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## **Do Politically Connected Directors Affect Accounting Quality? Evidence from China's Anti-Corruption Campaign (Rule 18)**

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# **Do Politically Connected Directors Affect Accounting Quality?**

## **Evidence from China's Anti-Corruption Campaign (Rule 18)**

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### **Abstract**

We examine the impact of politically connected directors on accounting quality using a quasi experiment in China. In October 2013, "Rule 18" was issued to prohibit government and party officials, who were concurrently holding public offices or had recently retired from such positions within the last three years, from serving as directors for publicly listed firms. The regulation is part of China's anti-corruption campaign, and it has led to a large number of politically connected directors resigning from their roles as directors involuntarily. As such, Rule 18 has effectively weakened, if not fully discontinued, the political connections of the firms that previously hired government officials as directors. Our empirical analyses employ a difference-in-differences research design with firm fixed effects to examine the pre- and post- period accounting quality around the enactment of Rule 18. We find that, compared to propensity-score-matched control firms, the accounting quality of firms with politically connected directors increases after Rule 18, and that the effect is stronger for non-state-owned enterprises firms than for state-owned enterprises firms. We further examine the channels through which politically connected directors affect accounting quality. The evidence suggests that connected firms have better access to preferential financing and are under lax regulations, which reduce firms' incentives to provide transparent information.

**Keywords:** Political Connections; Accounting quality; China; Quasi Experiment

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# Do Politically Connected Directors Affect Accounting Quality?

## Evidence from China's Anti-Corruption Campaign (Rule 18)

### 1. Introduction

In November of 2012, Xi Jinping became the “paramount leader” of China (i.e., General Secretary; President; and Chairman of the Central Military Commission). Shortly after he took power, Xi launched a far-reaching anti-corruption campaign, vowing to maintain “zero-tolerance attitude toward corruption” and to “look into every case involving corruption.”<sup>1</sup> As of 2016, more than 100,000 people have been indicted for corruption, and 120 high-ranking officials, including five national-level leaders, have been targeted. The campaign has shown no sign of stopping yet, and is said to become the “new normal.”<sup>2</sup>

As one important action of the anti-corruption campaign, the Communist Party of China (CPC) formally issued “Rule 18” on October 19, 2013.<sup>3</sup> Realizing that the connections between business and government officials could foster corruption, the CPC mandates in Rule 18 that party and government officials above certain ranks, either currently in position or retired within three years, are prohibited from holding any part-time or full-time position in any enterprises. Rule 18 triggered an unprecedented large-scale resignation tide of politically connected directors among publicly listed firms.<sup>4</sup> Because Rule 18 forced the politically connected directors to resign immediately, it led to a

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<sup>1</sup> [http://www.chinadaily.com.cn/china/2016-07/01/content\\_25936928.htm](http://www.chinadaily.com.cn/china/2016-07/01/content_25936928.htm)

<sup>2</sup> See, for example, [http://usa.chinadaily.com.cn/epaper/2015-03/02/content\\_19695097.htm](http://usa.chinadaily.com.cn/epaper/2015-03/02/content_19695097.htm)

<sup>3</sup> Rule 18 was issued by the Organization Department of the Central Committee of the CPC (CCCPC). The CPC has not only power over the government, but also over a variety of laws and regulations (Jones 2012). The CCCPC is responsible for promotions and demotions of all high-level officials, both in the government and in the CPC. Therefore, rules issued by CCCPC have very high authority.

<sup>4</sup> In our sample, a total of 819 directors resigned due to Rule 18, which affected 613 (or 29% of) listed nonfinancial firms.

loss of political connections for the firms that previously had political connections via these directors.

In this paper, we utilize the issuance of Rule 18 as a quasi experiment to investigate the causal effect of politically connected directors on accounting quality.<sup>5</sup> Politically connected directors can affect accounting quality in different directions. On one hand, because firms can establish political connections through their directors (hereafter, politically connected firms) to gain a variety of preferential treatments, such as preferential bank credit (e.g., Claessens, Feijen, and Laeven 2008), favorable government contracts (e.g., Agrawal and Knoeber 2001), and favorable court outcomes (e.g., Lu, Pan, and Zhang 2015), firms may have less incentive to provide transparent information. On the other hand, politically connected firms are subject to stricter media scrutiny; thus managers may have more incentive to be transparent in order to signal their commitment to investor protection (Watts and Zimmerman 1983).

Previous literature provides somewhat mixed evidence on the relation between political connections and accounting quality (see Section 2).<sup>6</sup> We utilize Rule 18 and use a difference-in-differences design with *firm fixed effects* to compare the effect of a loss of political connections on accounting quality for firms affected by Rule 18 to a *propensity-score-matched* (PSM) control group.

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<sup>5</sup> Although Rule 18 prohibits all positions in listed firms, most importantly the role as independent directors is affected because few officials serve full-time positions in listed firms. We examine all resignation announcements of top management during the sample period and don't notice that any full-time top managers (except for independent directors) resigned due to Rule 18.

<sup>6</sup> Also important, previous studies focus on the cross-sectional relation between political connections and accounting quality. Because firms strategically choose whether to develop their political connections, studies based on association tests are inherently subject to endogeneity problems such as reverse causality and omitted variable bias. Not only can political connections affect accounting quality, accounting quality may also affect political connections. For example, firms with lower transparency may choose to establish political connections, leading to a negative relation. Another endogeneity problem is the correlated omitted variables problem, where some firm characteristics affect accounting quality and political connections at the same time. For example, low-quality corporate governance may affect both at the same time.

We find that firms that lose politically connected directors experience a significant improvement in accounting quality (proxied by accruals quality in our primary tests; buttressed with model-free proxies in additional analyses) after the enactment of Rule 18 compared to the control firms. The results suggest that politically connected directors have a negative impact on accounting quality, so the accounting quality increases when they resign. Importantly, the results suggest a causal effect of political connections on accounting quality. We also find that the effects are stronger for non-state-owned firms than for state-owned firms (SOEs), suggesting that political connections through directors are more important for non-SOEs.

We further perform several cross-sectional analyses to investigate the channels through which politically connected directors affect accounting quality. First, firms may receive preferential access to bank credit through their political connections (Claessens et al. 2008), and if so, firms with politically connected directors have less incentive to provide transparent financial information to investors. However, after the resignations of politically connected directors, firms are likely to face greater difficulty in obtaining financing due to their weakened or ceased political ties; thus, they may increase accounting quality to ensure better access to capital markets. We execute two cross-sectional analyses to test this hypothesis. Because firms that receive preferential treatment in terms of bank credit have lower cost of debt, we split the sample based on the cost of debt in the *pre*-event period. We find that the increase in financial reporting quality is stronger in the subsample of firms with lower cost of debt, which is consistent with our hypothesis. In addition, politically connected firms have preferential access to domestic banks, so they are less likely to seek foreign capital before the connections are discontinued (Leuz and Oberholzer-Gee 2006). However, after the political connections have ceased, they may want to provide more transparent information to gain better access to foreign capital. The

results show that the increase in accounting quality is stronger when foreign capital plays a more important role. Taken together, the evidence suggests that politically connected directors grant firms preferential access to financing, which reduces management's incentive to provide high-quality financial reports.

Further, political connections result in lax enforcement of regulations and lower (or fewer) penalties if a misconduct is detected (e.g., Berkman, Cole, and Fu 2010; Yu and Yu 2011). After the loss of political connections, firms face stricter regulations, so they may be more likely to improve accounting quality. To test this hypothesis, we conduct two cross-sectional analyses. In the first analysis, we partition the sample based on the efficiency of the judiciary system in China. An efficient judiciary system imposes real costs and penalties on firms' misconduct, so firms are more likely to increase accounting quality to avoid these costs after losing their political protection via the politically connected directors. We find that the effect is stronger in the subsample with a more efficient judiciary system. The second analysis shows that the increase in accounting quality is stronger in the subsample of small firms. We argue that this finding is due to political connections being more effective in protecting small firms that are less scrutinized by the public media than large firms. Also, small firms are more vulnerable to legal costs (Lanjouw and Schankerman 2004). Collectively, the evidence suggests that lax regulations and lower penalties are other channels for politically connected directors to affect accounting quality.

We conduct several robustness tests to further validate our findings. First, we manually collect detailed data on personal characteristics and professional backgrounds of both the resigned politically connected directors and the successor directors. We control for these characteristics and no conclusions are altered.

Next, Rule 18 affects another group of directors who have no political connections in substance - university professors, leaders in publicly-funded organizations, and senior managers in SOEs. Although these individuals have official ranks, they do not have substantial political influence either in the government or the party, so we expect their resignations not to affect accounting quality. Consistent with this expectation, we do not find a significant change in the accounting quality for such firms.

Third, other events that occurred during this period in China could potentially confound our results. Because our research design controls for the time trend in accounting quality, only events that would systematically affect the treatment and control firms could affect our inferences. We consider two events that could possibly have different effects on the treatment and control firms. First, we examine whether the reduction of entertainment costs due to the “Eight-Point Regulation” in 2012 (another example of the government’s anti-corruption efforts) drives the results. Second, we examine whether the market-liberalization reform of 2015 affects our conclusions. Our conclusions are not impacted in these robustness tests.

