number and percentage of changes in the type of audit opinions (from year t-1 to year t) partitioned by changes in political connections of a firm (from year t-1 to year t). It shows that more than half of the firm-year observations receive the same audit opinion as that received in the previous year and retain connections or no connections as in the previous year. Interestingly, the distribution in Panel B indicates that firms currently establishing political connections are more likely to be given a favourable opinion in the current year when they previously received a qualified opinion. Specifically, 7 per cent of the firm-year observations receiving a qualified opinion in the previous year but a

favourable audit opinion in the current year have political connections. That percentage is higher than those without established political connections.

[Table 1]

Table 2 provides the descriptive statistics for firm characteristics and audit opinions partitioned by PC firms and NPC firms[10]. The mean (median) total assets of RMB 5,013 million (RMB 1,917 million) in PC firms is significantly larger than the mean (median) assets of RMB 3,935 (RMB 1,849) in NPC firms (t -statistic = -4.44, Wilcoxon z -statistic = 2.68). The mean (median) leverage of 0.54 (0.52) in PC firms is significantly higher than the mean (median) leverage of 0.52 (0.51) in NPC firms (t -statistic = -1.64, Wilcoxon z -statistic = 3.62). The current ratio, accounts receivable and inventory in PC firms are significantly lower than those in NPC firms. The results imply that PC firms are larger, have higher leverage but lower financial liquidity than non-PC firms. Interestingly, the proportion of PC firms choosing Big Four auditors is significantly more than the proportion of NPC firms. The proportion of PC firms receiving favourable audit opinions is significantly more than the proportion of NPC firms.

[Table 2]

5. Results

5.1 CEO's political connections and subsequent favourable opinion

Table 3 presents the logistic regressions for the association between political connections and the subsequent audit opinion based on model (1). The dependent variable is the dummy variable for a favourable audit opinion in the subsequent period. The main independent variable is the firm's political connections. Various control variables for firm characteristics are included. Column (1) shows that the likelihood of a favourable opinion in year $t+1$ is

significantly associated with political connections in year t (coefficient = 0.26, Wald Chi-statistic = 3.33, $p < 0.10$). Column (2) shows that the likelihood of a favourable opinion in year $t+1$ is significantly associated with political connections to local government in year t (coefficient = 0.39, Wald Chi-statistic = 3.31, $p < 0.10$). Column (3) shows that the positive association between subsequent favourable opinions and political connections to local government is significantly stronger (coefficient = 0.83, Wald Chi-statistic = 5.36, $p < 0.05$). Overall, our findings provide support for Hypothesis H1 that politically connected firms are more likely to obtain a favourable audit opinion than firms without political connections[11].

[Table 3]

5.2 CEO's political connections and subsequent favourable opinion with existence of government ownership

In Column (1) of Table 4, we extend model (1) to include an interaction term – political connections with a dummy variable for non-SOEs. The results show that the likelihood of a favourable opinion in year $t+1$ is significantly associated with local political connections in year t (coefficient = 1.23, Wald Chi-statistic = 3.22, $p < 0.10$). The interaction of local political connections and non-SOEs in year t is significantly positively associated with the likelihood of a favourable opinion in year $t+1$ (coefficient = 0.33, Wald Chi-statistic = 3.65, $p < 0.10$). The results suggest that auditors perceive local political connections to be more important in non-SOEs since connections with local government can have a powerful effect on their business. To further test these associations, in column (2) we partition the sample by different layers of SOEs (local SOEs and central SOEs) and non-SOEs. In the local SOE sample, column (3a) shows that the likelihood of a favourable opinion in year $t+1$ is positively associated with political connections in year t but the result is not statistically significant. Column (3b) shows that the likelihood of a favourable opinion in year $t+1$ is

significantly and positively associated with political connections to local governments in year t (coefficient = 0.33, Wald Chi-statistic = 3.12, $p < 0.10$). In the central SOE sample, columns (3c) and (3d) show that the likelihood of a favourable opinion in year $t+1$ is not significantly associated with either political connections or local connections in year t . In the non-SOE sample, columns (3e) and (3f) show that the likelihood of changing to a favourable opinion in year t is significantly and positively associated with political connections (coefficient = 0.11, Wald Chi-statistic = 3.27, $p < 0.10$) and political connections to local government in year t (coefficient = 0.78, Wald Chi-statistic = 3.44, $p < 0.10$). Overall, the positive association between political connections and audit opinions exists in local SOEs and non-SOEs but is stronger in the sample of non-SOEs. These results arise because CEO's political connections are more crucial in influencing corporate activities and other related parties in non-SOEs which lack natural political connections by way of ownership.

