Political corruption and auditor change decision: Evidence from China

Abstract:

We investigate how auditors respond to the local political corruption. By taking the number of corruption convictions as the proxy for corruption, we find that Big 10 auditors and review auditors tend to switch clients more frequently to avoid potential litigation /reputation costs when their client firms headquartered in more corrupt provinces. The results are more pronounced in non-state-owned-enterprises (non-SOEs) and firms with higher business risk. Complementary evidence shows that these firms have both low accounting quality and low litigation risk especially for those audited by non-Big 10 auditors. More importantly, we find auditors' tendency to change clients are mitigated after the anti-corruption campaign. Overall, our suggests that auditors' assessment of risk in provinces with more corruption convictions are subject to their size and degree of independence, where Big 10 auditors are more sensitive to potential risks while non-Big 10 auditors are more prone to government expropriation.

Keywords: political corruption; audit change decision, reputation and litigation, China

JEL: D73, G31, G34

1. Introduction

Given the pervasive and corrosive impact of political corruption on society and the economy, an increasing number of studies have begun to investigate how firms and their stakeholders respond to the local political corruption, but the evidence is controversial. Some studies hold the view that political corruption leads to low efficiency as it distorts capital allocation and hinders economic growth (Shleifer and Vishny, 1993; Lin et al., 2019). Corrupt officials are likely to extort firms for private benefits, so that firms respond by shielding their assets and practicing opaque disclosure to avoid political extraction (Smith, 2016; Xu et al., 2019a; Zhang and Zhang, 2022). However, others argue that firms can garner political favouritism in corrupt environment (Fisman, 2001; Claessens et al., 2008). That is, apart from extorting firms for private benefit, political power can bring political favouritism to local firms in exchange for political support, which then becomes a legitimate way for politicians to obtain personal benefits such as promotion. As a result, firms may respond to corrupt politicians' extortion in a favourable way to cultivate and establish connections for government protection (Cai et al., 2011), which may help firms to cut through the bureaucratic rules and reduce business risk and litigation risk in turn. Although there are numerous studies investigating economic implications of corruption, limited research focuses on the possible impact of corruption on auditors' behvaiours. This impact is important because auditors play a crucial role in providing independent assurance of the credibility of accounting information and ensuring proper functioning of the capital market (DeFond and Zhang, 2014; Lawson and Wang, 2016). Our study helps to illuminate this issue by examining how the local political corruption impacts auditing practice.

Investigating on auditors' responses to political corruption is worthwhile as it adds to better understanding of risk management strategies applied by external auditors when evaluating firms' local institutional and social environments. Extant research documents several client risk management strategies employed by auditors when performing auditing in a risky client (Chung et al., 2015; DeFond et al., 2016; Lawson and Wang, 2016). For example, auditors tend to increase audit efforts and allocate more resources to mitigate risk to tolerable levels; in addition, auditors may also charge a risk premium to transfer potential risk to the client and issue more conservative audit reports; if the client-related risk is so high, auditors may resign from clients.

In addition, recent studies have examined whether regions prone to political corruption affect auditors' perception of a client's risk and found that auditors tend to issue unfavourable opinions and charge higher audit fees under such circumstances (Xu et al., 2019b; Jha et al.,

2021). However, to the best of our knowledge, there is little research investigating auditors' change decision when a client's risk is relatively high because of corruption. Prior research on auditor switch shows that auditor change decision is affected by client firms' ownership structure (Wang et al., 2008), economic importance of clients and the form of audit firms (Chen et al., 2016), as well as clients' risk factors (Ghosh and Tang, 2015a). Accordingly, our study attempts to fill this void in the literature.

To examine our research question, we choose the Chinse setting which provides an interesting setting with significant tension to study auditors' decisions deeply for the following reasons. First, the Chinese capital market is characterized by weak investor protection and underdevelopment legal enforcement (Allen et al., 2005). Politicians in China have discretion over resource allocation and affect the corporate sector directly (Piotroski and Zhang, 2014). Such government involvement in business and local corruption vary significantly across regions.

Second, the Chinese audit market is less concentrated and suffers fierce competition, offering large bargaining power to audit clients (Wang et al., 2008). In addition, audit firms operating in China are subject to various levels of government interventions (Wang et al., 2008; Guan et al., 2016). With local audit firms, their clients are local firms so they remain heavily and economically dependent on local governments due to geographical restrictions (Chan et al., 2006; Gul et al., 2013). To protect local firms, politicians may directly use their power and pressure local auditors to treat local firms favourably through Bureau of Audit and local CPA institutes when licensing audit firms or monitoring their operational activities (Wang et al., 2008). In return, local governments would protect these involved auditors from being sued or exposed to harsh regulatory sanctions (He et al., 2021). Even though China has underdeveloped market mechanism compared with developed countries, the reputational and legal risks exposed by auditors are not negligible (Firth et al., 2011). In the case of Big 10 audit firms, their reputational and legal risks are much higher than their local counterparties. Once the accumulation of hidden risks from inappropriate audit outcomes reaches a threshold, they may come out at once, leading to considerable litigation and reputation costs to involved auditors.[1] Therefore, even local governments are able to protect involved auditors, Big 10 auditors may

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[1] See for example, the Ministry of Finance made an announcement on 17th of March, 2023 for imposing regulatory penalties for Deloitte, one of Big 4 audit firms and its client, China Huarong Asset Management Co., Ltd. This announcement stated that Huarong suffered from significant inherent and control risk and distortion of accounting information during 2014-2019, whereas Deloitte failed to implement necessary audit procedures and issue appropriate audit opinions. The penalties include 210 million yuan fine, suspending business of Beijing branch of Deloitte for 3 months and revoking auditing licenses of involved auditors.

also employ client risk management strategies when auditing risky clients. Hence, how different types of audit firms respond to local political corruption is an empirical issue.

More importantly, the Chinese data makes it possible for us to extend our investigation to the individual level. In China, the identity and characteristics of review auditors[2] are required to be publicly disclosed, which are not available in the US and other markets. It makes the Chinese setting unique to further analyze responses of individual review auditors towards political corruption.

According to the Corruption Perception Index 2019, China is ranked 80th out of 198 countries in corruption with a score of 41/100, which is lower than the average global score of 43, while the US and the UK are ranked 23rd and 12th with scores of 69 and 77 respectively.[3] This indicates that corruption and rent-seeking activities by the government are prevailing in the Chinese market compared to other markets. However, the fast growth of the Chinese economy over the past several decades presents a direct challenge to the traditional wisdom that corruption is detrimental to economic growth (Piotroski and Zhang, 2014). In fact, such political intervention can inflict pressure on auditors, dilute audit independence and increase auditor potential risk (Chan et al., 2006; 2012).

We hypothesize that auditors' decision to leave or stay is affected by client risk in the context of the local political corruption in China through two channels. First, firms in more corrupt regions, especially those having connections with the government, may obtain more political protection, which lowers business risk and consequently lowers risk assessed by auditors. Second, corrupt politicians may directly pressure local auditors to compromise their independence and treat local firms favourably to obtain private benefits. Given the distinct institutional framework and government intervention in the audit market in China, we predict that auditors assess firms located in more corrupt regions as risky clients or not depending on their exposure to potential reputational and legal damage.

We investigate the explicit impact of political corruption on audit firms' decision to change clients using a sample of listed firms in China. In particular, the local political corruption could be a manifestation of severe local government intervention over local firms. As such, we argue that the auditor's assessment of risk is based on where the firm is headquartered. Following Smith (2016), Xu et al. (2019b) and Jha et al. (2021), we use the total number of corruption convictions involving government officials at the province level as the primary proxy for the

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[2] In China, an audit report is signed by two auditors, a review auditor and an engagement auditor.
[3] See details at: https://www.transparency.ie/news_events/corruption-perceptions-index-2019.

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local political corruption. A province is identified to have a higher degree of corruption if the number of corruption convictions is larger. The data on provincial corruption cases is taken from the China Procuratorial Yearbook, and the official website of the Commission for Discipline Inspection of the Central Committee. Using data at the provincial level is intuitive under the Chinese top-down political personnel system that the provincial Communist Party Committee determines the appointment and dismissal of officials at both the municipal and county levels.

Our sample comprises 3,082 unique firms listed on both the Shanghai and Shenzhen Stock Exchanges during the period from 2006 to 2017 with a total of 22,659 firm-year observations. Using this sample, we find that auditors, especially Big 10 auditors and review auditors who take responsibility for decision-making in the auditing process, tend to switch clients more frequently to manage potential litigation or reputation risks when their client firms are located in provinces with more corruption conviction cases. These results are stronger in non-SOEs and firms with higher business risk. Complementary evidence shows that these firms have both low accounting quality and low litigation risk especially for those audited by non-Big 10 auditors. Hence, our empirical results suggest that auditors' assessment of risk in provinces with more corruption conviction are subject to their size and degree of independence. Big 10 audit firms have greater litigation and reputation concerns tend to change clients frequently while other audit firms may pick up dropped clients due to political protection. To consolidate the result, we examine auditors' responses to the anti-corruption campaign launched in 2012 and find that after its initiation, auditors' tendency to change clients decreased, which indicates that the campaign has disrupted political corruption.