To address the possibility that *unobservable* factors other than Rule 18 could drive our results, we conduct a placebo test using a “pseudo-event” year. We do not find significant differences in accounting quality between treatment and control firms around this pseudo-event. Finally, to assess the sensitivity of our findings to our proxy for accounting quality we use three alternative measures and inferences are unaffected.

Our paper contributes to the literature in the following ways. First, the large scale of the anti-



corruption campaign has attracted intensive interest from the press and academia.<sup>7</sup> For example, Griffin, Liu, and Shu (2016) and Lin, Morck, Yeung, and Zhao (2016) examine the effect of the Eight-Point Regulation. They document positive market reactions, a reduction in entertainment expenses, and an increase in firm performance associated with the policy. Ke, Liu, and Tang (2016) find that the anti-corruption campaign reduces the luxury-goods consumption of SOE firms. We examine another important policy during the anti-corruption campaign, Rule 18. Rule 18 focuses on government officials who take positions in listed companies. Our article is among the first to investigate the effects of the anti-corruption campaign in general, and it is the first paper that examines the impact of Rule 18 on accounting quality.

Second, our study establishes a causal effect of politically connected directors on accounting quality. While previous literature provides some evidence in other settings that political connections can bring value to firms, our findings suggest a negative effect of having political ties on firms' financial reporting quality; that is, the ceasing of political ties via the political connected directors improves firms' accounting quality. Further, firms strategically develop their political connections, so endogeneity issues are an important concern to understand the relation between political connections and accounting quality. We utilize an economically important regulatory change to establish a causal link between firms' political connections and their accounting quality.

Third, this article sheds light on the channels through which politically connected directors affect accounting quality. We test two non-exclusive channels: reduced financing pressures and lax

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<sup>7</sup> See, for example, <http://www.economist.com/news/china/21654664-many-wonder-what-xi-jinping-plans-next-his-anti-corruption-drive-after-zhou-who>; <http://www.forbes.com/sites/jackperkowsky/2014/06/05/the-price-of-fighting-corruption-in-china/#11f167065039>.

regulation. Our results support effects through both channels. That is, politically connected directors provide firms better access to preferential financing resources and better protection against strict regulations; as such, politically connected firms have less incentive to provide high-quality information to investors and regulators.

Fourth, previous literature only identifies political connections with high-level politicians, such as prime ministers or members of parliament (e.g., Faccio 2006; Chaney et al. 2011, Guedhami et al. 2014). Faccio (2006) suggests that firms' connections with local officials may be more important than their connections with high-level government officeholders. In particular, high-level government officeholders may not fully capture the total effect of political connections, and inferences cannot be easily generalizable to lower-level connections.<sup>8</sup> Our paper fills in the gap by identifying political connections with lower level officials, as such, it extends previous studies and provides a more complete assessment of the impact of political connections on accounting quality.

## **2. Institutional Background, Prior Research, and Hypothesis Development**

### **2.1 Institutional Background**

Although China has grown to become the second-largest economy in the world, it has distinctive characteristics that differentiate it from western countries. Two features are especially relevant to our study. The first is the central role of the government in the economy. The government directly controls a large group of enterprises as well as the financial market. More generally, the government has a

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<sup>8</sup> Among the 47 countries in Faccio (2006), only nine countries have more than ten firms with political connections; 30 countries have fewer than five firms with connections. Chaney et al. (2011) and Guedhami et al. (2015) use the same sample as Faccio (2006).

particularly significant role in allocating scarce resources, and it can intervene in judicial and regulatory decisions at its discretion. While the Chinese capital market has grown rapidly in the last 25 years, the regulatory regime has not kept pace with the developments in the financial market. China still has a weak legal system and inadequate investor protection (e.g., Piotroski and Wong 2012).

The other distinctive feature of China is a heavy emphasis on *relationship-management* in the economy. It is commonly believed that relationships (or social networks) - *Guanxi* - serve as substitutes for formal institutional development or formal contracts in the course of business (Gold and Guthrie, 2002). Allen, Qian, and Qian (2005) document that Chinese firms rely on relationships or informal channels to access various resources.

Based on the above two features, it is not surprising that firms in China attempt to establish political connections with officials or political leaders (Fan, Wong, and Zhang 2007; Hung, Wong, and Zhang 2012). One important phenomenon is that publicly listed firms hire government officials and just-retired officials as directors. In our sample, about 15 percent of the listed firms had hired officials as independent directors prior to Rule 18. The close relationships between the listed firms and the government officials can bring various preferential treatments for the firms (Li, Meng, and Wang, 2008), but they can also lead to corruption of government officials.

After Jinping Xi became the President of China and General Secretary of the Chinese Communist Party in 2012, he launched a large-scale anti-corruption campaign. This campaign has investigated and removed five national-level leaders and hundreds of high-ranking party or government officials. As one of the more significant measures, the Organization Department of the CCCPC released “Rule 18” on October 19, 2013 with a formal title of “To further regulate the officials who take positions in enterprises.” The purpose of Rule 18 is said to “enforce strict

requirements with cadre” and “to fight against corruption.” This regulation forbids all party and government officials above certain ranks from taking any position in enterprises on either a part-time or a full-time basis. The policy has a direct impact on listed firms and triggered a large-scale resignation tide of politically connected independent directors.<sup>9</sup>

Rule 18 provides a useful setting to study the causal effect of political connections on firms’ accounting quality. First, it is an exogenous event (at least at the firm level) that forced hundreds of directors to resign from listed firms. The political connections through those directors are therefore cut off, or at least weakened significantly, after the resignations. Previous studies utilize sudden deaths to investigate the value of independent directors or political connections (e.g., Fisman, 2001; Nguyen and Nielsen 2010; Faccio and Parsley 2009). Although those are interesting and exogenous events, the samples are usually very small and more importantly, their research questions are not about accounting quality.<sup>10</sup> In contrast, Rule 18 caused a large number of director resignations due to explicit and exogenous reasons, and we use the event to examine the effects of political connections on accounting quality.

Second, this context provides an effective way to identify political connections. We thus extend previous studies that use different measures for political connections. For example, Faccio and Parsley (2009) use geographic proximity to politicians, and Yu and Yu (2011) employ firms’ lobbying

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<sup>9</sup> See press reports about the resignation tide at <http://finance.sina.com.cn/stock/s/20140307/015318431403.shtml>, <http://www.chinanews.com/gn/2014/06-03/6238320.shtml>, <http://finance.people.com.cn/money/n/2014/0423/c42877-24930194.html>. Liu, Lin, and Wu (2016) find significant market reactions to the announcement of Rule 18.

<sup>10</sup> Fisman (2001) documents that the death of Suharto leads to negative market reactions to firms connected to Suharto’s family, Nguyen and Nielsen (2010) document negative market reactions to sudden deaths of independent directors, suggesting independent directors have value, Faccio and Parsley (2009) use geographic closeness to measure political connection, and examine the market reaction to politically connected firms around the death of politicians. None of these studies examine the effects on accounting quality.

activities as proxies. These measures are likely noisier measures of political connections than directors with a direct connection to the government. Rule 18 is an exogenous event and as such allows us to better measure the politically connected directors. Because these connected directors are forced to resign in a short period and these resignations need to be publicly disclosed, we can manually verify the reasons for the resignations.<sup>11</sup>

Third, existing studies often employ cross-country data, which raise concerns regarding endogeneity, the availability of variables at the country level, noisy variables, and the possibility of correlated omitted variables (Miller 2004). Cross-country studies are also affected by differences in legal, judicial, and cultural factors, which make it hard to disentangle firm-level effects from country-level factors (Gul 2006). The different disclosure regulations across countries further add noise to the data (Faccio 2016). Because we focus on a large sample of firms in one particular country, these concerns are mitigated in our setting.

Finally, China is an ideal environment to study the effect of political connections. As Agrawal and Knoeber (2001) articulate, the effect of political connections on firm behaviors is likely to be the most significant when regulations and government controls have important consequences for the corporate sector. Faccio (2006; 2010) shows that political connections have a larger effect in a weak institutional environment with a higher level of corruption and lower transparency. China is the largest emerging country with all these characteristics and it provides a large sample and an exogenous event for our study.

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<sup>11</sup> Note that our study focuses on one specific type of political connections: through politically connected directors. There could be other types of political connections that we cannot explicitly measure.

## 2.2 Prior Research

Political connections are a widespread phenomenon around the world.<sup>12</sup> Firms establish political connections to achieve a variety of preferential treatments. For example, Claessens, Feijen, and Laeven (2008) find that political connections increase firms' access to credit through bank financing. Berkman, Cole, and Fu (2010) examine the effects of regulations aimed at improving corporate governance. They show that although these regulations generally increase firm value, the effect is weaker for firms with stronger ties to government regulators (i.e., officials shield the companies from enforcement of the new rules). In a similar vein, Duchin and Sosyura (2012) document that politically connected firms are more likely to be funded when firms apply for the Troubled Asset-Relief Program.