[Table 4]

5.3 Political connections, subsequent favourable opinion and the level of market development

Fan *et al.* (2011) have developed a comprehensive index (MINDEX) to measure the strength of market forces across regions (provinces) in every year in China. They score regional market development from various perspectives including local legal enforcement, local government intervention, development of non-state business and product market competition in terms of regional trade barriers[12]. In column (1) of Table 5, we run model (2) including the institutional factor MINDEX and its interaction with CEO's political connections (PC). The results show that the likelihood of a favourable opinion in year $t+1$ is significantly associated with political connections in year t (coefficient = 0.08, Wald Chi-statistic = 3.04, $p < 0.10$). The interaction of political connections and MINDEX in year t has a significantly

negative association with the likelihood of a favourable opinion in year t+1 (coefficient = -0.12, Wald Chi-statistic = 10.07, $p < 0.01$). This result suggests that the CEO's political connections lead to more favourable audit opinions only in regions with a lower level of economic development.

To further test this association, we divide the country into three areas based on the level of economic development: eastern, middle, and western. The eastern area has the highest level of economic development, whereas the western area has the lowest level[13]. The middle region has more average levels of development. We re-estimate regression model (1) in three samples partitioned on these areas. Column (4c) of table 5 shows that the likelihood of a favourable opinion in year t+1 is positively and significantly associated with political connections in year t in the subsample of Western China where the economy is less developed (coefficient = 0.09, Wald Chi-statistic = 4.45, $p < 0.05$). In contrast, Column (4a) shows that political connections in year t have a significantly negative impact on the likelihood of a favourable opinion in year t+1 in Eastern China, suggesting that auditors may regard CEO's political connections as agency costs in regions with higher level of economy development (coefficient = -0.04, Wald Chi-statistic = 2.98, $p < 0.10$). The association between CEO's political connections and audit opinions is not significant in the middle area of China (see column (4b)). This may be because the middle area has a mix of relationship-based and market-based forces. Taken together, the results suggest that the effect of CEO's political connections on audit opinions is stronger in less developed regions where markets rely more on relationships and there is a lack of market competition and investor protection. Hypothesis H3 is therefore supported.

5.4 Political connections, subsequent favourable opinion and the demand for information in contracting

In column (2) of Table 5, we run model (2) including the institutional factor NSB, the number of non-state owned banks in a region, and its interaction with CEO's political connections (PC). The results show that the likelihood of a favourable opinion in year $t+1$ is not significantly associated with political connections in year t . The number of non-state owned banks (NSB) in the region is negatively associated with the likelihood of a favourable opinion (coefficient = -0.17, Wald Chi-statistic = 3.15, $p < 0.10$), suggesting that auditors are less likely to issue favourable opinions in regions with more non-state owned banks that may demand more credible information and accounting numbers for debt contracting. The interaction of political connections and NSB in year t has a significant negative association with the likelihood of a favourable opinion in year $t+1$ (coefficient = -0.24, Wald Chi-statistic = 3.07, $p < 0.10$). This result suggests that the influence of CEO's political connections on audit opinions is weakened by the information needs of accounting-based debt contracts. The results support hypothesis H4 that audit opinions are less influenced by political connections in regions with more non-state-owned banks where markets have more contractual demand for credible information.

5.4 Political connections, subsequent favourable opinion and the penalty of political corruption and accounting scandals

In column (3) of Table 5, we run model (2) including the institutional factor PENALTY, the number of firms caught and penalised by the CSRC for political corruption and accounting scandals in a region, and its interaction with CEO's political connections (PC). The results show that the likelihood of a favourable opinion in year $t+1$ is significantly positively

associated with political connections in year t (coefficient = 0.36, Wald Chi-statistic = 4.32, $p < 0.05$). This result is consistent with previous results that the CEO's political connections could help firms obtain favourable opinions. The number of firms caught in political corruption and accounting scandals in the region is negatively associated with the likelihood of a favourable opinion (coefficient = -0.33, Wald Chi-statistic = 3.31, $p < 0.10$), suggesting that auditors are less likely to issue favourable opinions in regions where more firms are caught and penalised in scandals. The interaction of political connections and PENALTY in year t has a significant negative association with the likelihood of a favourable opinion in year $t+1$ (coefficient = -2.4, Wald Chi-statistic = 8.79, $p < 0.01$). This result suggests that the influence of CEO's political connections on audit opinions is weakened by the potential risk for relationship-based economic behaviours, providing support for Hypothesis H5.

[Table 5]

6. Robustness tests and additional analysis

6.1 Change in political connections and change in opinions

To control for change in firm characteristics in the current year and self-selection problems, we follow prior studies and use the “difference-in-difference” model (Chan et al., 2006)[14]. We run a logistic regression for the association between the change in political connections and change in audit opinions. The dependent variable is a dummy variable equal to 1 if a firm previously receiving a qualified opinion receives a favourable opinion in the current year, and 0 otherwise. The main independent variable is a dummy variable equal to 1 if a firm which was not previously politically connected forms political connections in the current year, and 0 otherwise. Various control variables measuring changes in the firm's characteristics are included. The results (untabulated) show that the likelihood of changing to favourable

opinions in year t is significantly positively associated with political connections newly formed in year t ($p < 0.05$). Overall, the findings provide further support for Hypothesis H1 since a firm forming new political connections is more likely to receive a favourable opinion in the current year in contrast to a qualified opinion received in the prior year.