Our study makes several contributions to the literature. First, we extend the growing literature on political corruption (Ellis et a., 2020; Huang and Yuan, 2019; Smith, 2016; Xu et al., 2019b; Jha et al., 2021) in the auditing context and provide important insights into its economic implications. Prior studies provide mixed evidence which either hold political expropriation view (Smith, 2016; Xu et al., 2019b; Jha et al., 2021), or government protection view (Cai et al., 2011; Chen et al., 2020). Using the Chinese setting, we investigate how auditors respond to the local political corruption. The findings of our study suggest that political corruption offers an opportunity for firms to connect with governments to expedite regulatory procedures, in line with Mironov (2015). From the auditing perspective, the willingness of auditors staying in the same client firm in more corrupt regions depend on their tolerance of potential costs. More importantly, following the spirit of Xu et al. (2019b), we further identify another mechanism through which the local political corruption affects auditor'

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perception of client risk. We find auditors concern about their potential reputation costs thus feel reluctant to engage in auditing risky clients.

Second, our study advances knowledge about the effects of governmental intervention on auditor behaviour. Existing studies examine governmental intervention from the client firm's perspective, that is how auditor respond to SOEs or firms with political ties (Wang et al., 2008; He et al., 2017). Our study extends this stream of literature by focusing on both intervention on involved firms and auditors in the context of political corruption, and provides evidence of auditor change decision within this environment. We show that although firms operating in corrupt provinces are perceived as having lower audit risk due to government protection (regardless of whether these firms themselves engage in corruption activities), they contain considerable potential risk which suppresses auditors with high reputational concerns to stay in the same client firm for a long time. Therefore, this study also has policy implications for regulators and practitioners when launching reforms to disrupt political corruption.

Our study also contributes to the analysis of auditor behaviour at the individual level. Auditor behaviour at the partner level is under explored but this line of research also has important implications because engagement partners are ultimately responsible for audit engagements (DeFond and Francis, 2005; Chen et al., 2016). An increasing number of studies examine factors driven variation of audit quality using audit data at the individual level (Chen et al., 2016; Gul et al., 2013; Guan et al., 2016), our work provides new evidence that individual auditors exhibit significant variation in risk assessment when auditing firms in regions with more corruption.

The remainder of this paper is organized as follows. Section 2 reviews the prior literature and develops hypotheses. Section 3 describes the data and variables, Section 4 shows empirical results, and Section 5 concludes the paper.

2. Literature review and hypothesis development

2.1 Literature review

Political corruption, which is commonly defined as the abuse of political power to obtain individual gain, is a worldwide phenomenon occurring at all levels of government and incurring substantial costs in economic activities (Shleifer and Vishny, 1993).[4] Previous

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[4] According to the World Bank's Enterprise Surveys 2007-2013, around 20% of firms have experienced government officials' bribe payment request at least once. Moreover, the cost of corruption at the global level was approximately accounting for over 5% of global GDP. See details at: http://www.enterprisesurveys.org; http://reports.weforum.org/global-agenda- council-2012/councils/anti-corruption/.

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literature suggests that political corruption is largely determined by the government's institutional structure and the political process, which reflects the regulatory and business environment that firms operate in, thus having a direct impact on firm behaviour (Shleifer and Vishny, 1993). Generally, politicians can threaten firms or extort firms through regulations, licenses or extortionary taxes for the purpose of obtaining personal benefits or advancing their political agendas (Piotroski and Zhang, 2014).

Previous literature on auditor change mainly concentrates on two perspectives. One strand of research examines clients' propensity of changing auditors and shows that firms seeking for cleaned opinions (opinion shopping) are more likely to undertake downward switches from Big 10 to non-Big 10 auditors (Chan et al., 2006; Wang et al., 2008; Chen et al., 2016; Amin et al., 2021). Another strand of research investigates auditors' client risk management strategies and documents that auditors may charge higher audit fees, exert more efforts and even resign from an audit engagement when auditing risky clients (Ghosh and Tang, 2015a; DeFond et al., 2016; Lawson et al., 2016). Extant research on Chinese auditor behaviour majorly focuses on firms' ownership structures and political connections. They suggest that auditors usually perceive lower audit risk in politically connected firms due to government support (Wang et al., 2008; Yang, 2013), and lower litigation risk as they are less likely to be sued or exposed to harsh regulatory sanctions for audit failure under government protection (Firth et al., 2011; He et al., 2021). A growing body of literature has explored implications of corruption in China and suggests corruption leads to lower accounting quality (Chen et al., 2020), poor earnings informativeness (Fan et al., 2014). However, the questions of how auditor respond to the local political corruption and their strategies to manage risks have not yet been answered directly.

2.2 Hypothesis development

Political protection tempts auditors to compromise their independence and issue favourable audit results to avoid adverse effects from bad news. However, when the accumulation of hidden risks of firms passes a threshold (i.e local government officials are under investigation or arrested), they may come out at once, bringing high litigation or reputation costs to involved auditors. Accordingly, we focus on auditors' decisions whether they tend to trade off political protection from corruption with their reputation. Distinct size and ownership concentration of audit firms in China result in different abilities to resist political pressure and sensitivities to potential reputational and legal risk. Although China's legal and market mechanisms are relatively underdeveloped, litigation and reputational risks for auditors are still not negligible (Gul et al., 2016). Big 10 audit firms that possess larger reputational

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assets and abilities to detect hidden risks, any audit failure could bring them substantial litigation costs and huge client losses (He et al., 2016). To manage potential further litigation/reputation risks, Big 10 auditors have a high propensity to switch to other less risky firms or resign from risky clients (DeFond and Zhang, 2014; Ghosh and Tang, 2015b). In contrast, local audit firms bear a close relationship with local governments as many auditors are local officials and some partners are ex-bureaucrats of the local governments (Wang et al., 2008). In addition, local governments maintain a dominant influence over audit firms through Bureau of Audit, local CPA institutes for qualifying audit firms' licenses, as well as firms' auditor selection in the form of controlling shareholders or sponsors (Wang et al., 2008; He et al., 2017). Such significant economic dependence on local governments and firms actually dilutes auditor independence because they may suffer considerable costs at the expense of refusing officials' soliciting requests. Therefore, local audit firms are willing to pick up dropped clients as they are more vulnerable to political intervention (Yang, 2013). Therefore, we develop the following hypothesis:

Hypothesis 1: *Compared with local auditors, Big 10 auditors tend to switch firms more frequently when their clients are located in more corrupt provinces.*

We extend previous hypothesis to the partner level and the individual level. Audit partners are different in their abilities, ethical standards, and willingness to exercise professional scepticism, which affect their conservatism and final audit outcomes (Nelson and Tan, 2005; Gul et al., 2013). In addition, as Chinese audit firms lack weak quality control mechanisms, it is difficult to achieve consistent audit quality cross different audit partners even in the same firm (Chen et al., 2016). Audit partners with less conservatism may be susceptible to political pressure to treat clients more favourably, as retaining important clients provides considerable private benefits to them such as job security, promotion opportunities and so on (Chi et al., 2012; Chen et al., 2016). Considering lower litigation risk for audit failure and fierce competition in the audit market, non-Big 10 auditors tend to reach agreements with their clients to retain important clients. In the contrary, apart from possessing greater wealth at risk than their counterparties at the firm level, audit partners in Big 10 audit firms who signed the audit report also have their personal reputation at stake, so that they feel reluctant to stay in risky clients for a long time.

From the individual level, individual auditors' personal attributes such as risk preferences and expertise results in heterogeneous audit outcomes (Nelson and Tan, 2005). In practice,

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there are two auditors signing each audit report in China, including a review auditor who takes responsibility for decision-making on significant affairs in the auditing process, and an engagement auditor who mainly conducts the fieldwork (Gul et al., 2013). Signing the audit report enables auditors to clarify the responsibilities they performed. Compared with engagement auditor, the review auditor takes larger responsibility and exerts significant influence on audit outcomes, thus are exposed to higher potential risk for audit failures. Therefore, they have a high propensity to switch to less risky clients compared with their counterparties. Accordingly, we developed the following hypothesis:

Hypothesis 2a: *Compared with non-Big10 auditors, Big 10 audit firms tend to change audit partners in the incumbent client more frequently when their clients are located in more corrupt provinces*

Hypothesis 2b: *Compared with engagement auditors, review auditors tend to change clients more frequently when their clients are located in more corrupt provinces.*

We further extend previous hypotheses through focusing on the anti-corruption campaign launched in 2012. Since the anti-corruption campaign, corrupt government officials have been arrested or under investigation. Lin et al. (2019) claim that the vigorous enforcement of anti-corruption reforms hampers political corruption through depreciating the value of such political ties. The termination of political ties removes government protection obtained through rent-seeking activities, thus mitigating auditors' concerns for potential litigation/ reputation costs. As a result, auditors are likely to have a lower propensity to change clients in more corrupt provinces.

Hypothesis 3: *After the 2012 anti-corruption campaign, auditors' tendency to change clients in more corrupt provinces are relieved.*

3. Empirical data and method
3.1 Full sample

Our initial sample includes 26,024 firm-year observations that comprises 3,547 listed firms on the Shenzhen and Shanghai Stock Exchanges over the period from 2006 to 2017. The sample period is determined by the availability of data on corruption, which is detailed in Section 3.2. All the auditing and accounting data come from a widely used commercial database, the China Stock Market and Accounting Research Database (CSMAR). We remove 788 observations from financial firms as their financial reports follows special requirements

by the China Securities Regulatory Commission (CSRC) and the China Banking Regulatory Commission (CBRC) (Chen et al., 2018; He et al., 2017). We also remove 2,577 observations with missing data on our key variables. Furthermore, we manually collect corruption convictions at the province level to measure the magnitude of corruption. We collect convictions of government officials by year and merge the data with financial and auditing data. Then we match firms to provinces based on location of firm headquarters. Finally, we are able to identify 22,659 firm-year observations, corresponding to 3,082 unique firms.