More closely related to our study, researchers have also examined the effect of political connections on accounting quality. Using an international dataset on corporate political connections developed by Faccio (2006), Chaney et al. (2011) conclude that the presence of connections is associated with lower quality accounting. Guedhami et al. (2014) use the same database and examine the auditor choice of politically connected firms. Guedhami et al. (2014, 108) argue that "connected insiders who refrain from self-dealing would prefer higher-quality financial reporting" so as to convince outside investors that they will not divert corporate resources. Consistent with their argument, they find that firms with political connections are more likely to appoint a Big-4 auditor. Although the above two papers focus on different research questions and use different dependent variables, the basic concept under investigation is the relation between political connections and

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<sup>12</sup> As Faccio (2006) shows, political connections exist in 35 of her 47 sample countries. In addition, connected firms account for about 8% of the world's stock-market capitalization. These facts suggest that politically connected firms are a significant group of firms and that the issue we examine is of general interest.

accounting quality. Chaney et al. (2011) suggest a negative relation whereas Guedhami et al. (2014) conclude that connected firms are more likely to hire Big-4 auditors, and that connected firms with Big-4 auditors exhibit less earnings management.

Because firms strategically choose to establish political connections, there is an inherent endogeneity problem between accounting quality and such connections, which is difficult to tackle using cross-sectional analyses.<sup>13</sup> Our research design utilizes a quasi-experimental setting with firm fixed effects and PSM.<sup>14</sup>

### 2.3 Hypothesis Development

Ex ante, it is not clear whether political connections have a negative or positive effect on accounting quality. Such connections may negatively affect accounting quality for the following reasons. First, politically connected firms establish connections to derive gains from their connections, and these gains are often in the gray area or of dubious legality (Fisman 2001). Therefore, insiders may want to *obscure* reported earnings in order to obfuscate the gains from those connections.<sup>15</sup>

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<sup>13</sup> Leuz and Oberholzer-Gee (2006) use the demise of Suharto as an exogenous event and find firms are more likely to obtain access to foreign capital after the loss of political connection. However, they do not focus on accounting quality.

<sup>14</sup> Our research also relates to the literature on the role of independent directors. Previous studies suggest that independent directors play a role in the monitoring of management. For example, Weisbach (1988) finds that the existence of independent directors increases the likelihood of firing CEOs for poor performance. Nguyen and Nielsen (2010) investigate the market reactions to the sudden deaths of independent directors and find that the market perceives independent directors as valuable. Their further investigation indicates that the value of independent directors is incremental to their individual skills or competence. Armstrong, Core, and Guay (2014) document that corporate transparency generally improves following a required increase in the proportion of independent directors. Similarly, Wang, Xie, and Zhu (2015) show that independent directors with industry expertise are more effective in monitoring managers.

<sup>15</sup> Leuz and Oberholzer-Gee (2006) argue that firms with political connections dislike high transparency, as such transparency will expose political favors with dubious legality. Consistent with this argument, the authors find that firms with political connections are less likely to access global financing to avoid the scrutiny of foreign security markets.

Second, transparent financial information is fundamental to the development of financial markets. External investors demand transparent information when providing capital. Because connected firms gain access to preferential financing, they may attach lower importance to external investors. As a result, they have *reduced incentives* to improve the quality of the information they disclose, so managers invest less time to accurately portray accounting quality (Chaney et al. 2011).

Third, politically connected firms not only enjoy the benefits of political connections, but also carry some political burdens. For example, Piotroski et al. (2015) indicate that Chinese politicians prefer to suppress negative information during specific time periods, such as elections or political events. They find that politically connected firms in China suppress negative information in order to cater to the political needs of politicians. Therefore, the information of politically connected firms can be *distorted* by political needs (and thus the quality of the information provided is reduced).

Finally, regulators require firms to provide high-quality information, and they penalize firms that fail to follow rules. However, prior literature shows that the regulatory monitoring is less severe for politically connected firms. Yu and Yu (2011) find that politically connected firms are significantly less likely to be detected for fraud. Therefore, the relatively lax regulatory environment for the politically connected firms *reduces the regulatory motivation* for them to provide high-quality information.

On the other hand, according to the political-cost hypothesis (Watts and Zimmerman 1978), politically connected firms are more publicly visible and are subject to greater media scrutiny. When officials take positions in public firms, this information must be disclosed to the public, which could amplify the attention from media. The possibility of and thus the expected cost of the media and other public-watchdog organizations (and others who rely on the media for information) detecting earnings



manipulations are both higher. Li and Shen (2010) find that in China negative media coverage triggers further investigation by the government, and that the affected officials are more likely to lose positions or their promotion opportunity. Therefore, politically connected firms may have incentives to provide high-quality information.

Second, politically connected firms may have easier access to subsidized financing or government contracts. For example, Claessens et al. (2008) find that Brazilian firms that provide contributions to elected federal deputies significantly increase their access to bank financing. Piotroski and Wong (2012) conclude that Chinese firms with political connections are treated favorably when they access the capital market. Because capital-market pressures and fierce competition can cause managers to manipulate earnings, the preferential treatment may blunt incentives to manipulate earnings for capital-market and contracting purposes, suggesting a positive relation between political connections and earnings quality (Gul 2006). Aharony, Lee, and Wong (2000) argue that Chinese SOEs in protected industries are more likely to have political connections and receive preferential treatments. They find empirical evidence that these firms are less likely to manage earnings during the IPO process.

Third, independent directors have incentives to develop their reputations (Fama and Jensen 1983). Jiang, Wan, and Zhao (2016) provide evidence that independent directors in China care about their reputations, and that reputation concerns affect their voting behaviors. Finally, prior literature shows that politically connected firms are more likely to expropriate minority shareholders. Faccio (2006) finds evidence that outside investors perceive that controlling shareholders with political connections exploit these connections for their own benefits (while harming other owners). Given that outside investors prefer transparent information as a protection, Guedhami et al. (2014) argue that

insiders, who refrain from self-dealing, could provide higher quality financial reporting to signal to outside investors.

Taken together, the effect of politically connected directors on firms' accounting quality is not clear. In addition, accounting quality may affect the establishment of political connections. For example, opaque firms may establish connections in order to receive preferential treatments. Because of these empirical challenges, we believe that the nature of Rule 18 and the differences-in-differences methodology are especially useful in establishing the effect of politically connected directors on accounting quality. The resignation of politically connected directors due to Rule 18 effectively severs the political connections between the firm and politicians. To summarize, by observing the change of accounting quality around Rule 18, we can identify the causal effect of these connections. Our primary hypothesis is stated as follows in the null form:

**H1:** The accounting quality of firms with politically connected directors does not change after the enactment of Rule 18.

### **3. Sample and Research Design**

#### **3.1 Sample Selection**

We start our sample with all firms listed on the Main and SME boards of China's stock markets.<sup>16</sup> To identify the treated firms, we *hand collect* all resignation announcements of directors

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<sup>16</sup> Our sample does not include firms listed on ChiNext, which is established to attract small, innovative, and fast-growing enterprises, especially high-tech firms. The listing standards of ChiNext are less stringent than those of the Main and SME Boards.

after Rule 18, which was released on October 19, 2013.<sup>17</sup> Many resignation announcements explicitly state that the director has to resign from the firm to comply with Rule 18. However, some firms tend to blur the true reason by providing ambiguous statements such as “due to personal reasons.” To mitigate any possible omissions for announcements without explicit explanations, we check the background of the resigned directors to identify whether the director is affected by Rule 18. The background information is retrieved from each director’s resume obtained from the China Stock Market and Accounting Research (CSMAR) database and supplemented from companies’ home pages or other websites.<sup>18</sup> Because university professors, leaders in publicly-funded organizations, and top managers in SOEs in China have similar civil-service ranks as government officials, they were also affected by Rule 18 and were forced to resign.<sup>19</sup> To assure that the resigned directors represent the loss of political connections, we exclude these cases from the treatment sample.<sup>20</sup> All other firms are control firms in the difference-in-differences (DiD) regression when employing the full sample, and as candidates as matching firms for tests using PSM.

To examine the effects of political connections, we collect financial information for the two years before and two years after Rule 18. Specifically, since Rule 18 was released in October 2013,

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<sup>17</sup> Almost all official directors announced their resignations before the issuance of 2014 annual reports. Therefore, we collect resignation announcements from the introduction of Rule 18 until April 30, 2015, the mandatory deadline for 2014 annual reports.

<sup>18</sup> For example, [www.baidu.com](http://www.baidu.com), <http://stockdata.stock.hexun.com>, <http://stock.jrj.com.cn>, <http://finance.sina.com.cn>, <http://www.stockstar.com>, and <http://www.10jqka.com.cn>.

<sup>19</sup> Based on a practice that has been followed for several decades, universities, publicly-funded organizations, and SOEs are given civil-service ranks equal to those of government departments. For example, prestigious universities usually have a civil-service rank of vice-ministerial level, and the leaders of those universities have the civil-service ranks similar to vice-minister. Publicly-funded organizations are mostly nonprofit organizations, such as the Chinese Academy of Science, General Research Institution for Nonferrous Metals, etc.

<sup>20</sup> In a robustness test, we separately test the effects of resigned directors in this subsample and find no significant change of accounting quality.

we use 2012 and 2013 as the pre-rule period, while 2014 and 2015 comprise the post-rule period.<sup>21</sup>

Financial information is obtained from CSMAR. Following prior literature, we exclude financial firms because computing discretionary accruals for these firms is problematic. We also eliminate firms with missing data or negative equity. All continuous variables are winsorized at the 1st and 99th percentiles in order to mitigate the effects of outliers.