6.2 Politically connected CEOs and politically connected chairpersons

We retest the relationship between a CEO's political connections and audit opinions based on the sample including both board chair and CEO. Under Chinese corporate law, the chair is the legal representative of the company. Therefore, this person is endowed with the highest level of authority in the firm and bears the overall responsibility for firm operations. In most cases, the chair is also the highest paid employee. For these reasons, some studies regard the position of chair, rather than that of CEO, as the top management post in a firm (e.g., Firth *et al.*, 2006; Liao *et al.*, 2009). Hence, we redefine our dependent variable in model (1) as a dummy variable equal to 1 if either the chair or CEO has political connections. The untabulated regression results are consistent with the results reported in Table 3.

6.3 Auditors' features and audit opinions

It is well documented that audit opinions are influenced by audit firm attributes. For example, DeAngelo (1981) has established a positive association between auditor size and audit quality. Some Chinese studies find that local and small auditors are more likely to issue unqualified opinions (Chan *et al.*, 2006, Wang *et al.*, 2008 and Chan *et al.*, 2012). Studies also find that companies use auditor switching in order to avoid receiving unfavourable audit reports (Chow and Rice, 1982; DeAngelo, 1981; Haskins and Williams, 1990; Schwartz and Menon,

1985 and Smith, 1986). Following these prior studies, we further examine the influence of political connections on audit opinions with features such as audit firm size, audit firm locality and auditor switching.

In column (1) of Table 6, we partition the sample by firms audited by Big Ten and non-Big Ten auditors[15]. Consistent with prior studies indicating that small auditors dominate China's audit market (Chan *et al.*, 2012; Chan and Wu, 2011), our results show that 77 percent of firms are audited by non-Big Ten firms in our sample. The results in columns (1a) to (1d) show that the likelihood of a favourable opinion in year t+1 is significantly positively associated with political connections ($p < 0.10$) and political connections to local government ($p < 0.05$) in year t in both of the subsamples. Overall, our findings show that politically connected firms are more likely to receive favourable audit opinions in the subsequent period regardless of whether they are audited by Big Ten or non-Big Ten auditors. This suggests that the association between CEO's political connections and favourable opinions is not affected by audit firm size.

In column (2) of Table 6, we partition the sample by firms audited by local auditors and non-local auditors. The results show that 57 percent of firms are audited by local auditors in our sample. Columns (2a) and (2c) show that the likelihood of a favourable opinion in year t+1 is significantly positively associated with political connections in year t in both subsamples ($p < 0.10$). Further, columns (2b) and (2d) show that the likelihood of a favourable opinion in year t+1 is significantly positively associated with political connections to local government in year t in both subsamples ($p < 0.05$ for local audit clients and $p < 0.10$ for non-local audit clients). The results suggest that politically connected firms are more likely to obtain a favourable audit opinion regardless of the locality of auditors.

In column (3) of Table 6, we partition the sample on the basis of whether firms switch or retain their auditor. The table shows that 59 percent of firms in our sample retain their

incumbent auditors. The likelihood of a favourable opinion in year t+1 is positively but not significantly associated with political connections or connections to local government in year t in the subsample of firms that switch auditors (see columns (3a) and (3b)). The likelihood of a favourable opinion in year t+1 is significantly positively associated with political connections and connections to local government in year t in the subsample of no auditor switch ($p < 0.10$). Overall, our findings show that politically connected firms that retain their incumbent auditors are more likely to receive favourable audit opinions in the subsequent period. This suggests that politically connected firms may not select or switch to a new auditor to obtain more favourable opinions, providing evidence that the favourable opinions might be obtained in the absence of auditor switching.

[Table 6]

7. Policy implications

Our results have important implications for regulators, practitioners and investors. The development of stock markets in China in the past two decades has created a demand for greater auditor independence. In response to this demand, the Chinese government launched a series of audit market reforms including transforming the organisation of audit firms and adopting international auditing standards. While these reforms have led to considerable advancement in accounting and auditing practices, our results suggest that the unique political and institutional factors in China still have an important influence on audit independence. Our findings indicate that relationship plays an important role in contracting in China's emerging market. Further, the quality of the auditing profession may be compromised by the economic environment such as the level of market development. Hence,

there may be a need to increase the monitoring of audit independence, particularly in the relatively less developed regions.

8. Conclusion

In response to calls for research on political influence and the audit market (Wang *et al.*, 2008), we examine the importance of corporate insiders' political connections to audit opinions. Based on a sample of listed firms in China, we find that CEOs' political connections are positively associated with subsequent favourable opinions. This political influence appears to be stronger in non-SOEs which lack political ties with government. Moreover, the association between CEO's political connections and audit opinions is less pronounced in regions with a more developed market and a better information environment with stronger investor protection, stronger demand for credible information for contracting and greater penalties for relationship-based contracts.