3.2 Measurement of political corruption

Following prior literature (Smith, 2016; Xu et al., 2019b), we apply the number of convictions involving government officials per 10,000 province population as the primary proxy for the magnitude of local political corruption. As for the convictions measure, we use data at provincial level for the following reasons. First, the Chinese political system is characterized as a multidivisional-form (M-form) structure with five layers of administration, including central, province, municipal, county and village, where government officials at the higher level of the hierarchy are in charge of those at a lower level. In this system, the central committee of the Communist Party has ultimate discretion in the appointment and dismissal of government officials at other levels, while the other levels of governments function as different divisions that take charge of political and economic affairs in their jurisdictions (Li and Zhou, 2005). As a result, political corruption at the provincial level can radiate to the lower levels within a province. Second, prior studies show that data at the provincial level has a higher degree of homogeneity in terms of economic and institutional environment (Fan et al., 2014; Chang et al., 2017). Therefore, we adopt provincial convictions data and argue that a province with a larger number of convictions are more corrupt, which may affect both firms' and auditors' behaviour in the province.

Data on corruption cases mainly comes from the China Procuratorial Yearbook and the official website of the Commission for Discipline Inspection of the Central Committee. In rare cases where a corruption number is missing, we apply the average value of the adjacent years as the conviction number for missing observations. Overall, we are able to collect a total of 549,232 official convictions in China from 2006 to 2017. Appendix Table A.2 presents a distribution of corruption cases by provinces. In general, we find that the number of corruption cases is highest in Henan, followed by Shandong and Guangdong. Figure 1 presents the visual presentation of corruption convictions summarized in Appendix Table A.2. We use mean corruption cases per province and display these mean data in the choropleth map. The data is

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split to four levels of convictions which highlights the geographic variations in corruption within China. We further break down corruption cases in each year, which are presented in Appendix Table A.3.[5] As it is shown in Table A.3, the number of conviction cases has experienced an increase since 2012, when the anti-corruption reform was initiated.

One important concern is that provinces with more corrupt convictions lead to less corruption as such provinces develop better law enforcement. Such a concern could be alleviated by several points. First, as direction and monitoring flow are from the Commission for Discipline Inspection of the Central Committee, which is above the influence of local corruption, we follow Glaeser and Saks (2006) and expect moderate homogeneity of enforcement. Second, as shown in Figure 1 and Appendix Table A.2, corruption conviction numbers are consistent with anecdotal evidence about provinces with more political corruption in China. Moreover, the results are robust to using alternative measures of corruption to address this concern.

[Insert Figure 1 here]

3.3 Method

Model for auditor change

To investigate the effects of political corruption on auditor tendency to change clients, we build a model as follows:

$Audit\ firm\ switch_{i,t}\ (Auditor\ switch_{i,t}) = \alpha_0 + \alpha_1\ Corruption\_per\_capita_{i,t} + \alpha_2 Size_{i,t} + \alpha_3 ROA_{i,t} + \alpha_4\ Leverage_{i,t} + \alpha_5\ Loss_{i,t} + \alpha_6\ Marketization_{i,t} + \alpha_7 Largest_{i,t} + \alpha_8 Receivable_{i,t} + \alpha_9 ABH_{i,t} + Q_{i,t} + \alpha_{11}\ Inventory_{i,t} + \alpha_{12} Ln(GDP)_{i,t} + \sum \beta YearDummy_{i,t} + \sum \gamma IndustryDummy_{i,t}$

$$+ \sum \theta ProvinceDummy_{i,t} + \varepsilon_{i,t} \qquad (1)$$

The dependent variable *Audit firm switch* is an indicator variable, which is equal to 1 if an audit firm switches to another client firm during a five-year mandatory rotation and 0 otherwise.[6] *Auditor switch* is an indicator variable that equals to 1 if a client firm change its audit partner in the same audit firm within the five-year mandatory rotation and 0 otherwise. The variable of interest is *Corruption_per_capita*, which is the number of corruption

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[5] For example, Chen Shulong, the former vice-mayor of Wuhu Municipality, who facilitated the success of San An Guang Dian (Stock code: 600703) in obtaining government subsides over 2.5 billion RMB and governmental procurement contracts more than 2.5 billion RMB during the period of his incumbency. In exchange, he received bribes of more than 30.31million RMB, and was promoted to vice-governor of An Hui province in 2012.

[6] The CSRC (Chinese Securities Regulatory Commission) requires a mandatory audit partner rotation for client firms in every five years since 2003. See detail at https://neris.csrc.gov.cn/falvfagui/rdqsHeader/mainbody?navbarId=1&secFutrsLawId=eeb33ce66d8049d990dd2a530916033e.

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convictions involving government officials per 10,000 province population. Following prior studies (He et al., 2017; Xu et al., 2019b), we include several control variables, such as firm size (*Size*), return on assets (*ROA*), financial leverage (*Leverage*), the presence of loss (*Loss*), the ratio of account receivables to total assets of a client company (*Receivable*), the ratio of inventory to total assets of a client company (*Inventory*), Tobin's Q (*Q*), the ratio of shares that owned by the largest shareholder (*Largest*), an indicator for whether firms issues both A and B/H shares (*ABH*) to capture firm characteristics. In addition, the marketization index (*Marketization*) and GDPs for each province (*Ln(GDP)*) are also included in this model to account for characteristics of the Chinese market. All above variables are defined in detail in the Appendix Table A.1.

4. Empirical results

4.1 Political corruption and auditor response: Auditor change decision

Table 2 presents the empirical results for auditor switch. Columns 1 to 3 of panel A examine auditors' incentives to resign from clients at a firm-level. We find coefficients on *Corruption_per_capita* are significantly positive in the full sample (column 1) and subsample which switches from Big 10 auditors to local auditors (column 2). It indicates that the clientele-adjustment is more prevalent in firms operating in more corrupt provinces. In addition, local audit firms are willing to pick up dropped clients as they are more vulnerable to political intervention while Big 10 audit firms are reluctant to do so due to risk management and reputation concerns. Columns 4 to 6 of panel A examine auditor switch at a partner-level, where clients change audit partners within the same audit firm instead of switching to another audit firm. The estimated coefficients on *Corruption_per_capita* are significantly positive in the full sample and Big 10 audit firms (columns 4 and 5), which suggest that in more corrupt provinces, auditors especially Big 10 auditors are reluctant to stay in the same firm until the mandatory rotation limit, so they switch frequently for risk and reputational reasons. In panel B, we report results for auditor switch at an individual-level. We apply *Review auditor switch* as the dependent variable with a value of 1 if the changed auditor within the five-year mandatory rotation is the review auditor and 0 otherwise. To make a comparison, we also introduce *Engagement auditor switch* as the dependent variable, which is equal to 1 if the changed auditor is the engagement auditor within the five-year mandatory rotation and 0 otherwise. The coefficient on *Corruption_per_capita* is positively associated with *Review auditor switch* while insignificant for *Engagement auditor switch*. It suggests that compared to engagement auditors, review auditors are more likely to switch to other clients.

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4.2 Political corruption and auditor response: Additional evidence

4.2.1 Accounting quality

As auditors are ultimately concerned about accounting quality, it is necessary to examine how accounting quality is affected by local political corruption in China. Studies has shown that due to the favourable treatment from the government, capital market participants have fewer incentives for high-quality financial reports (Liu and Subramaniam, 2013). Thus, we expect firms operating in more corrupt provinces to have financial reports of lower quality.

As no single proxy can capture all aspects of financial quality, we construct a composite proxy following Biddle et al. (2009) and Chen et al. (2011). Specifically, we first estimate two commonly used models, including (a) modified Jones model (Dechow et al., 1995) and (b) Dechow-Dichev model (Dechow and Dichev, 2002),[7] and obtain residuals which are measures for discretionary accruals. Through multiplying each discretionary accrual by -1, the higher value of discretionary accrual denotes higher accounting quality. To reduce noise and measurement error of individual proxies, we chose the average of these two measures as our proxy of accounting quality. This method is similar to that used by Chen et al. (2020) in the Chinese setting. Finally, we use *Accounting Quality* as the dependent variable and include a set of control variables. Column 1 of Table 3 presents the relevant results, which indicates that local corruption has a negative impact on accounting quality. These findings are consistent with Chen et al. (2020), and provide complementary evidence that severe government intervention in auditing practice reflects poor accounting quality.