### **3.2 Research Design**

Our main tests involve DiD analyses using a PSM control group. This methodology compares the accounting quality of a sample of treatment firms with politically connected directors who have resigned to that of control firms (without resigned directors but otherwise comparable), before and after the Rule 18 - induced director resignations.

The DiD approach has several advantages. First, this methodology controls for omitted trends that are correlated with accounting quality in both the treatment and the control groups.<sup>22</sup> With the development of the stock market and the improvement of regulation, Chinese firms may have improved corporate governance and accounting quality over time (Jiang, Lee, and Yue 2010). Second, the tests are conducted surrounding policy changes that cause a change in political connections. This helps to rule out reverse-causality concerns, such as firms with lower accounting quality choosing to

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<sup>21</sup> The policy is issued at the end of 2013, so nearly all affected independent directors began to resign from 2014. Therefore we classify 2013 as pre-policy period. Our inferences are not affected if we exclude 2013 from our sample period or employ 2011 and 2012 as the pre-rule period. We also employ a specification that includes four years as pre-rule period (i.e. 2010, 2011, 2012, and 2013 as the pre-rule period, and 2014 and 2015 as the post-rule period). Inferences are not affected (untabulated).

<sup>22</sup> We observe that the two groups of firms exhibit similar trends in accounting quality in the four years prior to the reform (untabulated).

establish connections. In addition, we include either industry or *firm fixed effects* in the regressions. Firm fixed effects control for any time-invariant unobserved differences between the treatment and the control groups. For example, corporate governance could be correlated with both political connections and accounting quality, and may lead to spurious correlations between them.

The PSM approach generates samples in which treatment firms and control firms are more similar, which helps mitigate the possibility that omitted correlated variables are driving our results (e.g., Hope, Thomas, and Vyas 2013). To implement this PSM approach, we first estimate a logit regression using the information in the year 2013 to model the probability of being affected by Rule 18 (i.e., whether a particular firm has affected directors). Similar to the study of DeFond, Hung, Li, and Li (2014), we include all independent variables in equation (1) in the PSM model to assure that all known factors that may potentially affect accounting quality are similar across the treatment and control samples. The estimation results of the logit model are presented in Appendix A. Next, we calculate the propensity score for each firm using the predicted probabilities from the logit model, and match each treatment firm to the control firm using the nearest-neighborhood technique without replacement.

We compare the changes in accounting quality among connected firms with non-politically connected firms over the period 2012-2015. In order to perform this comparison, we regress our accounting quality measures on  $OFFICIAL_i \times POST_{it}$  that captures the interaction between political connections (boards with official directors) and the post-policy period, along with a set of control variables. The main regression model is as follows:

$$|DA|_{it} = \alpha + \beta_1 \times OFFICIAL_i \times POST_{it} + \beta_2 \times POST_{it} + \beta_3 \times OFFICIAL_i + \gamma \times Controls \\ + Fixed\ Effects + \varepsilon_{it} \quad (1)$$

where  $|DA|_{it}$  is our primary measure of accounting quality, the absolute value of discretionary accruals for firm  $i$  in year  $t$ . We use Kothari, Leone, and Wasley's (2005) cross-sectional performance-adjusted model that partially controls for industry-wide changes in economic conditions that affect total accruals while allowing the coefficients to vary across time (Kasznik 1999; DeFond and Jiambalvo 1994).<sup>23</sup> Higher absolute values of discretionary accruals indicate lower accounting quality.

*OFFICIAL* is an indicator variable that takes the value of one for firms with resigned official directors, and zero otherwise. *POST* is defined as one when the year is after the issuance of Rule 18, (i.e., 2014 or 2015), and zero otherwise.

To purge the effect of underlying business processes and other fundamental drivers of the accruals quality, we include several control variables that the literature has shown to associate with firms' accounting quality (e.g., Dechow and Dichev 2002; Daniel, Denis, and Naveen 2008; Hribar and Nichol, 2007; Raman and Shahrur 2008; Gopalan and Jayaraman 2012): firm size (*SIZE*),

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<sup>23</sup> Specifically, we estimate the following model each year using all firm-year observations for each industry:

$$Acc_{it} = \beta_0 + \beta_1 \left( \frac{1}{Assets_{it-1}} \right) + \beta_2 (\Delta Sale_{it} - \Delta AR_{it}) + \beta_3 PPE_{it} + \beta_4 ROA_{it} + \varepsilon_{it}$$

where  $Acc_{it}$  is the total accruals, calculated as net income before extraordinary items minus total cash flow from operation, scaled by lagged total assets;  $Assets_{it-1}$  is the lagged total assets;  $\Delta Sale_{it}$  is change in sales;  $\Delta AR_{it}$  is change in account receivable;  $PPE_{it}$  is property, plant, and equipment, and  $ROA_{it}$  is current return on asset, all scaled using lagged total assets. We use total assets as the deflator to mitigate heteroskedasticity in the residuals. Industry is defined by China Security Regulatory Commission (21 different industries). The residuals from the regressions are then used to measure discretionary accruals.

leverage (*LEV*), operating cycle (*CYCLE*), volatility of the operating environment (*SDSALES*; the volatility of sales), capital intensity (*PPE*), dividend payments (*DIVIDEND*), and firm age (*AGE*).

Next, we include a set of variables to control for corporate governance. Specifically, we incorporate managers' ownership (*INSIDER*), board size (*BOARDSIZE*), the percentage of independent directors (*INDPRO*), analyst following (*ANALYSTS*), auditor quality (*BIG4*), and audit fees (*AF*) in our model.<sup>24</sup>

Previous research indicates that firm growth and firm performance affect accruals quality (e.g., Kasznik 1999; Lee, Li, and Yue 2004). Therefore we include return on assets (*ROA*), an indicator variable indicating negative earnings (*LOSS*), annual stock returns (*RETURN*), market-to-book ratio (*MB*), and annual sales growth (*GROWTH*). Given that our setting is China, we additionally follow Chen, Chen, Lobo, and Wang (2011) and include an indicator variable for whether the firm is a state-owned enterprise (*SOE*) as well as the marketization index for each province or provincial region (*MI*).<sup>25</sup> Consistent with Chen et al. (2011), we also control for stock beta (*BETA*).

Finally, we include year fixed effects and either industry or firm fixed effects.<sup>26</sup> We cluster standard errors at the firm level to mitigate the overstatement of statistical significance owing to serial correlation in the error term (Petersen 2009). All variables are defined in Appendix B.

The major variable of interest is the interaction between political connection and post-period

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<sup>24</sup> Igan and Pinheiro (2004) show that insider ownership affects the decision to manage earnings. Klein (2002) suggests that board characteristics are related to the effectiveness in monitoring the corporate financial accounting process. Yu (2008) finds that analysts play a monitoring role on earnings management. Frankel, Johnson, and Nelson (2002) observe an association between auditor characteristics and earnings management.

<sup>25</sup> The marketization index is produced by the National Economic Research Institute (NERI), with higher scores indicating that the market plays a more important role in the economy (Fan, Wang, and Zhu 2011).

<sup>26</sup> When firm fixed effects are included, the variable *OFFICIAL* drops out.

( $OFFICIAL_i \times POST_{it}$ ). The coefficient on the interaction term,  $\beta_1$ , captures the incremental change in accounting quality from the pre- to the post- period for firms with resigned official directors relative to the change for firms in the benchmark group. A negative (positive) coefficient on  $\beta_1$  is consistent with a decrease (increase) in absolute discretionary accruals, which indicates that the cutting-off of connections improves (impairs) accounting quality.

## 4. Empirical Results

### 4.1 The Influence of Rule 18

Table 1 presents the sample-selection procedure. We start from all firms listed on both the Main and SME boards of the Shanghai and Shenzhen Stock Exchanges. We have 2,090 listed firms with a total of 8,337 directors on the date when Rule 18 was issued. Among those listed firms and directors, 819 directors were forced to resign after Rule 18, which affects a total of 613 firms (or 29% of the whole population of listed non-financial firms). It is evident that Rule 18 had a highly significant impact on the directors and publicly traded companies. We further remove observations if resigned directors are not government or party officials. As explained, these directors are university professors, leaders in publicly-funded organizations, or SOE managers. They have similar civil-service ranks as officials but are considerably less likely to provide political connections for firms. This leaves us with 315 firms. After eliminating firms with missing variables or without appropriate PSM matching firms, our final treated group includes 292 firms with 377 resigned official directors.

The large sample of resigned official directors indicates that listed firms in China were keen to hire officials as directors in order to build up political connections. This is consistent with previous evidence that firms tend to establish such connections, especially in regions where the government



plays an important role (e.g., Korn/Ferry 2000; Hillman 2005). The large-scale resignation wave due to this event provides us with an ideal setting to study the effect of political connections on accounting quality.

## 4.2 Descriptive Statistics

Panel A of Table 2 reports descriptive statistics for our main variables separately in the treatment group, non-treatment group, and PSM control group prior to the event. We observe that the treatment and non-treatment firms have significant differences in many firm characteristics. Specifically, relative to the control group, treatment firms are larger, have lower market-to-book ratio, are more likely to be SOEs, are older, have a larger board of directors, pay higher audit fees, and are located in regions with a lower level of marketization. These differences suggest the necessity to employ PSM.