Our study has several limitations. For example, our data period is restricted to the period 2005 to 2010 and may not be generalisable to other periods. The overall strength of our models is quite low and some of our significance levels are marginal (10 per cent). The models may be strengthened by using alternative measures for some of our control variables or including additional control variables. Alternatively, expanding our definition of political connections may strengthen our results. For example, our measure of CEO's political connections does not include other types of political influence such as corporate political connections by donations or contributions to governments. Broadening the time period of our study and strengthening our models are opportunities for further research. Further, testing whether these various political connections facilitate opinion shopping or reduce audit risks

in different levels of economic and institutional environments are additional opportunities for future research.

Notes

1. A ‘favourable opinion’ means a non-modified opinion. A firm favours a non-modified opinion issued by the auditor because it indicates that its financial statements give a true and fair view and have been prepared in accordance with accounting standards.
2. In China, the market is less developed and investor protection is poorer in Western and inland areas whilst the market is more competitive and developed in Eastern China.
3. The market share of the Big Ten audit firms, which are assumed to provide better quality and more independent audits, has been declining (DeFond *et al.*, 1999).
4. In accordance with prior studies (Chan *et al.*, 2012; Wang *et al.*, 2008), SOEs have a stronger tendency to select small local auditors since those auditors are more likely to issue favourable opinions under political influence of government owners.
5. Qualified opinions are typically issued for events such as uncertainty about asset values, limitations of scope, and financial distress/going concern issues. The events and transactions for disclaimer or adverse opinions are similar to those of qualified opinions but with more pervasive and material effects.
6. As indicated in the official guidelines, events and transactions for unqualified opinions with explanatory paragraphs are those which are important to financial statement users but do not have a direct influence on the financial statements. The events include uncertainty about asset values, related party transactions, and financial distress/going concern issues.
7. In accordance with Chinese regulations, listed companies are required to achieve a target profitability level in order to raise additional capital through a rights issue. Further, if they report losses for three consecutive years, they will be de-listed.
8. The link to the website is <http://finance.sina.com.cn/stock/>.
9. The SASAC’s mandate does not cover financial institutions. The supervision of financial institutions is the responsibility of the Central Banking Supervisory Committee (CBRC). In financial institutions, ownership and regulatory functions are more clearly separated.
10. Our regression diagnostics indicate that some of our control variables are not normally distributed. Eliminating some outliers improved the strength of our models in terms of the overall r squares but had no material impact on our reported results. In order to maximise our sample size, we have therefore chosen to retain all observations.
11. We have also examined the contemporaneous relationship between political connection and audit opinion but results are not significant. The most likely reason for this is that establishing political connections has a more pronounced effect on subsequent audit opinions.
12. This index assesses the relative progress in marketisation of Chinese districts using a comparative method, considering 23 basic indicators in five fields. The index has been sponsored by the National Economic Research Institute (NERI) and the China Reform Foundation. The index captures: (1) the development of market intermediaries based on the ratio of the number of lawyers and registered accountants to local population; (2) the protection of the legal rights of firms based on a nation-wide survey on the frequency of local economic crimes (scaled by local GDP) and managers’ ratings on local investor protection; (3) intellectual property rights (IPRs) enforcement based on the total number of patents applied for and approved (adjusted by the number of engineers in the region); and (4) consumer rights protection based on the frequency of consumer complaints received by the Consumer Association of China (adjusted by local GDP).

13. The eastern region includes the eleven provinces of Beijing, Fujian, Guangdong, Hainan, Hebei, Jiangsu, Liaoning, Shandong, Shanghai, Tianjin, and Zhejiang. The middle region is composed of eight provinces: Anhui, Hei Longjiang, Henan, Hubei, Hunan, Jiangxi, Jilin, and Shanxi. The western region consists of twelve provinces, namely, Chongqing, Gansu, Guangxi, Guizhou, Inner Mongolia, Ningxia, Qinghai, Shaanxi, Sichuan, Xinjiang, Xizang, and Yunnan.
14. In the “difference-in-difference” model, all variables are transformed as changes between current and prior period, namely, $X_{it}-X_{it-1}$. This method is used to control for changes in firm characteristics (Chan *et al.*, 2006).
15. As Big Four auditors have merged with domestic auditors in China, Big Ten auditors based on total revenues or market share are more often used in research as a proxy for reputation and quality of auditors in China.

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Table 1 Descriptive statistics of audit opinions partitioned by politically connected firms (PC) and non-political connected firms (NPC).

Panel A: Audit opinions partitioned by PC vs. NPC

Audit Opinions	PC		NPC	
	number	%	number	%
Unqualified	2126	94	5264	83
Unqualified with explanation	98	4	517	9
Qualified	35	2	286	5
Disclaimer & adverse	14	6	277	4
Observation No.	2273	100	6344	100

Note: unqualified opinions are identified as “favourable opinions”. The others (unqualified with explanation, qualified, disclaimer & adverse) are identified as “unfavourable opinions”.