4.2.2 Litigation risks

Our main argument suggests that government protection and preferential treatment obtained through rent-seeking activities can provide to firms a large security margin from bankruptcy and reduce litigation and government sanction risks for audit failure. Moreover, the previous literature documents that Chinese courts may render judgments according to interests of state officials because (1) the Chinese judiciary is not independent from the Party and

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[7] (a) Modified Jones model can be written as:

$TCAC_{i,t} = \beta_0 + \beta_1(1/ASSET_{i,t-1}) + \beta_2\Delta REV_{i,t} + \beta_3PPE_{i,t} + \beta_4ROA_{i,t} + \mu_{i,t}$

which measures discretionary accruals using total assets, the change of revenus minus change of account receivable, property, plant and equipment (PPE) (Dechow et al., 1995);

(b) Dechow-Dichev model can be written as:

$TCAC_{i,t} = \beta_0 + \beta_1 Cash\,Flow_{i,t-1} + \beta_2 Cash\,Flow_{i,t} + \beta_3 Cash\,Flow_{i,t+1} + \beta_4\Delta REV_{i,t} + \beta_5 PPE_{i,t} + \mu_{i,t}$,

which measures discretionary accruals using cash flow, the change of revenus, property, plant and equipment (PPE) (Dechow and Dichev, 2002).

government, where its adjudication committee consists of the Party secretary and presidents and remains the highest decision-making power; (2) Chinese courts are financed by governments and the promotion and recruitment of judges are directly determined by local politicians (Lu et al. 2015; He and Su, 2013). As a result, we expect firms in more corrupt provinces especially audited by non-Big10 audit firms to be exposed to lower litigation risks. In this section, we provide direct evidence to test this argument. Empirically, we introduce an indicator variable *Lawsuit* which equals to 1 if firms are involved in major litigation cases and 0 otherwise. This indicator captures litigation cases against clients, rather than their auditors. We run a regression to investigate the correlation between litigation risks and political corruption. As shown in columns 2-4 of Table 3, the estimated coefficients on *Corruption_per_capita* are significantly negative for *Lawsuit* and pronounced for non-Big10 audit firms. It indicates that firms in more corrupt provinces face less litigation exposure, which is in accordance with lower risks assessed by auditors, especially non-Big 10 auditors.

[Insert Table 3 here]

4.3 Robustness tests

4.3.1 Alternative measures of corruption

In our main regressions, we use *Corruption_per_capita* as the primary proxy for the magnitude of local political corruption. In this section, we perform robustness tests using three alternative measures. First, we use *ln(corruption)* as the proxy for corruption level, which is defined as the natural logarithm of the number of corruption convictions of public officials. Such approximations obtained through log transformation have an unbiased property, which assists us to rule out disturbance from the large population base in China. Furthermore, we adopt *Corruption_indicator* as the second alternative proxy, which equals to convictions per capita multiplied by an indicator for the top quartile of corruption (Smith, 2016; Xu et al., 2019b). Moreover, we use a third proxy which measures corruption convictions per 10,000 Communist Party members for each province. It is well established that the Communist Party of China enjoys a constitutionally guaranteed monopoly on power, and all layers of governments are led by Party officials (Chang et al., 2017). Thus, it is reasonable to adopt the number of Communist Party members in each province to further validate our main findings. Table 4 provides the results of empirical regressions using alternative measures of the magnitude of political corruption. As shown in Table 4, the coefficients on *Audit firm switch*, *Auditor switch*, and *Review auditor* have signs identical to the main tests and they are statistically significant.

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[Insert Table 4 here]

4.3.2 Propensity Score Matching

Following Xu et al. (2019b), we also implement propensity score matching (PSM) method to control for potential endogeneity. In this method, we match firms in more corrupt regions with those in less corrupt regions in the same year, industry, province, and with the closest total assets. Table 5 reports the results for the matched sample. Using this PSM sample, we can ensure that both treatment firms and control firms are similar in terms of observable characteristics. We find the results are consistent with our main findings.

[Insert Table 5 here]

4.3.3 Change in political corruption

In this section, we examine the change in political corruption to further complete our investigation. In particular, we introduce *Change of corruption*, which refers to change of *Corruption_per_capita* from year t-1 to t, and rerun our main equations. All relevant results are reported in Table 6. We found that coefficients on *Change of corruption* are positively associated with auditor change decisions, which suggest robustness to our main results.

[Insert Table 6 here]

4.4 Cross-sectional analyses

4.4.1 Political corruption and auditor response: Conditional on firm ownership structure

We examine auditor response to the local political corruption conditional on firms' different ownership structure. Columns 1 and 2 of panel A in Table 7 show audit firms switch from one client to another. The estimated coefficient on *Corruption_per_capita* is positively significant for non-SOEs (the coefficient is 0.228) while insignificant for SOEs, which indicates that compared to SOEs, auditors hired by non-SOEs in provinces with more political corruption are more likely to change clients. Columns 1 and column 2 of panel B in Table 7 present results for auditor switch at a partner-level, where the estimated coefficient on *Corruption_per_capita* is significantly positive at 5% level for non-SOEs. However, it is insignificant for SOEs. It suggests that compared to SOEs, audit partners in non-SOEs change frequently in more corrupt provinces. Columns 1 and 2 of panel C in Table 7 show results for *Review auditor switch*, where the estimated coefficient on *Corruption_per_capita* is positively related to review auditor change in non-SOEs while insignificant for SOEs, suggesting review auditors frequently change their non-SOE clients. We also conduct Chow tests to examine the statistical significance, which equals to 6.49 (p-value=0.00) for *Audit firm switch*, 3.85 (p-value=0.00) for *Auditor switch* and 1.75 for *Review auditor switch* (p-value=0.00). These

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findings support our main hypothesis that non-SOEs in more corrupt regions bear higher risks assessed by auditors compared with SOEs, so that auditors feel reluctant to stay in the same firm until the mandatory rotation limit.

4.4.2 Political corruption and audit response: Conditional on firm's business risk

The basic rationale of our main results is that firms in more corrupt provinces tend to switch frequently to manage potential risk. If this is the case, we expect our main results to be stronger for firms with higher business risk. Empirically, we evaluate business risk by measuring operating risk. Following Kim et al. (2016), we use sales volatility to evaluate operating risk. We conduct our test by classifying firms into two categories—High operating risk (*H*) and low operating risk (*L*) — based on the median sales volatility.[8] Columns 3 and 4 of panel A, B, and C in Table 7 present results for *Audit firm switch*, *Auditor switch*, and *Review auditor switch* respectively. We find that the coefficients on *Corruption_per_capita* are significant and positive for firms with high business risk. These results are stronger than in firms with low business risk.

[Insert Table 7 here]

4.5 Further analysis

4.5.1 Anti-corruption campaigns

Table 8 reports results for the anti-corruption campaign. We introduce an interaction term *Event* Corruption_per_capita* to capture how auditors' tendency to switch clients vary in firms operating in more corrupt provinces since the anti-corruption campaign. The estimated coefficient on *Event* Corruption_per_capita* is significantly negative for *Audit firm switch* and *Auditor switch*, while insignificant for *Review auditor switch*. These results suggest that the anti-corruption campaign removes government protection obtained through rent-seeking activities, thus reducing potential litigation and reputation risks of auditors in more corrupt provinces, which relieves auditors' propensity to change clients. These findings provide complementary evidence to our major results.

[Insert Table 8 here]

4.5.2 Audit fees

Table 9 reports results for audit fees. In principle, government officials also seek favourable audit outcomes within their jurisdiction because unfavourable auditor reports contain auditors' substantial concerns on firms' reporting quality and going concern abilities

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[8] As sales volatility varies across industries, we apply industry adjusted sales volatility.

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(Guan et al., 2016), and are associated with negative market reactions, which may bring government officials unwanted scrutiny and even damage politicians' career prospects (Chen et al., 2000; Chan et al., 2006). In return, they would prevent involved auditors from being sued or exposed to harsh regulatory sanctions (Firth et al., 2011; He et al., 2021). Therefore, such government protection could mitigate auditors' litigation risks and reduce the amount of audit effort needed to render an opinion. We expect that auditors are induced to charge lower audit fees for involved firms. Empirically, we introduce an interaction term *Audit firm switch*Corruption_per_capita* capture how audit fees vary in firms operating in more corrupt provinces conditional on auditors' change decisions. The estimated coefficients on *Audit firm switch*Corruption_per_capita* is significantly negative and profound for non-Big10 audit firms, indicating that firms in more corrupt provinces face more frequent auditor change and those auditors who are willing to pick up dropped clients charge lower audit fees. These findings support our argument that non-Big10 auditors face lower litigation risks under government protection and have less reputational concerns.

[Insert Table 9 here]

5. Conclusion

In this study, we investigate how the institutional and social environment affect auditors' risk management strategies in China. Specifically, we take advantage of political corruption convictions in China and collect a sample of listed firms from 2006 to 2017. We find that auditors, especially Big 10 auditors and review auditors tend to switch clients frequently to avoid potential future risks if their client firms locate in more corrupt provinces while their counterparties present more tolerance to risky clients due to political protection and incentives to retain economically important clients. We also observe that firms operating in more corrupt provinces have lower accounting quality and low litigation risk especially for those audited by non-Big10 auditors. Our major results are more significant for non-SOEs, and firms with higher business risk. These findings are robust to alternative corruption measures. Moreover, after the anti-corruption campaign, such effects are reduced.

Overall, our study shows that political corruption has helped firms conceal low quality financial reports, and discourages due-diligence by auditors, while increase potential future risk concerned by auditors in China, which can be detrimental to the capital market and destroy investor confidence resulting from information asymmetry. This may also further weaken the proper functioning of the capital market, relevant regulations and investor participation.

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Therefore, it is essential to promote anti-corruption campaigns to eradicate the influence of political corruption in markets where corruption is prevalent.

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Figure 1 Mean Corruption Convictions from 2006 to 2017

This figure is a map which plots mean corruption data at provincial level from Appendix Table A.2 for the period of 2006 to 2017.