Importantly, after we use PSM to identify the control sample, *all* significant differences are eliminated. We also evaluate the effectiveness of PSM by examining whether the covariates are balanced across treatment and control group. In untabulated analyses, we find that the mean bias drops significantly from 10.1% before matching to 4.5% after matching. Thus, the PSM approach is effective in removing meaningful differences in the matched variables across the treatment and control groups.

In Panel B of Table 2 we present firm characteristics for the main sample in our regression tests. There are 2,204 firm-year observations for a total of 584 firms.

### 4.3 Political Connections and Accounting Quality

Table 3 provides our main results of the impact of political connections on accounting quality. In columns (1) and (2), we use *all* other firms as control firms, and use industry fixed effects and firm fixed effects, respectively. The estimated coefficients on  $\beta_1(OFFICIAL_i \times POST_{it})$  are -0.0135 and -0.0130 respectively, and both are significant at the 1% level (using two-sided tests). In models (3) and (4), we use PSM firms as control firms, and again use industry fixed effects and firm fixed effects, respectively. The coefficients for the test variable are -0.0198 and -0.0199, respectively (significant at the 1% level). The results from the two sets of regressions are consistent, and the coefficients using the PSM sample are even larger in magnitude. The evidence indicates that firms improve the accounting quality when their official directors resign, suggesting political connections impair accounting quality. Our results establish a causal relation between such connections and accounting quality.

Because the PSM procedure generates control firms similar to treatment firms, it mitigates the effects of possible omitted variables. We therefore use PSM in the following analyses. The ownership type of firms may influence the effects of connections on accounting quality. Listed firms with the government as the ultimate largest shareholders are generally carved out from large state-owned economic groups, and may have political connections by nature. They often receive preferential treatments from banks and government regulations and take social-policy burdens (Lu et al. 2015; Park and Luo 2001). Therefore, SOEs may not need to depend on official directors for political connections, and the resignations of official directors are expected to have less effect. We divide the full sample based on whether the government or its agent is the firm's ultimate controller (SOEs) or

not, and redo the analysis.<sup>27</sup> Columns (5) and (6) in Table 3 present the results. As we can see,  $OFFICIAL_i \times POST_{it}$  is significant in both the non-SOE group (-0.0297) and the SOE group (-0.0112). More importantly, the magnitude of  $\beta_1$  in the non-SOE group is larger than that in the SOE group (and the difference is statistically significant), suggesting that the effect of politically connected directors is more important for non-SOE firms.

#### 4.4 Channel Analysis: Lower Financing Pressure

To further understand how political connections affect accounting quality, we examine two potential channels. First, political connections may affect accounting quality due to financing pressures. As discussed, politically connected firms receive preferential treatments in terms of financing. For example, Claessens et al. (2008) find that firms with political connections have more access to bank financing. Piotroski and Zhang (2014) show that in China political intervention plays a significant role in the IPO process, and that firms gain access to stock-market financing through their connections. Yu, Wang, and Jin (2012) find that political connections can mitigate financial constraints, especially for non-SOEs. They suggest that political connections bring more resources for those firms. Piotroski and Wong (2012) conclude that Chinese firms with political connections are treated favorably when they access the capital market. Therefore, when firms have preferential treatments in the access to external financing, they do not face the same level of pressure from external investors who usually require transparent disclosure. In contrast, when the political connections are cut off, firms are forced to increase accounting quality.

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<sup>27</sup> We compare across the partitions because this approach allows the coefficients on the control variables to vary across the partitions (Covrig, DeFond, and Hung 2007).

To test the financing-pressure channel, we use two conditioning variables. The first is a firm-level variable, the cost of debt before the event. Following Pittman and Fortin (2004), we calculate the cost of debt as interest expense divided by the amount of interest-bearing debt. When the cost of debt is lower, firms are more likely to receive preferential credit, therefore, after the political connection is severed, they will face greater pressure from external investors. Recall that we employ PSM in these analyses.

The other variable is a region-level variable - the degree to which foreign capital is used in the province. Foreign investors are more likely to require high-quality information compared with local banks that are usually controlled by the government. Before the event, firms with political connections can more easily depend on local banks and do not need financing from foreign capital, however, Rule 18 cuts off the connections and these firms are more likely to have to face foreign investors. Therefore, for firms in regions in which foreign capital is more important, the increase of pressure from financing due to loss of political connections is larger, and firms are more likely to increase accounting quality.<sup>28</sup>

We partition our sample into two subsamples based on the (median) cost of debt or the index for the foreign-capital importation, respectively. We then rerun the regression and compare the coefficients on  $OFFICIAL_i \times POST_{it}$  between two subsamples. Panel A of Table 4 reports the results of partition analysis based on the cost of debt.  $\beta_1$  is significantly negative in both groups, and the magnitude of the coefficient is significantly larger in the group with lower cost of debt than that in the

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<sup>28</sup> To be precise, before Rule 18, firms with political connections will not care (or will care much less) about accounting quality no matter whether the importance of foreign capital is high or low, because these firms obtain financing regardless.

group with higher cost of debt.<sup>29</sup> These results indicate that firms with lower cost of debt before the policy have the motivation to satisfy the higher demand of external investors for accounting quality.<sup>30</sup>

Panel B of Table 4 presents the results of partition analysis based on the degree of foreign-capital importation. We use the index compiled by Fan, Wang, and Zhu (2011), with a high index value indicating the larger involvement of foreign capital in the province. We partition the sample based on the median. The results indicate that the test variable is significant in both subsamples. More importantly, the magnitude of the coefficient in the group with more foreign capital involved is significantly larger than that in the other group.<sup>31</sup>

Together, these results provide support for the financing-pressure channel. When firms receive more preferential treatment in terms of credit before the event, or when foreign capital plays a greater role, the severing of political connections is more likely to increase the pressure from the capital market for those firms. Therefore, these firms increase their accounting quality more.

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<sup>29</sup> We alternatively group firms based on the median of the treatment firms and then put the matching firms in the same group. Inferences are unchanged.

<sup>30</sup> In an untabulated analysis, we divide the sample into two groups according to whether short-term debt deflated by total debt is higher than the median. Firms with higher ratio face re-financing pressure in the near future, therefore the financing pressure induced by the cut-off of political connections is stronger. We find that the effects of politically connected directors are more significant in this group.

<sup>31</sup> As an alternative and untabulated test, we consider Fan, Wang, and Zhu's (2011) financial-market marketization index that consists of two parts: (1) The market share of non-state-owned banks and (2) the percentage of loans given to non-SOEs. Chen, Chen, Lobo, and Wang (2010) find that non-state-owned banks care more about quality accounting and firms that borrow from non-state-owned banks have more conservative accounting. Before the event, firms with political connections can more easily depend on state-owned banks and do not need financing from non-state-owned banks, however, Rule 18 cuts off the connections and these firms are more likely to have to borrow from non-state owned banks. Therefore, for firms in regions in which non-state owned banks have great market share, the increase of pressure from financing due to loss of political connections is larger, and firms are more likely to increase accounting quality. We find evidence consistent with the idea, with *OFFICIAL*×*POST* being significantly different between high and low finance marketization.

#### 4.5 Channel Analysis: Lax Regulation

Another channel through which political connections may affect accounting quality is lax regulation. The regulatory environment and regulatory monitoring are important to motivate firms to provide high-quality information (Bhattacharya, Daouk, and Welker 2003; Hope 2003). However, politically connected firms face less strict regulation. For example, Correia (2014) finds that politically connected firms in U.S. are less likely to be inspected by the SEC, and if those firms are prosecuted, the penalties are lower. Yu and Yu (2011) conclude that for firms under class-action lawsuits, those with political connections have longer class-action periods, consistent with such connections delaying the detection of fraud. Lu, Pan, and Zhang (2015) show that Chinese courts deliberately favor SOE firms and firms with political ties, suggesting that politically connected firms face a lax regulatory environment. The regulator imposes a variety of rules to promote the transparent disclosure of important information and to penalize accounting fraud. However, political connections may shield firms from the regulation mechanism and therefore they have less incentive to supply high-quality financial reports. After the political connections are cut off, the regulatory environment becomes stricter for those firms, and they are motivated to increase their accounting quality.

We first use a within-China region-level variable that measures the efficiency of courts in enforcing contracts.<sup>32</sup> Although laws and regulations are set at the national level, the efficiency of courts varies significantly across regions.<sup>33</sup> The World Bank developed the index by following a

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<sup>32</sup> See “Doing Business in China” report at <http://www.doingbusiness.org/Reports/Subnational-Reports/China>. The data are collected through a study of the civil-procedure codes and other court regulations as well as surveys completed by local litigation lawyers.

<sup>33</sup> In regions characterized as having low judiciary efficiency, such as Jilin (average time for court case: 540 days), the risk of lawsuits is low, not only for connected firms but for all firms. Thus, political connections do not matter (or matter much

commercial dispute through local courts.<sup>34</sup> In regions with low efficiency of courts, the time cost and monetary cost of going to courts are higher, therefore firms face lower legal threats and political connections likely do not provide as large benefits. In contrast, for firms in regions with high efficiency of courts, the legal threat is stronger and political connections can provide greater benefits. We expect that political connections will affect accounting quality to a larger extent in regions with higher judiciary efficiency, where firms face a stronger legal threat after losing political connections.