Panel B: Audit opinions from year to year partitioned by political connections from year to year

Audit opinion	PC				NPC			
	From NPC to PC		No change		From PC to NPC		No change	
	number	%	number	%	number	%	number	%
Change from unfavourable to favourable	7	0.07	37	0.03	7	0.03	101	0.02
Change from favourable to unfavourable	2	0.02	20	0.01	12	0.05	89	0.02
No change - favourable	88	0.86	1311	0.92	204	0.87	3714	0.91
No change - unfavourable	5	0.05	55	0.04	12	0.05	188	0.05
Obervation No.	102	100	1423	100	235	100	4092	100

Table 2 Descriptive statistics on client firm characteristics partitioned by politically connected firms (PC) and non-political connected firms (NPC)

	PC N=2273		NPC N=6344		PC vs. NPC			
	Mean	Median	Mean	Median	Mean (t-test) Difference	t-statistic	Median (Wilcoxon) Difference	z-statistic
Total Assets (RMB Million)	5013	1917	3935	1849	1078	-4.44***	68	2.68***
ROE	0.02	0.03	0.03	0.03	-0.01	1.39	0	-3.58***
Debt Ratio	0.54	0.52	0.52	0.51	0.02	-1.64*	0.01	3.62***
Current Ratio	1.49	1.12	1.79	1.26	-0.3	5.66***	-0.14	-9.10***
Receivable	0.09	0.06	0.11	0.08	-0.02	6.70***	-0.02	-7.74***
Inventory	0.16	0.12	0.18	0.14	-0.02	4.31***	-0.02	-7.57***
Loss	0.12	0	0.11	0	0.01	-1.39	0	1.42
Ownership (%)	0.33	0.31	0.32	0.3	0.01	-2.67***	0.01	2.58***
Big Four	0.05	0	0.04	0	0.01	-1.77*	0	1.84*
Age (years)	12	12	11	11	1	-6.92***	1	6.52
Bshare	0.08	0	0.05	0	0.03	-3.68***	0	3.98***
Audit Fee (RMB Million)	0.59	0.46	0.6	0.48	-0.01	0.38	-0.02	-0.73
Opinion	0.94	1	0.83	1	0.11	-2.23*	0	0.23

Note: Total Assets is nominated in million RMB. Return on equity (ROE) is defined as the net income divided by the average net assets. Debt Ratio is defined as the total debts divided by total assets. Current Ratio is defined as the ratio of total current assets to total current liabilities. Receivable is defined as the account receivable divided by total assets. Inventory is defined as the inventory divided by total assets. Loss is defined as a dummy variable equal to 1 if a firm's net income is less than zero. Ownership is defined as the percentage of shareholdings held by the largest ultimate owner. Big Four is defined as a dummy variable equal to 1 if a firm is audited by an international Big Four auditor. Age is defined as firm's age. B share is defined as a dummy variable equal to 1 if a firm has foreign-owned shares. Audit fees are nominated in million RMB. *, **, and *** indicate significance at 10%, 5%, and 1% level, respectively.

Table 3 Logistic regression of subsequent audit opinions and political connections (use Model (1)).

Independent variables	Dependent variable = Opinion _{it+1}		
	(1)	(2)	(3)
Intercept	0.27 (0.48)	-1.31 (0.36)	-1.71 (0.60)
PC _{it}	0.26 (3.33*)		0.31 (2.70*)
Local_PC _{it}		0.39 (3.31*)	0.83 (5.36***)
Size _{it}	0.19 (5.24**)	0.30 (9.06***)	0.30 (9.19***)
ROE _{it}	0.17 (0.06)	-0.05 (0.39)	-0.05 (0.34)
Debt_Ratio _{it}	-0.73 (22.99***)	-2.76 (33.24***)	-2.78 (33.58***)
Current_Ratio _{it}	0.11 (2.45)	-0.07 (1.36)	-0.07 (1.36)
Receivable _{it}	-2.36 (15.56***)	-1.65 (5.15**)	-1.56 (4.61**)
Inventory _{it}	0.99 (4.17**)	1.65 (7.37***)	1.69 (7.77***)
Loss _{it}	-1.39 (65.28***)	-1.37 (64.85***)	-1.36 (64.06***)
Ownership _{it}	1.48 (12.71***)	1.61 (11.03***)	1.61 (10.99***)
Age _{it}	-0.10 (37.94***)	-0.08 (14.18***)	-0.08 (14.42***)
Audit_Fee _{it}	-0.17 (1.11)	-0.13 (0.48)	-0.13 (0.48)
B share _{it}	-0.21 (0.61)	-0.04 (0.01)	-0.06 (0.03)
Year dummy	Yes	Yes	Yes
Indus dummy	Yes	Yes	Yes
Pseudo R-square	0.08	0.06	0.06
Obs. No	8617	8617	8617

Note: The dependent variable is subsequent audit opinion (Opinion_{it+1}), which is defined as 1 if audit opinion is favourable and 0 otherwise. The independent variable is PC_{it}, which is defined as 1 if a CEO is politically connected (refer to as definition in Section 3) and 0 otherwise, or Local_PC_{it}, which is defined as 1 if a CEO is politically connected to local government (refer to as definition in Section 3) and 0 otherwise. See Table 2 for other variable descriptions. The year dummy variables and industry dummy variables are also included. The number in the parenthesis below is Wald Chi-square value. *, **, and *** indicate significance at 10%, 5%, and 1% level, respectively.