1995 - 4166
1521 - 1995
418 - 1521
0 - 418
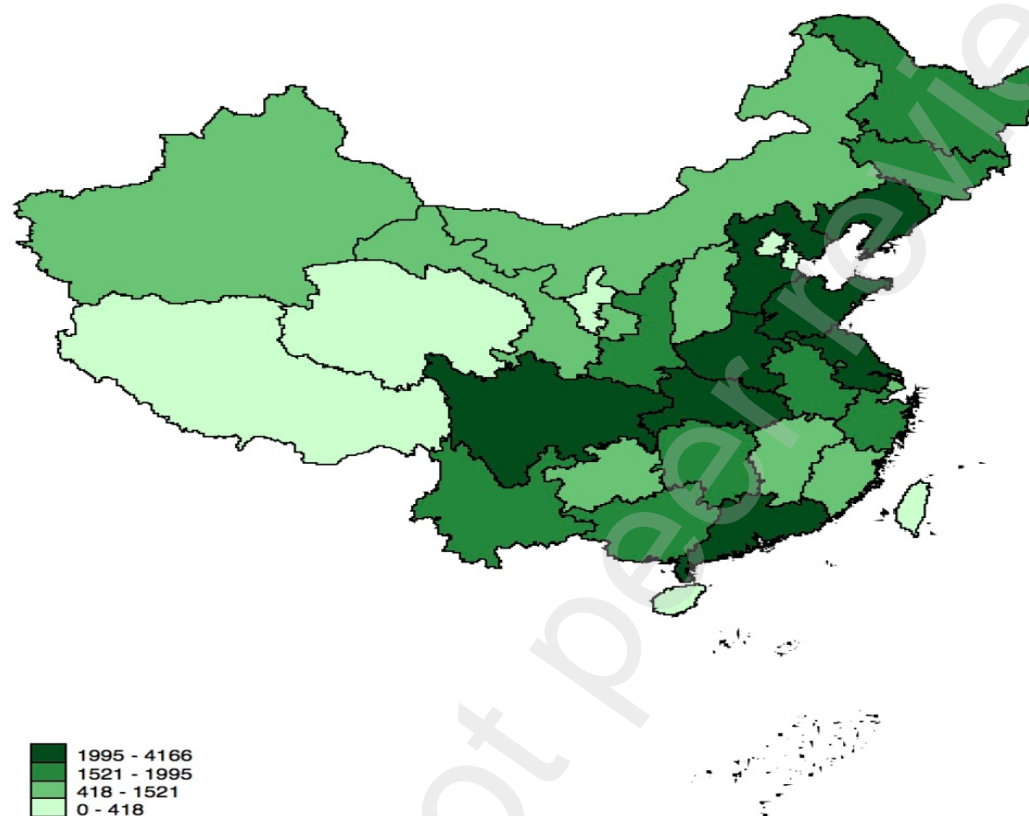
Table 1 Descriptive Statistics

This table reports the summary of descriptive statistics of all variables used in our model. Our sample includes all listed firms from the Shanghai and Shenzhen Stock Exchanges ranging from 2006 to 2017. After excluding financial firms and firms with missing data, we finally obtain 22,659 firm-year observations. All continuous variables are winsorized at the top and bottom 1% to mitigate the effect of outliers. The detailed definitions of these variables are presented in Appendix Table A.1.

Variable	N	Mean	S.D.	Min	25%	Median	75%	Max
Audit firm switch	22,659	0.22	0.41	0.00	0.00	0.00	0.00	1.00
Auditor switch	22,659	0.43	0.49	0.00	0.00	0.00	1.00	1.00
Ln(auditfee)	22,659	13.59	0.73	12.21	13.12	13.46	13.96	16.30
Corruption_per_capita	22,659	0.35	0.10	0.10	0.28	0.35	0.40	0.91
Big10	22,659	0.47	0.50	0.00	0.00	0.00	1.00	1.00
SOE	22,659	0.46	0.50	0.00	0.00	0.00	1.00	1.00
ROA	22,659	0.04	0.06	-0.24	0.01	0.03	0.06	0.20
Leverage	22,659	0.46	0.22	0.05	0.29	0.46	0.62	1.06
Marketization	22,659	9.42	3.07	2.59	7.15	9.31	12.15	16.19
Loss	22,659	0.10	0.30	0.00	0.00	0.00	0.00	1.00
Q	22,659	2.24	2.09	0.21	0.90	1.62	2.81	12.41
Inventory	22,659	0.16	0.15	0.00	0.06	0.12	0.20	1.34
Size	22,659	21.98	1.29	19.18	21.06	21.82	22.72	25.83
Independent	22,659	0.37	0.05	0.30	0.33	0.33	0.40	0.56
Receivable	22,659	0.12	0.11	0.00	0.03	0.09	0.17	0.47
Largest (%)	22,659	35.28	15.10	8.70	23.27	33.47	45.80	74.98
Audit lag	22,659	4.51	0.27	2.64	4.42	4.53	4.72	5.49
Weak internal control	22,659	0.10	0.30	0.00	0.00	0.00	0.00	1.00
Ln(GDP)	22,659	10.11	0.81	7.41	9.64	10.17	10.75	11.40

Table 2 Political corruption and auditor response: Auditor switch

This table presents results for the effect of political corruption on auditor switch. Our sample covers all listed firms from 2006 to 2017. In panel A, the first three columns present the effect of political corruption on changing audit firms, where column 2 shows the results of firms switching from Big 10 audit firms to local audit firms. The last three column show the effect of political corruption on changing audit partners within the same audit firm using full sample, Big 10 and non-Big 10 respectively. In panel B, columns 1 and 2 report results for review auditors (signing auditors) and engagement auditors respectively. All variables are defined in the Appendix Table A.1. Robust standard errors are in parentheses. ***, ** and * indicate two-tailed significance levels at 1 percent, 5 percent and 10 percent, respectively.

Panel A

	Audit firm switch			Auditor switch		
	Full sample	Switch to local	others	Full sample	Big10	Non-Big10
Explanatory variables	(1)	(2)	(3)	(4)	(5)	(6)
Corruption_per_capita	0.139***	0.198*	-0.024	0.102**	0.127**	0.047
	(0.046)	(0.114)	(0.044)	(0.052)	(0.056)	(0.082)
Size	-0.036***	-0.007	-0.030***	0.012***	0.024***	0.014**
	(0.003)	(0.010)	(0.003)	(0.004)	(0.005)	(0.006)
ROA	0.173**	-0.026	0.257***	0.030	-0.054	0.073
	(0.070)	(0.190)	(0.077)	(0.081)	(0.122)	(0.109)
Leverage	-0.054***	-0.069	-0.051***	0.020	-0.023	0.043*
	(0.017)	(0.047)	(0.018)	(0.020)	(0.030)	(0.026)
Loss	0.008	-0.020	0.014	0.021	0.027	0.010
	(0.012)	(0.034)	(0.013)	(0.015)	(0.022)	(0.020)
Receivable	0.160***	-0.038	0.125***	-0.115***	-0.090*	-0.109**
	(0.029)	(0.084)	(0.030)	(0.034)	(0.049)	(0.048)
Marketization	-0.003	-0.008*	0.001	0.011***	0.004	0.015***
	(0.002)	(0.005)	(0.002)	(0.003)	(0.003)	(0.004)
Q	0.004**	0.014***	0.010***	-0.002	-0.002	0.005*
	(0.002)	(0.005)	(0.002)	(0.002)	(0.003)	(0.003)
Inventory	-0.011	-0.047	0.0028	-0.018	-0.005	-0.029
	(0.020)	(0.062)	(0.021)	(0.025)	(0.038)	(0.033)
Largest	0.002***	0.001*	0.0019***	-0.001***	-0.002***	-0.001
	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)
Ln(GDP)	-0.062***	0.130***	-0.060***	0.331***	0.302***	0.396***
	(0.018)	(0.027)	(0.009)	(0.010)	(0.018)	(0.033)
ABH	-0.022**	-0.056	-0.030***			
	(0.010)	(0.041)	(0.011)			
constant	1.556***	-0.417	1.334***	-3.249***	-3.054***	-3.876***
	(0.182)	(0.309)	(0.087)	(0.091)	(0.187)	(0.309)
Year Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes
Industry Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes
Province Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes
Adj R²	0.091	0.071	0.069	0.048	0.050	0.052
Observations	22,659	2,982	19,678	22,659	10,705	11,954

Panel B

	Review auditor switch	Engagement auditor switch
Explanatory variables	(1)	(2)
Corruption_per_capita	0.094***	0.006
	(0.032)	(0.049)
Size	0.005**	0.007**
	(0.003)	(0.003)
ROA	0.115**	-0.049
	(0.058)	(0.074)
Leverage	0.013	0.022
	(0.014)	(0.018)
Loss	0.002	0.016
	(0.010)	(0.014)

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Receivable	-0.044*	-0.106***
	(0.024)	(0.031)
Marketization	0.003	0.009***
	(0.002)	(0.002)
Largest	-0.001**	-0.001***
	(0.001)	(0.001)
Q	0.001	-0.001
	(0.001)	(0.002)
Inventory	-0.015	0.001
	(0.015)	(0.023)
Ln(GDP)	0.059***	0.207***
	(0.007)	(0.010)
constant	-0.180***	-0.184**
	(0.063)	(0.080)
Year Fixed Effect	Yes	Yes
Industry Fixed Effect	Yes	Yes
Province Fixed Effect	Yes	Yes
Adj R²	0.007	0.033
Observations	22,659	22,659

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Table 3. Political corruption and auditor response: Additional evidence

This table presents the empirical results for additional tests. The dependent variable of column 1 is *Accounting quality*. The dependent variable of columns 2-4 is *Lawsuit*, which is an indicator variable with a value of one if firms are involved in major litigation cases and 0 otherwise. All other variables are defined in the Appendix Table A.1. Robust standard errors are in parentheses. ***, ** and * indicate two-tailed significance levels at 1 percent, 5 percent and 10 percent, respectively.