Second, we use firm size as a conditioning variable. Previous literature suggests that small firms lose more when facing lawsuits because of higher financing costs and greater reliance on external counsel (Lanjouw and Schankerman 2004; Lanjouw and Lerner 2001). Also, large firms are under greater media scrutiny and the connected official may be reluctant to or find it difficult to protect the firms (Watts and Zimmerman 1983). Therefore, small firms are likely to benefit more from political connections related to regulation.<sup>35</sup>

In Panel A of Table 5, we divide our sample based on the judicial-efficiency ranking, and in Panel B based on firm size. Consistent with our prediction, we observe that the accounting-quality improvement is more significant when the regional judicial efficiency is high and when firms are smaller. These results provide us with evidence supporting the lax-regulation channel. Political connections can provide firms with protection from detection or threat of laws and regulations. Losing the connections means stricter regulation, therefore firms affected by Rule 18 improve their

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less).

<sup>34</sup> The index combines two indicators: (1) Time, including the number of days from the time the plaintiff files the lawsuit in court until the time of payment. This measure includes both the days on which actions take place and the waiting period between actions; and (2) costs, including the official cost of going through court procedures, expressed as a percentage of the claim value. The costs include court costs, enforcement costs, and attorney fees.

<sup>35</sup> We acknowledge that firm size can also proxy for other factors. This is why we do not rely solely on this empirical proxy.

accounting quality.

In summary, we find significant evidence supporting both the financing-pressure and the lax-regulation channels. The mechanism analyses reveal how political connections can impact accounting quality, which helps us better understand the relation between political connections and accounting quality.

## 5. Robustness Tests

### 5.1 Personal Characteristics of Directors

In Panel C of Table 2 we provide descriptive statistics on personal characteristics of the directors who were forced to resign. We manually collect these data.<sup>36</sup> We observe that 40% of the resigned directors held government positions that meant they had particular power in the industry in which the firm operates,<sup>37</sup> 36% held “national rank” (an important dimension in China), most of the resigned directors (87%) reside within the same province as the resigned director, the vast majority (89%) are male, and 20% are retired.

In Table 6, we include these personal characteristic as additional controls (in the specification with industry fixed effects). Column 1 shows that the estimated coefficient on  $OFFICIAL_i \times POST_{it}$  is -0.0207 with a t-statistic of -5.61. Thus we find that no conclusions are altered after controlling for

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<sup>36</sup> We collect resignation reports from <http://www.cninfo.com.cn/cninfo-new/index>. Then we scrutinize the corresponding CVs from CSMAR and supplement with information from companies’ home pages or other websites. For the successor directors, we first compare the directors’ names for each treated firm between years. After identifying the incoming directors, we read through their CVs (again from CSMAR database and supplemented with information from companies’ home pages and other websites).

<sup>37</sup> As an example, if a real-estate development company hires an official director from *People's Republic of China Ministry of Housing*, which has the authority to monitor the operations of the real-estate industry, this official has some power related to the real-estate industry.



detailed personal characteristics of the outgoing directors.

Next we collect data on the replacement directors. Most firms replace the resigned directors in a timely fashion. Panel D of Table 2 shows the details of the successor directors' backgrounds. Of the incoming directors without political connections, 30% have their primary experience within the same industry. In terms of professional backgrounds, 54% are from accounting and finance, 15% from law, and 6% from banking. With regard to personal characteristics, 83% are male and under 5% are retired.

Again, we include these as additional controls and no inferences are impacted (Column 2).<sup>38</sup> Finally, in Column 3 we include both all resigned director characteristics *and* successor director characteristics and again we reach the same conclusion (test coefficient of -0.0206 with a t-statistic of -5.59).

## **5.2 Falsification Tests: Directors with No or Limited Political Connections**

In this section, we execute a series of additional tests to provide corroborating evidence. First, to validate that the change of accounting quality is caused by political connections, we examine the effect of the resignation of directors with official ranks but who are highly unlikely to provide important political connections. If our results are not driven by political connections, then we expect that the resignation of these directors will also affect the accounting quality. We use firms with resigned directors from universities, publicly-funded organizations, or SOEs as the treated group. We have a total of 267 pseudo-treatment firms, among which 173 firms with resigned directors from universities, 61 with resigned directors from publicly-funded organizations, and 33 with resigned

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<sup>38</sup> For example, our results are not driven by having incoming directors with accounting expertise.

directors from other SOEs.<sup>39</sup> We use a similar PSM procedure and match these firms with control firms using the firm characteristics in the year before Rule 18. We define *NOFFICIAL* as a binary variable that equals 1 if the firm has resigned director from universities, publicly-funded organizations, or SOEs, and 0 otherwise. We then execute similar DiD analyses as in equation (1) and present the results in Table 7. The results show that *NOFFICIAL*×*POST* is *not* significant. This test further corroborates that our results are driven by political connections.

### 5.3 Potential Confounding Events

We consider two potential confounding events that occurred around the event we examine. After President Xi Jinping assumed power in the 18th National Congress of the Communist Party of China, the government launched a large-scale anti-corruption campaign, and the Eight-Point Regulation was issued on December 4, 2012.<sup>40</sup> The regulation requires government officials to forego conspicuous perks, and was perceived as the launch of China's anti-corruption reform. The Eight-Point Regulation regulates the general behavior of government officials, while Rule 18 specifically focuses on the officials who serve as directors in firms. Lin, Morck, Yeung, and Zhao (2016) find that the market reacts positively to the launch of the Eight-Point Regulation, and firms (especially SOE firms) greatly reduce their entertainment and travel costs (*ETC*), which are presumably used for corruption. Griffin et al. (2016) confirm that the Regulation leads to a decrease in entertainment expenses, but find no evidence that it affects discretionary accruals, one of their measures for corruption. To control the

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<sup>39</sup> The relevant regulation requires that at least one of the independent directors should have accounting expertise. Therefore, it is a common practice that university professors who have accounting backgrounds serve as independent directors.

<sup>40</sup> For details, see [http://cpcchina.chinadaily.com.cn/2012-12/05/content\\_15991171.htm](http://cpcchina.chinadaily.com.cn/2012-12/05/content_15991171.htm).

effects of abrupt change of *ETC* due to the Eight-Point Regulation, we add *ETC* as a control variable and rerun our main tests as in equation (1). The results are presented in Table 8, models (1) and (2). We find that controlling for *ETC* does not change our conclusion that the curtailing of political connections increases accounting quality.<sup>41</sup> To further ensure our results are not driven by the Eight-Point Regulation, we also exclude the year 2012 from our sample, which makes our sample years all post the Eight-Point Regulation. The results are presented in columns (3) and (4) in Table 8 and again no inferences are affected.

The second potential confounding event we consider is a market-liberalization reform, the Shanghai-Hong Kong Stock Connect, which significantly changed the market segmentation in China. Through a centralized platform set up by the Shanghai Stock Exchange and Hong Kong Stock Exchange, international investors, either institutional or non-institutional investors, can directly trade a selected batch of stocks listed on the Shanghai Stock market if they have stock accounts in Hong Kong.<sup>42</sup> The market-liberalization reform introduces foreign investors and could affect accounting quality (e.g., Leuz, Lins, and Warnock 2010). To control for the effects of the market liberalization, we first include an indicator variable, which equals one if the stocks can be directly traded by Hong Kong and international investors after the reform. The conclusions do not change.<sup>43</sup> Next, we eliminate the year 2015 from our sample, which makes our sample years all before the liberalization

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<sup>41</sup> In an untabulated analysis we further include the interaction term *ETC*×*POST* and no inferences are affected.

<sup>42</sup> The Shanghai-Hong Kong Stock Connect was announced in November 17, 2014, with 568 stocks included in the program. Before the reform, A-shares could only be traded by mainland Chinese nationals, except for Qualified Foreign Institutional Investors (QFII). QFIIs have been allowed to trade A-share since 2002. However, there are strict quota limits for QFII.

<sup>43</sup> In an untabulated analysis we further include the interaction term *Market-Liberalization*×*POST* and no inferences are affected.

reform. Our inferences hold again. The results are presented in Table 9.

#### 5.4 Placebo Analysis

Next we implement a placebo analysis. To address the possibility that unobservable shocks that are unrelated to Rule 18 could drive the results, we artificially pick the years 2010 and 2011 as the post-event period, and 2008 and 2009 as the pre-event period. We do not find a significant difference in the accounting quality between the treatment and control firms around these “pseudo-event” years. The results are shown in Table 10.<sup>44</sup>

#### 5.5 Alternative Proxies for Accounting Quality

In our tabulated analyses we employ the Kothari et al.’s (2005) accruals model to measure accounting quality. As Keung and Shih (2014) suggest, performance-adjusted accruals models may introduce systematic biases. To mitigate potential bias produced by a specific type of accruals model, in untabulated analyses we alternatively use Jones (1991) and Dechow, Sloan, and Sweeney (1995) and inferences remain intact. Finally, we employ a *model-free* proxy that has been widely used in China research – below-the-line items (e.g., Hou et al. 2015; Gul, Wu, and Yang 2013; Haw, Qi, Wu, and Wu 2005; Chen and Yuan 2004).<sup>45</sup> Again, we find consistent results and conclude that our inferences are not driven by bias related to a particular accounting-quality proxy.