Table 4 Logistic regression of subsequent audit opinions and CEO's political connections in SOEs versus non-SOEs.

Independent var.	(2)						
	(1)	Local SOEs		Central SOEs		Non-SOEs	
	(a)	(b)	(c)	(d)	(e)	(f)	
Intercept	0.56 (0.23)	0.98 (0.3)	0.39 (0.15)	0.174 (0.616)	0.17 (2.00)	-0.64 (0.05)	-3.04 (0.9)
PC _{it}	0.4 (2.36)	0.17 (1.93)		0.014 (0.786)		0.11 (3.27*)	
Local_PC _{it}	1.23 (3.22*)		0.33 (3.12*)		0.003 (0.993)		0.78 (3.44*)
PC _{it} * NSOE _{it}	0.18 (2.43)						
Local_PC _{it} * NSOE _{it}	0.33 (3.65*)						
NSOE _{it}	0.63 (1.09)						
Size _{it}	0.51 (2.15)	0.03 (1.86)	0.12 (2.71*)	0.124 (0.58)	-0.05 (4.15**)	0.35 (7.18***)	0.35 (5.68**)
ROE _{it}	-0.03 (0.73)	-0.23 (0.22)	-0.16 (0.52)	-0.416 (0.15)	-0.62 (2.96*)	-0.06 (0.63)	-0.01 (0.003)
Debt_Ratio _{it}	-2.25 (12.21***)	-2.23 (8.91***)	-3.04 (14.30***)	-1.864 (1.63)	-2.74 (1.96)	-2.47 (15.87***)	-2.73 (13.25***)
Current_Ratio _{it}	-0.19 (1.17)	-0.18 (0.49)	-0.26 (2.30)	-0.576 (0.59)	-0.78 (1.05)	-0.13 (1.98)	-0.1 (0.84)
Receivable _{it}	-2.54 (1.64)	-2.45 (6.02***)	-2.96 (6.71***)	-2.154 (1.06)	-3.13 (2.69)	-0.81 (0.72)	-0.03 (0.001)
Inventory _{it}	1.47 (2.44)	1.14 (2.64)	1.85 (4.32**)	1.08 (1.86)	0.88 (4.67**)	1.7 (5.96***)	1.93 (5.13**)
Loss _{it}	-1.26 (9.52***)	-1.35 (29.74***)	-1.29 (22.62***)	-1.67 (8.94***)	-1.84 (7.25***)	-1.49 (46.44***)	-1.57 (36.82***)
Ownership _{it}	1.35 (2.78*)	1.23 (4.72**)	1.8 (7.83***)	0.964 (2.20)	0.77 (0.55)	1.35 (3.59*)	1.16 (2.08)
Age _{it}	-0.19 (12.39***)	-0.21 (9.58***)	-0.18 (4.06**)	-0.58 (11.81***)	-0.78 (10.16***)	-0.1 (14.69***)	-0.09 (9.35***)
Audit_Fee _{it}	-0.14 (0.44)	-0.15 (0.17)	-0.28 (0.30)	-0.53 (0.25)	-0.73 (2.67)	-0.25 (0.95)	-0.13 (0.19)
B share _{it}	-0.03 (0.39)	0.15 (0.58)	0.24 (0.74)	-0.03 (0.20)	-0.62 (2.61)	-0.3 (0.32)	-0.58 (1.14)
Year dummy	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Indus dummy	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Pseudo R-square	0.08	0.08	0.07	0.04	0.05	0.09	0.09
Obs. No	8617	3559	3559	1204	1204	3854	3854

Note: The dependent variable is subsequent audit opinion (Opinion_{it+1}), which is defined as 1 if audit opinion is favourable and 0 otherwise. The independent variable is PC_{it}, which is defined as 1 if a CEO is politically connected (refer to as definition in Section 3) and 0 otherwise, or Local_PC_{it}, which is defined as 1 if a CEO is politically connected to local government (refer to as definition in Section 3) and 0 otherwise. NSOE is a dummy variable equal to 1 if a firm is not owned by government. See Table 2 for other variable descriptions. The year dummy variables and industry dummy variables are also included. The number in the parenthesis below is Wald Chi-square value. *, **, and *** indicate significance at 10%, 5%, and 1% level, respectively.

Table 5 Logistic regression of subsequent audit opinions, CEO's political connections and institutional factors.