	Accounting quality	Lawsuit	Lawsuit	Lawsuit
	Full sample	Full sample	Big10	Non-Big10
Explanatory variables	(1)	(2)	(3)	(4)
Corruption_per_capita	-0.030*	-0.127**	-0.099	-0.141*
	(0.017)	(0.052)	(0.070)	(0.081)
Size	-0.014***	-0.027***	-0.015***	-0.039***
	(0.003)	(0.004)	(0.005)	(0.006)
Loss	0.016***	0.072***	0.068***	0.072***
	(0.005)	(0.018)	(0.025)	(0.025)
Leverage	0.001	0.350***	0.353***	0.342***
	(0.011)	(0.024)	(0.034)	(0.034)
Marketization	-0.001	-0.001	-0.004	0.002
	(0.001)	(0.002)	(0.003)	(0.003)
Receivable	-0.093***	-0.225***	-0.229***	-0.209***
	(0.019)	(0.036)	(0.050)	(0.052)
ROA	-0.325***	-0.238***	-0.264**	-0.209
	(0.036)	(0.092)	(0.126)	(0.134)
Inventory	-0.188***	-0.051*	-0.086**	-0.023
	(0.054)	(0.030)	(0.044)	(0.041)
Ln(GDP)	0.004	-0.023***	-0.019*	-0.027**
	(0.005)	(0.008)	(0.011)	(0.012)
Age	0.002***			
	(0.001)			
Big10	0.004			
	(0.006)			
Largest		-0.001***	-0.001***	-0.001***
		(0.001)	(0.001)	(0.001)
Independent		-0.016	-0.006	-0.043
		(0.069)	(0.095)	(0.102)
constant	0.302***	1.038***	0.668***	1.315***
	(0.092)	(0.118)	(0.165)	(0.176)
Year Fixed Effect	Yes	Yes	Yes	Yes
Industry Fixed Effect	Yes	Yes	Yes	Yes
Province Fixed Effect	Yes	Yes	Yes	Yes
Adj. R^2	0.015	0.078	0.072	0.086
Observations	21,665	13,345	6,770	6,575

Table 4. Political corruption and auditor response: alternative measures of corruption

This table displays empirical results from models using alternative measures of the magnitude of local political corruption. Our sample contains all listed firms from 2006 to 2017. The dependent variables in columns 1 to 6 are *Audit firm switch* and *Auditor switch*. Columns 7 and 8 report results for review auditors (signing auditors) and engagement auditors respectively. *Ln(corruption)* is the natural logarithm of corruption convictions of a province. *Corruption_indicator* refers to corruption per capita multiplied by an indicator for the top quartile of corruption. *Corruption_per_party* is measured by corruption convictions per 10,000 party members for each province. All other variables are defined in the Appendix Table A.1. Robust standard errors are in parentheses. ***, ** and * indicate two-tailed significance levels at 1 percent, 5 percent and 10 percent, respectively.

Explanatory variables	Audit firm switch			Auditor switch			Review auditor	Engagement auditor
	Full sample	Switch to local	others	Full sample	Big10	Non-Big10	Full sample	Full sample
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Panel A: ln(corruption)								
Ln(corruption)	0.034**	0.048**	-0.001	0.044***	0.023*	0.017	0.029**	0.024
	(0.014)	(0.023)	(0.008)	(0.016)	(0.014)	(0.025)	(0.012)	(0.016)
Size	-0.036***	-0.051***	-0.035***	0.013***	0.025***	0.014**	0.005*	0.009**
	(0.003)	(0.009)	(0.003)	(0.004)	(0.005)	(0.006)	(0.003)	(0.004)
ROA	-0.053***	-0.011	-0.042**	0.020	-0.033	0.047*	0.126**	-0.132
	(0.017)	(0.050)	(0.018)	(0.020)	(0.030)	(0.026)	(0.063)	(0.081)
Leverage	0.009	-0.029	0.016	0.022	0.032	0.011	0.009	0.018
	(0.012)	(0.034)	(0.013)	(0.015)	(0.022)	(0.020)	(0.015)	(0.020)
Loss	0.157***	0.018	0.106***	-0.113***	-0.076	-0.110**	0.005	0.006
	(0.029)	(0.084)	(0.030)	(0.034)	(0.047)	(0.047)	(0.011)	(0.015)
Receivable	-0.003	-0.002	0.004**	0.011***	-0.001	0.015***	-0.046*	-0.081**
	(0.002)	(0.005)	(0.002)	(0.003)	(0.003)	(0.004)	(0.027)	(0.035)
Marketization	0.034**	0.048**	-0.001	0.044***	0.023*	0.017	0.004*	0.006*
	(0.014)	(0.023)	(0.008)	(0.016)	(0.014)	(0.025)	(0.002)	(0.003)
Q	0.004*	0.002	0.006***	-0.002	-0.001	0.005**	-0.002	0.001
	(0.002)	(0.005)	(0.002)	(0.002)	(0.003)	(0.003)	(0.002)	(0.002)
Inventory	-0.012	0.010	-0.001	-0.018	0.004	-0.031	-0.022	-0.004
	(0.020)	(0.062)	(0.021)	(0.025)	(0.037)	(0.033)	(0.019)	(0.025)
Ln(GDP)	-0.057***	-0.079***	-0.052***	0.328***	0.252***	0.360***	0.084***	0.251***
	(0.018)	(0.026)	(0.008)	(0.010)	(0.017)	(0.032)	(0.007)	(0.010)
Largest	0.002***	0.002***	0.002***	-0.001***	-0.002***	-0.001	-0.001**	-0.001**
	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)
ABH	-0.022**	-0.045	-0.024**					
	(0.010)	(0.038)	(0.011)					
constant	1.339***	1.834***	1.314***	-3.465***	-2.704***	-3.637***	-1.028***	-2.570***
	(0.186)	(0.250)	(0.092)	(0.116)	(0.197)	(0.337)	(0.094)	(0.120)
Year Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Province Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Adj R²	0.091	0.081	0.065	0.048	0.046	0.051	0.009	0.039
Observations	22,659	2,982	19,677	22,659	10,705	11,954	19,146	19,146
Panel B: Corruption indicator								
Corruption indicator	0.669**	1.405*	-0.128	0.668***	0.552**	-0.031	0.426**	0.342
	(0.265)	(0.734)	(0.207)	(0.243)	(0.254)	(0.439)	(0.194)	(0.245)
Size	-0.036***	-0.015	-0.033***	0.012***	0.025***	0.014**	0.004	0.009**
	(0.003)	(0.010)	(0.003)	(0.004)	(0.005)	(0.006)	(0.003)	(0.004)
ROA	0.173**	-0.010	0.273***	0.041	-0.056	0.073	0.136**	-0.124
	(0.070)	(0.190)	(0.077)	(0.081)	(0.122)	(0.109)	(0.063)	(0.082)
Leverage	-0.055***	-0.064	-0.041**	0.016	-0.024	0.043*	0.008	0.016
	(0.017)	(0.051)	(0.018)	(0.020)	(0.030)	(0.026)	(0.015)	(0.020)
Loss	0.008	-0.024	0.014	0.022	0.030	0.010	0.005	0.009

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	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	(0.012)	(0.033)	(0.013)	(0.015)	(0.022)	(0.020)	(0.011)	(0.015)
Receivable	0.160***	0.054	0.114***	-0.100***	-0.083*	-0.109**	-0.048*	-0.077**
	(0.029)	(0.083)	(0.030)	(0.034)	(0.049)	(0.048)	(0.027)	(0.035)
Marketization	-0.003*	-0.022***	0.004	0.007***	0.003	0.014***	0.002	0.004
	(0.002)	(0.006)	(0.002)	(0.002)	(0.003)	(0.004)	(0.002)	(0.003)
Q	0.004**	0.012**	0.009***	-0.003	-0.001	0.005*	-0.002	-0.001
	(0.002)	(0.005)	(0.002)	(0.002)	(0.003)	(0.003)	(0.002)	(0.002)
Inventory	-0.011	-0.014	0.002	-0.011	-0.010	-0.029	-0.021	0.002
	(0.020)	(0.060)	(0.021)	(0.025)	(0.038)	(0.033)	(0.019)	(0.025)
Ln(GDP)	-0.061***	0.174***	-0.042***	0.305***	0.282***	0.396***	0.081***	0.211***
	(0.018)	(0.028)	(0.008)	(0.010)	(0.018)	(0.033)	(0.008)	(0.011)
Largest	0.002***	0.001**	0.002***	-0.001***	-0.002***	-0.001	-0.001**	-0.001**
	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)
ABH	-0.022**	-0.063	-0.032***					
	(0.010)	(0.042)	(0.011)					
constant	1.582***	-0.936***	1.236***	-2.923***	-2.853***	-3.865***	-0.786***	-2.023***
	(0.186)	(0.243)	(0.083)	(0.0926)	(0.183)	(0.309)	(0.074)	(0.098)
Year Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Province Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Adj R²	0.091	0.127	0.068	0.048	0.048	0.052	0.009	0.039
Observations	22,659	2,982	19,677	22,659	10,705	11,954	19,103	19,103