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<sup>44</sup> We also use 2010 and 2011 as the pre-event period, and 2012 and 2013 as the post-event period. We do not find significant results for these pseudo-event years. Since President Xi took the office in 2012, the results suggest that the increase of accounting quality after Rule 18 cannot be attributed to a Xi’s effect.

<sup>45</sup> Following prior literature, this measure is computed as below-the-line items scaled by total sales. We also employ an industry-adjusted version of this proxy following Chen and Yuan (2004) and find consistent results.

## 6. Conclusion

In this paper, we examine the effects of politically connected directors on accounting quality and shed light on the channels of the effects. We utilize a natural experiment in China, in which more than 400 official directors were mandated to resign, effectively severing the political connections of those firms. We examine accounting quality in the pre- and post- event periods using a difference-in-differences approach combined with propensity-score matching and firm fixed effects. Our results indicate that compared to control firms, the accounting quality of firms with politically connected directors increases after those directors resign. Also, the effect of political connection on accounting quality is stronger for non-SOE firms than that for SOE firms. The results are consistent with the idea that politically connected directors negatively affect accounting quality.

We further examine two channels through which political connections affect accounting quality. We find that the impact of such connections on accounting quality is through lower financing pressure and lax regulation. Because political connections provide preferential access to financing and lax regulation, those firms face less financing pressure and less strict regulation, and therefore provide lower quality of financial information. Our paper contributes to the understanding of the effects of China's anti-corruption campaign in general and to research on the effects of political connections on accounting quality in particular.

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## APPENDIX A

### Procedure to Construct the Propensity-Score-Matched Sample

The PSM approach involves pairing treatment and comparison units that are similar in terms of their observable characteristics (Dehejia and Wahba 2002). We implement this procedure by first estimating a logit regression to model the probability of being affected by Rule 18 (i.e., firms with resigned official directors). We use all of the control variables in equation (1) as our predictors. Next, we estimate the propensity score for each firm using the predicted probabilities from the logit model. We then match each treatment firm to the control firm using nearest neighborhood technique with no replacement. The estimation result for our logit regression is as follows (with a Likelihood Ratio Chi-Squared of 47.49):

Dependent Variable = Resigned Official Directors		
VARIABLES	Coefficient	Z
SIZE	0.171	1.351
LEV	-0.593	-1.377
MB	-0.045	-0.863
PPE	0.204	0.424
SOE	0.013	0.079
AGE	0.396*	1.811
CYCLE	-3.541	-1.002
ANALYSTS	-0.018	-0.208
INSIDER	-0.009	-0.017
BOARDSIZE	0.843**	2.152
INDPRO	2.274*	1.718
ROA	-2.606	-1.342
LOSS	-0.340	-1.059
SDSALE	0.812*	1.695
GROWTH	-0.011	-0.090
RETURN	0.001	0.003
DIVIDEND	0.085	0.448
BIG4	0.024	0.083
AF	0.055	0.327
BETA	0.385	1.253
MI	-0.066*	-1.876
Constant	-9.993***	-4.194
Industry Fixed Effects	YES	
Observations	1,932	

## APPENDIX B

### Variable Definitions

Variables	Definitions
DA	The absolute value of abnormal discretionary accrual, calculated using the performance-adjusted model (Kothari et al. 2005);
OFFICIAL	Indicator variable for official director, equal to 1 if the firm has resigned official directors due to Rule 18, and 0 otherwise;
POST	Indicator variable for post-policy period, equal to 1 if it is year 2014 or 2015, and 0 otherwise;
SIZE	Firm size, calculated as the natural logarithm of firm's market capitalization at the year end;
LEV	Financial Leverage, calculated as total liabilities divided by total assets;
MB	Market-to-book ratio, calculated as the ratio of the market capitalization of equity divided by the book value of equity at the year end;
PPE	Fixed assets, calculated as Property, Plant and Equity divided by total assets;
SOE	Indicate variable for state-owned enterprise, equal to 1 if the ultimate controller is the state, and 0 otherwise;
AGE	Firm age, calculated as the natural logarithm of years that the firm has listed;
CYCLE	Operating cycle, calculated as the sum of the number of days receivables and days inventory. Days receivable is calculated as $(360 * \text{Average accounts receivables} / \text{Sales})$ , Days inventory is calculated as $(360 * \text{Average Inventory} / \text{Sales})$ . We scale the variable by 10000 for exposition;
ANALYSTS	Number of analyst following, calculated as the natural logarithm of the number of analysts following the firm;
INSIDER	Insider shareholding, calculated as shares held by managers divided by total shares outstanding;
BOARDSIZE	Board size, calculated as the natural logarithm of the number of board directors;
INDPRO	The percentage of independent directors, calculated as the number of independent directors as a percentage of total board directors;
ROA	Return on asset, calculated as net income before extraordinary items divided by the average total asset;
LOSS	Indicator variable for loss, equal to 1 if the firm report negative net income, and 0 otherwise;
SDSALE	The standard deviation of sales, calculate as the standard deviation of sales (deflated by total assets) in the previous five years. We require at least three observations to estimate the variable;
GROWTH	Growth rate, calculated as the sales in the current year divided by the sales in the last year, minus one;
RETURN	Stock return, represents the annual stock return of the firm;
DIVIDEND	Indicator variable for dividend payment, equal to 1 if the firm pays dividend, and 0 otherwise;
BIG4	Indicator variable for Big-4 auditor, equal to 1 if the firm is audited by the Big-4 auditors, and 0 otherwise;
AF	Audit fee, calculated as the natural logarithm of audit fee paid to the auditor;
BETA	Beta of the stock, obtained from the China Stock Market and Accounting Research (CSMAR) database;
MI	Marketization index for each province or provincial level region in China, achieved from Fan, Wang, and Zhu (2011).

**TABLE 1: Sample Selection**

This table describes the sample selection process. For the number of resigned directors, when a person serves as director for two firms, we count as two.

	Number of Firms	Number of Resigned Directors
All firms listed on the Main and SME Boards of Shanghai and Shenzhen A-share stock exchanges	2136	8610
Non-financial firms	2090	8337
Firms with resigned directors due to Rule18	613	819
Excluding firms with resigned directors from universities, publically funded organizations, or SOEs	298	418
Firms with resigned official directors	315	401
Excluding firms with missing variables or no PSM control firms	23	24
Treated firms in our sample	292	377

**TABLE 2: Descriptive Statistics**

**Panel A: Comparison between treated firms and control firms**

VARIABLES	Treatment Group		Non-Treatment Group (No-PSM)		Treatment-Non-Treatment (No PSM)	Control Group (With PSM)		Treatment-Control (With PSM)
	N	mean	N	mean	<i>Difference</i>	N	mean	<i>Difference</i>
DA	292	0.055	1,640	0.054	<b>0.001</b>	292	0.049	<b>0.006</b>
SIZE	292	22.923	1,640	22.690	<b>0.233***</b>	292	22.916	<b>0.007</b>
LEV	292	0.492	1,640	0.477	<b>0.015</b>	292	0.479	<b>0.013</b>
MB	292	2.102	1,640	2.328	<b>-0.226*</b>	292	2.172	<b>-0.070</b>
PPE	292	0.257	1,640	0.242	<b>0.015</b>	292	0.237	<b>0.020</b>
SOE	292	0.548	1,640	0.474	<b>0.074**</b>	292	0.562	<b>-0.014</b>
AGE	292	2.786	1,640	2.742	<b>0.044*</b>	292	2.771	<b>0.015</b>
CYCLE	292	0.021	1,640	0.023	<b>-0.002</b>	292	0.021	<b>0.000</b>
ANALYSTS	292	2.076	1,640	1.986	<b>0.090</b>	292	2.082	<b>-0.006</b>
INSIDER	292	0.066	1,640	0.082	<b>-0.016</b>	292	0.061	<b>0.005</b>
BOARDSIZE	292	2.201	1,640	2.164	<b>0.037***</b>	292	2.208	<b>-0.007</b>
INDPRO	292	0.375	1,640	0.371	<b>0.004</b>	292	0.376	<b>-0.001</b>
ROA	292	0.035	1,640	0.037	<b>-0.002</b>	292	0.040	<b>-0.005</b>
LOSS	292	0.086	1,640	0.103	<b>-0.017</b>	292	0.062	<b>0.024</b>
SDSALE	292	0.143	1,640	0.131	<b>0.012</b>	292	0.136	<b>0.007</b>
GROWTH	292	0.176	1,640	0.179	<b>-0.003</b>	292	0.150	<b>0.026</b>
RETURN	292	0.186	1,640	0.215	<b>-0.029</b>	292	0.199	<b>-0.013</b>
DIVIDEND	292	0.733	1,640	0.704	<b>0.029</b>	292	0.767	<b>-0.034</b>
BIG4	292	0.086	1,640	0.061	<b>0.025</b>	292	0.106	<b>-0.020</b>
AF	292	13.832	1,640	13.687	<b>0.145***</b>	292	13.871	<b>-0.039</b>
BETA	292	1.046	1,640	1.023	<b>0.023</b>	292	1.041	<b>0.005</b>
MI	292	8.877	1,640	9.148	<b>-0.271**</b>	292	8.939	<b>-0.062</b>