Independent variables	(1)	(2)	(3)	(4) Partitioned by AREAs		
	MINDEX	NSB	PENALTY	(a) East	(b) Middle	(c) West
Intercept	0.15 (0.70)	0.03 (0.58)	1.38 (0.98)	0.077 (0.22)	0.05 (0.89)	0.63 (0.70)
PC _{it}	0.08 (3.04*)	-0.04 (0.15)	0.36 (4.32**)	-0.04 (2.98*)	0.003 (0.99)	0.09 (4.45**)
Institutional_Factor _{itr}	-0.05 (1.03)	-0.17 (3.15*)	-0.33 (3.31*)			
PC _{it} * Institutional_Factor _{itr}	-0.12 (10.07***)	-0.24 (3.07*)	-2.40 (8.79***)			
Size _{it}	-0.49 (8.24***)	-0.61 (3.36**)	-0.77 (6.96***)	0.65 (7.32***)	0.25 (0.28)	0.29 (5.43**)
ROE _{it}	0.03 (0.63)	-0.15 (0.51)	0.31 (1.91)	0.85 (9.15***)	1.64 (0.65)	0.55 (0.74)
Debt_Ratio _{it}	-0.14 (0.31)	-0.28 (0.19)	-0.52 (0.07)	-8.30 (0.75)	-7.03 (0.83)	-7.09 (0.38)
Current_Ratio _{it}	-0.18 (0.94)	-0.30 (1.06)	-0.56 (1.32)	-1.99 (1.65)	-1.13 (1.40)	-0.99 (1.63)
Receivable _{it}	-0.008 (0.77)	-0.02 (0.89)	-0.04 (1.15)	-0.28 (0.81)	0.21 (0.71)	-0.45 (1.07)
Inventory _{it}	0.00 (1.23)	0.12 (0.35)	0.38 (0.61)	1.14 (2.17)	1.08 (2.01)	1.7 (3.98**)
Loss _{it}	-0.17 (5.08**)	0.05 (3.20*)	-1.45 (11.36***)	0.016 (14.9***)	0.08 (7.24***)	-0.07 (35.70***)
Ownership _{it}	0.25 (0.92)	0.49 (2.92*)	0.03 (1.30)	0.24 (1.58)	0.38 (2.14)	0.15 (2.93*)
Age _{it}	-1.13 (0.56)	-0.25 (0.68)	-0.41 (0.64)	-0.09 (1.57)	-0.07 (1.67)	-0.22 (1.48)
Audit_Fee _{it}	0.02 (0.58)	0.14 (0.70)	1.30 (2.98*)	-0.27 (0.97)	-0.65 (0.68)	-0.37 (0.27)
B share _{it}	0.14 (0.24)	0.26 (0.12)	0.42 (0.52)	0.03 (0.73)	-0.25 (0.66)	-0.42 (1.09)
Year dummy	Yes	Yes	Yes	Yes	Yes	Yes
Industry dummy	Yes	Yes	Yes	Yes	Yes	Yes
Pseudo R-square	0.09	0.08	0.10	0.07	0.05	0.09
Obs. No	8617	8617	8617	3016	2240	3361

Note: The dependent variable is subsequent audit opinion (Opinion_{it+1}), which is defined as 1 if audit opinion is favourable and 0 otherwise. The independent variable is PC_{it}, which is defined as 1 if a CEO is politically connected (refer to as definition in Section 3) and 0 otherwise. See Table 2 for other variable descriptions. MINDEX is a marketization index reported by Fan et al. (2011). NSB is defined as the number of non-state owned banks (including foreign banks) in a region (based on provinces) of China. Penalty is defined as the number of firms caught in both political corruption and accounting scandals by CSRC in a region (based on provinces) of China. The year dummy variables and industry dummy variables are also included. The number in the parenthesis below is Wald Chi-square value. *, **, and *** indicate significance at 10%, 5%, and 1% level, respectively.

Table 6: Logistic regression of subsequent audit opinions and political connections in a subsample of firms partitioned by auditors' features including Big Ten audit firms versus non- Big Ten audit firms, local auditors versus non-local auditors and auditor switching versus no auditor switching.