Panel C: Corruption_per_party

Corruption_per_party	0.011***	0.021**	-0.002	0.007**	0.007**	-0.001	0.005***	0.002
	(0.003)	(0.009)	(0.003)	(0.003)	(0.003)	(0.006)	(0.002)	(0.003)
Size	-0.036***	-0.044***	-0.032***	0.020***	0.028***	0.014***	0.008***	0.014***
	(0.003)	(0.009)	(0.003)	(0.004)	(0.005)	(0.006)	(0.003)	(0.004)
ROA	0.181***	0.062	0.275***	-0.029	-0.100	0.088	0.097	-0.179**
	(0.069)	(0.193)	(0.077)	(0.081)	(0.122)	(0.109)	(0.062)	(0.082)
Leverage	-0.053***	-0.031	-0.044**	0.009	-0.040	0.047*	0.003	0.006
	(0.017)	(0.051)	(0.018)	(0.020)	(0.030)	(0.026)	(0.015)	(0.020)
Loss	0.009	-0.022	0.015	0.020	0.028	0.011	0.003	0.006
	(0.012)	(0.035)	(0.013)	(0.015)	(0.022)	(0.020)	(0.011)	(0.015)
Receivable	0.158***	-0.003	0.115***	-0.110***	-0.071	-0.110**	-0.041	-0.086**
	(0.029)	(0.085)	(0.030)	(0.034)	(0.049)	(0.047)	(0.027)	(0.034)
Marketization	-0.003	-0.024***	0.003	0.001	0.001	0.014***	0.001	-0.002
	(0.002)	(0.005)	(0.002)	(0.002)	(0.003)	(0.004)	(0.002)	(0.002)
Q	0.004*	-0.001	0.009***	0.002	-0.002	0.006**	0.001	0.003
	(0.002)	(0.005)	(0.002)	(0.002)	(0.003)	(0.003)	(0.002)	(0.002)
Inventory	-0.012	-0.025	0.002	-0.013	0.007	-0.031	-0.021	-0.006
	(0.020)	(0.063)	(0.021)	(0.025)	(0.037)	(0.033)	(0.019)	(0.024)
Ln(GDP)	-0.065***	-0.191***	-0.045***	0.264***	0.199***	0.360***	0.062***	0.189***
	(0.018)	(0.033)	(0.009)	(0.010)	(0.016)	(0.033)	(0.007)	(0.011)
Largest	0.002***	0.002**	0.002***	-0.001***	-0.002***	-0.001	-0.001**	-0.001***
	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)
ABH	-0.022**	-0.050	-0.027**					
	(0.010)	(0.039)	(0.011)					
constant	1.605***	3.584***	1.203***	-2.674***	-2.125***	-3.534***	-0.694***	-1.886***
	(0.184)	(0.335)	(0.0874)	(0.0966)	(0.169)	(0.308)	(0.073)	(0.096)
Year Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Province Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Adj R²	0.091	0.097	0.067	0.043	0.040	0.051	0.008	0.037
Observations	22,659	2,982	19,677	22,659	10,705	11,954	19,146	19,146

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Table 5. Propensity score matching

This table presents results for the effect of political corruption on audit opinions and audit fees using propensity score matching. Our sample covers all listed firms from 2006 to 2017. The first dependent variable is *Audit firm switch*, which is an indicator variable that equals 1 if an audit firm switches to another client firm during a five-year mandatory rotation and 0 otherwise. The second dependent variable is *Auditor switch*, which is an indicator variable that equals 1 if a client firm change its audit partner within the five-year mandatory rotation and 0 otherwise. The dependent variable in column 3 is *Review auditor switch*, which is an indicator variable with a value of 1 if the changed auditor within the five-year mandatory rotation is the review auditor and 0 otherwise. We match more corrupt provinces with less corrupt provinces by total assets. All other variables are defined in the Appendix Table A.1. Robust standard errors are in parentheses. ***, ** and * indicate two-tailed significance levels at 1 percent, 5 percent and 10 percent, respectively.

	Audit firm switch	Auditor switch	Review auditor switch
Explanatory variables	(1)	(2)	(3)
Corruption_per_capita	0.033***	0.016*	0.010***
	(0.008)	(0.009)	(0.003)
Size	-0.039***	0.019***	0.005***
	(0.004)	(0.004)	(0.002)
ROA	0.206***	-0.013	0.066*
	(0.078)	(0.090)	(0.037)
Leverage	-0.046**	0.017	-0.006
	(0.018)	(0.022)	(0.009)
Loss	0.015	0.014	0.001
	(0.013)	(0.016)	(0.006)
Receivable	0.136***	-0.125***	-0.012
	(0.032)	(0.038)	(0.016)
Marketization	-0.005**	0.003	-0.001
	(0.002)	(0.003)	(0.001)
Q	0.002	0.001	-0.001
	(0.002)	(0.002)	(0.001)
Inventory	-0.015	-0.012	-0.001
	(0.023)	(0.027)	(0.011)
Ln(GDP)	-0.062***	0.299***	0.018***
	(0.019)	(0.010)	(0.003)
Largest	0.002***	-0.001***	-0.001
	(0.001)	(0.001)	(0.001)
ABH	-0.007		
	(0.012)		
constant	1.690***	-2.947***	-0.207***
	(0.194)	(0.097)	(0.043)
Year Fixed Effect	Yes	Yes	Yes
Industry Fixed Effect	Yes	Yes	Yes
Province Fixed Effect	Yes	Yes	Yes
Adj R²	0.094	0.048	0.011
Observations	19,002	19,206	19,146

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Table 6. Change of corruption

This table presents results for the effect of political corruption on audit opinions and audit fees. Our sample covers all listed firms from 2006 to 2017. Dependent variables are *Audit firm switch, Auditor switch* and *Review auditor switch* respectively. *Change of corruption* is change of *Corruption_per_capita* from year t-1 to t. All other variables are defined in the Appendix Table A.1. Robust standard errors are in parentheses. ***, ** and * indicate two-tailed significance levels at 1 percent, 5 percent and 10 percent, respectively.

	Audit firm switch	Auditor switch	Review auditor switch
Explanatory variables	(1)	(2)	(3)
Change of corruption	0.085**	0.096*	0.043**
	(0.043)	(0.058)	(0.020)
Size	-0.012***	-0.002	0.001
	(0.003)	(0.004)	(0.002)
ROA	-0.074	0.186*	0.128***
	(0.077)	(0.098)	(0.038)
Leverage	0.069***	-0.038	-0.008
	(0.018)	(0.024)	(0.009)
Loss	0.007	0.013	0.003
	(0.013)	(0.017)	(0.006)
Receivable	0.050*	-0.025	-0.007
	(0.030)	(0.042)	(0.016)
Marketization	-0.003	0.004	0.001
	(0.002)	(0.003)	(0.001)
Inventory	-0.009	-0.035	-0.014
	(0.022)	(0.029)	(0.011)
Ln(GDP)	0.051***	0.096***	0.026***
	(0.019)	(0.017)	(0.004)
Largest	0.001**	-0.001	-0.001
	(0.001)	(0.003)	(0.001)
ABH	-0.014		
	(0.011)		
constant	-0.090	-0.379**	-0.225***
	(0.190)	(0.172)	(0.052)
Year Fixed Effect	Yes	Yes	Yes
Industry Fixed Effect	Yes	Yes	Yes
Province Fixed Effect	Yes	Yes	Yes
Adj R²	0.060	0.017	0.018
Observations	16,495	16,495	19,592

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Table 7. Cross-sectional results

This table presents empirical results for firms with different ownership structure and firms with different level of business risk. Panel A reports results for *Audit firm switch*, panel B reports results for *Auditor switch* and panel C reports results for *Review Auditor switch*. *Corruption_per_capita* is the percentage of corruption convictions to the province's population per 10,000. SOEs refers to state-owned enterprises. A firm is classified as having high business risks if its sales volatility is equal or large than the median of sales volatility. All other variables are defined in the Appendix Table A.1. Robust standard errors are in parentheses. ***, ** and * indicate two-tailed significance levels at 1 percent, 5 percent and 10 percent, respectively.

	Ownership structure		Business risk	
	SOEs	non-SOEs	High	Low
Explanatory variables	(1)	(2)	(3)	(4)
Panel A: Audit firm switch				
Corruption_per_capita	0.075	0.228***	0.159**	0.093
	(0.063)	(0.067)	(0.071)	(0.062)
constant	1.200***	2.075***	2.047***	1.763***
	(0.247)	(0.276)	(0.267)	(0.253)
Other controls	Yes	Yes	Yes	Yes
Adj R²	0.072	0.123	0.101	0.109
Chow test (p-value)		6.49(0.00)		2.06(0.00)
Observations	10,384	12,275	10,177	10,374
Panel B: Auditor switch				
Corruption_per_capita	0.048	0.149**	0.148*	0.113
	(0.074)	(0.073)	(0.082)	(0.077)
constant	-3.206***	-3.348***	-3.510***	-3.746***
	(0.118)	(0.147)	(0.120)	(0.110)
Other controls	Yes	Yes	Yes	Yes
Adj R²	0.091	0.127	0.050	0.063
Chow test (p-value)		3.85(0.00)		2.20(0.00)
Observations	10,384	12,275	10,177	10,374
Panel B: Review auditor switch				
Corruption_per_capita	0.059	0.097**	0.092**	0.056
	(0.042)	(0.045)	(0.045)	(0.043)
constant	-0.581***	-0.525***	-0.431***	-0.094
	(0.091)	(0.110)	(0.105)	(0.117)
Other controls	Yes	Yes	Yes	Yes
Adj R²	0.011	0.004	0.003	0.016
Chow test (p-value)		1.75 (0.00)		2.00(0.00)
Observations	10385	12275	10,177	10,374

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Table 8. 2012 Anti-corruption campaign

This table presents the empirical results of the effect of the anti-corruption campaign on auditor switch. Our sample includes all listed firms from the Shanghai and Shenzhen Stock Exchanges ranging from 2006 to 2017. *Event* is an indicator variable that equals to 1 for years since anti-corruption reforms were launched. *Corruption_per_capita* is the percentage of corruption convictions to the province's population per 10,000. All other variables are defined in the Appendix Table A.1. Robust standard errors are in parentheses. ***, ** and * indicate two-tailed significance levels at 1 percent, 5 percent and 10 percent, respectively.

	Audit firm switch	Auditor switch	Review auditor switch
Explanatory variables	(1)	(2)	(3)
Event*Corruption_per_capita	-0.216***	-0.204***	0.074
	(0.079)	(0.079)	(0.058)
Corruption_per_capita	0.029***	0.036***	0.001
	(0.008)	(0.008)	(0.005)
Event	0.177***	0.157***	-0.031
	(0.034)	(0.028)	(0.020)
Size	-0.042***	0.027***	0.009***
	(0.003)	(0.004)	(0.003)
ROA	0.239***	-0.007	0.081
	(0.072)	(0.082)	(0.058)
Leverage	-0.040**	0.011	0.003
	(0.017)	(0.020)	(0.014)
Loss	0.010	0.017	0.001
	(0.012)	(0.015)	(0.010)
Receivable	0.127***	-0.128***	-0.029
	(0.028)	(0.034)	(0.024)
Marketization	-0.002	0.007***	-0.001
	(0.002)	(0.002)	(0.001)
Q	-0.001	0.006***	0.002
	(0.002)	(0.002)	(0.001)
Ln(GDP)	-0.311***	0.042***	0.028***
	(0.027)	(0.007)	(0.005)
Inventory	-0.013	-0.006	-0.015
	(0.021)	(0.025)	(0.017)
Largest	0.002***	-0.001***	-0.001**
	(0.001)	(0.001)	(0.001)
ABH	-0.017		
	(0.011)		
Constant	4.000***	-0.797***	-0.304***
	(0.249)	(0.104)	(0.070)
Year Fixed Effect	Yes	Yes	Yes
Industry Fixed Effect	Yes	Yes	Yes
Province Fixed Effect	Yes	Yes	Yes
Adjust R^2	0.087	0.026	0.004
Observations	22,659	22,659	22,659

Table 9. Political corruption and auditor response: Audit fees

This table presents results for the effect of political corruption on audit fees. Our sample covers all listed firms from 2006 to 2017. The dependent variable is *Ln(auditfee)*, which is defined as natural logarithm of the total audit fees of the client company. *Audit firm switch* is an indicator variable that equals 1 if an audit firm switches to another client firm during a five-year mandatory rotation and 0 otherwise. *Corruption_per_capita* is the percentage of corruption convictions to the province's population per 10,000. All other variables are defined in the Appendix Table A.1. Robust standard errors are in parentheses, clustered at the firm level. ***, ** and * indicate two-tailed significance levels at 1 percent, 5 percent and 10 percent, respectively.

	Ln(auditfee)	Ln(auditfee)	Ln(auditfee)
	Full sample	Big10	Non-Big10
Explanatory variables	(1)	(2)	(3)
Audit firm switch*Corruption_per_capita	-0.130*	0.056	-0.195**
	(0.072)	(0.107)	(0.095)
Audit firm switch	0.027	-0.084**	0.070**
	(0.026)	(0.039)	(0.033)
Corruption_per_capita	0.029	-0.284***	0.071
	(0.039)	(0.061)	(0.050)
Size	0.463***	0.497***	0.376***
	(0.004)	(0.010)	(0.005)
ROA	-0.627***	-0.663***	-0.416***
	(0.075)	(0.118)	(0.093)
Leverage	0.059***	-0.007	0.163***
	(0.018)	(0.029)	(0.022)
Loss	0.039***	0.039*	0.027
	(0.013)	(0.021)	(0.017)
Receivable	0.100***	0.113***	0.053
	(0.029)	(0.044)	(0.039)
Marketization	0.025***	0.026***	0.024***
	(0.002)	(0.002)	(0.002)
Q	0.047***	0.049***	0.037***
	(0.004)	(0.004)	(0.002)
Inventory	-0.194***	-0.248***	-0.113***
	(0.021)	(0.032)	(0.025)
Ln(GDP)	-0.025***	-0.054***	-0.025***
	(0.005)	(0.009)	(0.007)
Independent	0.184***	0.157*	0.124
	(0.061)	(0.087)	(0.081)
Audit lag	0.107***	0.110***	0.094***
	(0.010)	(0.018)	(0.012)
Weak internal control	0.062***	0.082***	0.048***
	(0.010)	(0.015)	(0.013)
constant	2.740***	2.527***	4.723***
	(0.100)	(0.167)	(0.148)
Year Fixed Effect	Yes	Yes	Yes
Industry Fixed Effect	Yes	Yes	Yes
Province Fixed Effect	Yes	Yes	Yes
Adj R²	0.641	0.673	0.603
Observations	22,659	10,705	11,954

Appendix

Table A.1 Definition of variables

Dependent Variables	
Audit firm switch	Indicator variable that equals 1 if an audit firm switches to another client firm during a five-year mandatory rotation and 0 otherwise.
Auditor switch	Indicator variable that equals to 1 if a client firm change its audit partner within the five-year mandatory rotation and 0 otherwise.
Review auditor switch	Indicator variable with a value of 1 if the changed auditor within the five-year mandatory rotation is the review auditor and 0 otherwise.
Engagement auditor switch	Indicator variable with a value of 1 if the changed auditor within the five-year mandatory rotation is the engagement auditor and 0 otherwise.
Ln(auditfee)	Natural logarithm of the total audit fees of the client company
Independent Variables	
Corruption_per_capita	The number of corruption convictions involving government officials per 10,000 province population
Big10	Indicator variable that equals to 1 if the auditor is one of the Big 10 audit firms, and 0 otherwise
Marketization	Marketization index developed by Fan et al. (2011)
ROA	The ratio of operation income to the total sales of the client company
Independent	The percentages of independent directors to the boards of client firms
Loss	Indicator variable that equals to 1 if the firm reports a bottom-line loss, and 0 otherwise.
Leverage	The ratio of the long-term total liability to total assets of the client company
Size	Natural logarithm of the total assets of the client company
Receivable	The ratio of accounting receivables to total assets of a client company
Q	Tobin Q, the ratio of companies' market value to the book value
Largest	The ratio of shares held by the largest shareholder
Ln(GDP)	Natural logarithm of GDPs for each province
ABH	Indicator variable that equals 1 if the firm issues both A and B/H shares, and 0 otherwise.
Event	Indicator variable that equals 1 for the year when anti-corruption campaign is launched, and 0 otherwise
Distance	The natural logarithm of geographic distance between audit firms and firms.
Age	The number of years a company has been listed
Lawsuit	Indicator variable that equals to 1 if firms are involved in major litigation cases and 0 otherwise
Weak internal control	Indicator variable that equals to 1 if a firm discloses material deficiency in its internal control in the fiscal year and 0 otherwise.
Sales volatility	The standard deviation of sales revenue scaled by lagged total assets for the previous five years
Ln(corruption)	Natural logarithm the number of duty-related corruption convictions of public officials
Corruption_indicator	Corruption per capita multiplied by an indicator for the top quartile of corruption
Corruption_per_party	The percentage of officials' corruption convictions of a province to the number

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	of provincial Party members per 10,000
Change of corruption	Change of *Corruption_per_capita* from year t-1 to t.

Table A.2 Summary Statistics for Corruption by Provinces

Province	Median	Mean	Minimum	Maximum	Total corruption
	(1)	(2)	(4)	(5)	(6)
Shanghai	422	425	218	524	5190
Yunnan	1511	1648	890	2654	18963
Neimenggu	1036	1221	762	1713	14105
Beijing	438	418	116	553	5443
Jilin	1981	1901	1254	2438	21972
Sichuan	2221	2238	1975	2483	26454
Tianjin	448	411	268	477	5518
Ningxia	380	365	255	471	4367
Anhui	2061	1995	1404	3149	23075
Shandong	2997	3163	2648	3675	37560
Shanxi	1478	1521	1198	1991	17993
Guangdong	2825	2711	1826	3443	29966
Guangxi	1723	1632	1415	1841	19300
Xinjiang	786	770	586	945	9016
Jiangsu	2022	2002	1735	2155	23428
Jiangxi	1419	1435	1135	1712	16867
Hebei	2583	2426	1244	3030	28363
Henan	4180	4166	3583	4487	48964
Zhejiang	1757	1695	1217	2065	20028
Hainan	303	300	226	354	3538
Hubei	2374	2270	1708	3021	26317
Hunan	1801	1757	1196	2105	21235
Gansu	999	1047	615	1439	11982
Fujian	1351	1373	1176	1623	16320
Guizhou	1255	1237	1114	1324	14846
Liaoning	2055	2104	1588	2640	24875
Chongqing	878	855	603	1180	10287
Shaanxi	1438	1638	1306	2175	19034
Qinghai	245	224	149	251	2610
Heilongjiang	1790	1825	1284	2277	21616

Table A.3 Distribution of Corruption by Year

Year	Corruption Convictions	Firm-year observations
2006	40072	1057
2007	40108	1000
2008	40369	1247
2009	41672	1373
2010	43748	1487
2011	42905	1775
2012	44931	2241
2013	50718	2348
2014	54801	2332
2015	53327	2383
2016	46908	2578
2017	49673	2838
Total	549232	22659

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