Independent var.	(1)				(2)				(3)			
	Big Ten		Non-Big Ten		Local Auditor		Not Local Auditor		Auditor Switch		No Auditor Switch	
	(a)	(b)	(c)	(d)	(a)	(b)	(c)	(d)	(a)	(b)	(c)	(d)
Intercept	7.46 (0.001)	8.09 (0.002)	0.39 (0.03)	-1.36 (0.3)	-1.76 (0.31)	-3.5 (0.87)	1.98 (0.86)	0.28 (0.01)	-2.96 (0.86)	-4.93 (1.73)	1.29 (0.32)	-0.04 (0.00)
PC _{it}	0.87 (2.92*)		0.11 (3.48*)		0.29 (3.27*)		0.27 (2.92*)		0.03 (0.02)		0.33 (2.85*)	
Local_PC _{it}		0.27 (4.05**)		0.74 (4.62**)		1.16 (5.58**)		0.25 (3.29*)		0.69 (1.97)		0.6 (2.87*)
Size _{it}	0.21 (1.17)	0.2 (0.61)	0.33 (11.04***)	0.35 (10.71***)	0.34 (5.09**)	0.44 (6.11***)	0.13 (1.61)	0.23 (3.62*)	0.23 (2.45)	0.35 (4.11**)	0.26 (5.57**)	0.26 (4.64**)
ROE _{it}	0.06 (0.19)	0.92 (0.73)	-0.06 (1.12)	-0.04 (0.34)	-0.51 (0.15)	-0.12 (0.08)	0.91 (1.14)	-0.03 (0.3)	-0.01 (0.07)	-0.01 (0.02)	-0.02 (0.81)	-0.13 (0.38)
Debt_Ratio _{it}	-3.3 (6.35***)	-3.91 (4.05**)	-1.84 (16.10***)	-2.23 (19.68***)	-0.57 (4.59**)	-2.65 (10.34***)	-0.84 (15.46***)	-2.64 (16.38***)	-1.42 (3.32*)	-1.91 (4.65**)	-2.67 (24.67***)	-3.4 (28.47***)
Current_Ratio _{it}	0.44 (1.68)	0.67 (1.26)	-0.06 (1.16)	-0.06 (1.22)	0.02 (0.08)	-0.07 (1.24)	0.19 (3.15*)	-0.01 (0.01)	0.14 (0.12)	0.02 (0.02)	-0.11 (2.04)	-0.13 (2.26)
Receivable _{it}	-2.34 (2.56)	-5 (6.50***)	-1.48 (3.81**)	-1.01 (1.57)	-1.57 (2.42)	-1.37 (1.31)	-3.01 (15.22***)	-2.09 (4.89**)	-2.15 (3.97**)	-2.39 (4.01**)	-1.55 (3.35*)	-1.21 (1.73)
Inventory _{it}	2.72 (2.66*)	5.35 (3.54*)	1 (3.39*)	1.22 (3.82**)	2 (4.92**)	4.65 (12.93***)	-0.5 (0.72)	0.64 (0.77)	2.21 (5.61**)	3.5 (7.11***)	0.97 (2.31)	1.28 (3.27*)
Loss _{it}	-0.64 (2.12)	-0.006 (0.001)	-1.49 (79.10***)	-1.48 (66.41***)	-1.57 (25.69***)	-1.17 (12.39***)	-1.25 (34.22***)	-1.43 (46.44***)	-1.51 (35.34***)	-1.54 (28.83***)	-1.25 (40.78***)	-1.29 (32.15***)
Ownership _{it}	1.59 (2.41)	1.45 (1.31)	1.36 (7.77***)	1.64 (9.36***)	1.59 (5.10**)	2.05 (6.18***)	1.46 (7.61***)	1.49 (5.88**)	0.82 (1.41)	1.11 (1.98)	2.02 (11.75***)	2.02 (10.00***)
Age _{it}	-0.07 (2.80*)	-0.12 (3.72**)	-0.1 (22.97***)	-0.07 (11.37***)	-0.11 (17.01***)	-0.08 (4.78**)	-0.1 (22.54***)	-0.08 (9.98***)	-0.15 (27.60***)	-0.13 (16.68***)	-0.06 (5.94***)	-0.04 (2.81*)
Audit_Fee _{it}	0.2 (0.39)	0.11 (0.08)	-0.3 (2.04)	-0.26 (1.34)	-0.22 (0.61)	-0.34 (1.05)	-0.11 (0.35)	-0.09 (0.15)	0.13 (0.23)	0.01 (0.001)	-0.25 (1.37)	-0.16 (0.5)
B share _{it}	-0.34 (0.48)	-0.2 (0.12)	0.46 (0.9)	0.2 (0.16)	-0.27 (0.33)	-0.05 (0.01)	-0.01 (0.001***)	-0.05 (0.01)	0.5 (0.23)	0.25 (0.11)	-0.15 (0.16)	-0.25 (0.41)
Year dummy	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Indus dummy	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Psuedo R-square	0.08	0.1	0.06	0.06	0.08	0.07	0.09	0.07	0.08	0.08	0.06	0.07
Obs. No	1970	1970	6647	6647	4875	4875	3742	3742	3552	3552	5065	5065

Note: The dependent variable is subsequent audit opinion (Opinion_{it+1}), which is defined as 1 if audit opinion is favourable and 0 otherwise. The independent variable is PC_{it}, which is defined as 1 if a CEO is politically connected (refer to as definition in Section 3) and 0 otherwise, or Local_PC_{it}, which is defined as 1 if a CEO is politically connected to local government (refer to as definition in Section 3) and 0 otherwise. See Table 2 for other variable descriptions. The year dummy variables and industry dummy variables are also included. The number in the parenthesis below is Wald Chi-square value. *, **, and *** indicate significance at 10%, 5%, and 1% level, respectively.