**TABLE 2: Descriptive Statistics****Panel B: Treatment firms with propensity-score matched firms as control samples**

VARIABLES	N	Mean	SD	P25	P50	P75
DA	2,204	0.051	0.051	0.017	0.037	0.067
SIZE	2,204	23.118	1.149	22.292	22.938	23.795
LEV	2,204	0.484	0.207	0.324	0.495	0.647
MB	2,204	2.486	2.053	1.359	1.844	2.778
PPE	2,204	0.247	0.179	0.109	0.201	0.359
SOE	2,204	0.559	0.497	0	1	1
AGE	2,204	2.808	0.336	2.639	2.833	3.045
CYCLE	2,204	0.023	0.030	0.007	0.013	0.024
ANALYSTS	2,204	2.074	1.122	1.099	2.303	2.996
INSIDER	2,204	0.059	0.140	0	0	0.009
BOARDSIZE	2,204	2.192	0.207	2.079	2.197	2.303
INDPRO	2,204	0.375	0.055	0.333	0.364	0.400
ROA	2,204	0.035	0.052	0.011	0.028	0.057
LOSS	2,204	0.104	0.305	0	0	0
SDSALE	2,204	0.136	0.143	0.053	0.091	0.161
GROWTH	2,204	0.119	0.472	-0.068	0.054	0.192
RETURN	2,204	0.316	0.491	-0.030	0.217	0.540
DIVIDEND	2,204	0.578	0.494	0	1	1
BIG4	2,204	0.096	0.294	0	0	0
AF	2,204	13.892	0.777	13.353	13.710	14.221
BETA	2,204	1.066	0.245	0.908	1.083	1.233
MI	2,204	8.903	1.989	7.390	8.930	10.420

**TABLE 2: Descriptive Statistics**

**Panel C: Resigned Director Backgrounds**

	Number	Percentage
In charge of related industry	161	40.15%
National level rank	146	36.41%
Company registered within the jurisdiction of the official	348	86.78%
Male directors	356	88.78%
Retired	81	20.20%
Total	401	100%

**Panel D: Successor Director Backgrounds**

	Number	Percentage
From same industry	120	30.08%
Accounting, finance or tax	215	53.88%
Banking	24	6.02%
Law	60	15.04%
At least belong to one of these categories	363	90.98%
Male directors	332	83.21%
Retired	18	4.51%
Total	399	100%

**TABLE 3: Political Connections and Discretionary Accruals**

This table reports our main results of the impact of political connections on absolute discretionary accruals. The model is as follows:

$$|DA|_{it} = \beta_0 + \beta_1 OFFICIAL_i \times POST_{it} + \beta_2 POST_{it} + \beta_3 OFFICIAL_i + \beta_4 SIZE_{it} + \beta_5 LEV_{it} \\ + \beta_6 MB_{it} + \beta_7 PPE_{it} + \beta_8 SOE_{it} + \beta_9 AGE_{it} + \beta_{10} CYCLE_{it} + \beta_{11} ANALYSTS_{it} \\ + \beta_{12} INSIDER_{it} + \beta_{13} BOARDSIZE + \beta_{14} INDPRO_{it} + \beta_{15} ROA_{it} + \beta_{16} LOSS_{it} \\ + \beta_{17} SDSALE_{it} + \beta_{18} GROWTH_{it} + \beta_{19} RETURN_{it} + \beta_{20} DIVIDEND_{it} \\ + \beta_{21} BIG4_{it} + \beta_{22} AF_{it} + \beta_{23} BETA_{it} + \beta_{24} GEO_{it} + Fixed\ Effects + \varepsilon_{it}$$

The dependent variable is the absolute value of discretionary accruals estimated from Kothari et al. (2005). Model (1) and (2) present full sample regressions, model (3) and (4) present PSM regressions, Model (5) and (6) present PSM regressions for non-SOE firms and SOE firms respectively. The whole PSM sample includes 2204 observations from 584 firms, including treatment firms and control firms, in the pre and post periods. Please see Appendix B for variable definitions. The p-values are based on standard errors clustered by firm. \*, \*\*, \*\*\* indicate statistical significance at the 10 percent, 5 percent, and 1 percent levels, respectively.

VARIABLES	(1) Full Sample	(2) Full Sample	(3) Full PSM Sample	(4) Full PSM Sample	(5) Non-SOE	(6) SOE
<i>OFFICIAL</i> × <i>POST</i>	<b>-0.0135***</b> (-4.96)	<b>-0.0130***</b> (-4.51)	<b>-0.0198***</b> (-5.62)	<b>-0.0199***</b> (-5.61)	<b>-0.0297***</b> (-5.08)	<b>-0.0112***</b> (-2.63)
					<i>(Diff: Z value=2.55**)</i>	
<i>POST</i>	0.0017 (0.75)	0.0018 (0.53)	0.0027 (0.62)	0.0023 (0.27)	0.0221* (1.70)	-0.0129 (-1.13)
<i>OFFICIAL</i>	0.0058** (2.42)		0.0086*** (2.98)			
<i>SIZE</i>	-0.0014 (-1.13)	0.0114*** (2.81)	0.0004 (0.21)	0.0139** (1.96)	0.0063 (0.69)	0.0208* (1.86)
<i>LEV</i>	0.0328*** (7.27)	0.0498*** (4.51)	0.0252*** (3.10)	0.0422** (1.98)	0.0601** (2.20)	0.0118 (0.38)
<i>MB</i>	0.0007* (1.79)	-0.0010 (-1.23)	0.0006 (0.72)	-0.0005 (-0.35)	0.0001 (0.06)	-0.0043 (-1.55)
<i>PPE</i>	-0.0240*** (-4.92)	-0.0469*** (-3.59)	-0.0219** (-2.52)	-0.0568** (-2.27)	-0.1007*** (-2.72)	-0.0137 (-0.39)
<i>SOE</i>	-0.0037** (-2.22)	0.0103 (1.18)	-0.0036 (-1.08)	-0.0093 (-0.92)		
<i>AGE</i>	-0.0006 (-0.29)	-0.0283 (-1.48)	0.0038 (0.98)	-0.0312 (-0.94)	-0.0522 (-1.12)	-0.0193 (-0.44)
<i>CYCLE</i>	0.0648* (1.81)	0.0305 (0.35)	0.1703** (2.05)	0.1407 (0.78)	0.0028 (0.02)	0.3818 (1.27)
<i>ANALYSTS</i>	-0.0027*** (-3.28)	-0.0019 (-1.19)	-0.0016 (-1.11)	-0.0014 (-0.45)	-0.0017 (-0.35)	-0.0040 (-1.05)
<i>INSIDER</i>	-0.0041	-0.0126	0.0041	0.0335	0.0507*	-0.4533***



	(-0.89)	(-0.81)	(0.38)	(1.17)	(1.84)	(-4.40)
<i>BOARDSIZE</i>	-0.0033	-0.0043	-0.0010	-0.0050	0.0157	-0.0234
	(-0.83)	(-0.49)	(-0.16)	(-0.33)	(0.64)	(-1.22)
<i>INDPRO</i>	0.0118	0.0279	0.0028	0.0308	0.1450**	-0.0162
	(0.85)	(1.18)	(0.12)	(0.90)	(2.50)	(-0.41)
<i>ROA</i>	0.1317***	0.1606***	0.1194***	0.0552	0.1424**	0.0201
	(6.22)	(4.75)	(3.24)	(1.08)	(2.20)	(0.23)
<i>LOSS</i>	0.0129***	0.0148***	0.0161***	0.0093*	0.0251***	0.0028
	(5.18)	(4.72)	(3.43)	(1.78)	(2.66)	(0.43)
<i>SDSALE</i>	0.0489***	0.0178	0.0527***	0.0127	0.0275	-0.0073
	(7.45)	(1.42)	(5.06)	(0.69)	(1.18)	(-0.24)
<i>GROWTH</i>	0.0147***	0.0107***	0.0184***	0.0116**	0.0052	0.0195***
	(7.44)	(4.52)	(4.29)	(2.23)	(0.74)	(2.71)
<i>RETURN</i>	0.0016	-0.0012	0.0040	0.0012	-0.0002	0.0048
	(1.03)	(-0.68)	(1.42)	(0.40)	(-0.05)	(1.24)
<i>DIVIDEND</i>	-0.0027	0.0008	-0.0081**	-0.0050	-0.0074	-0.0062
	(-1.52)	(0.40)	(-2.36)	(-1.24)	(-1.20)	(-1.10)
<i>BIG4</i>	0.0009	0.0010	0.0017	0.0031	0.0348**	-0.0152
	(0.31)	(0.09)	(0.40)	(0.19)	(2.41)	(-0.57)
<i>AF</i>	-0.0035**	-0.0007	-0.0056**	-0.0045	-0.0022	-0.0040
	(-2.22)	(-0.19)	(-2.13)	(-0.79)	(-0.25)	(-0.60)
<i>BETA</i>	-0.0025	-0.0025	-0.0052	0.0019	0.0113	-0.0073
	(-0.92)	(-0.74)	(-1.06)	(0.33)	(1.31)	(-0.93)
<i>MI</i>	-0.0001		-0.0007			
	(-0.36)		(-1.00)			
Constant	0.1276***	-0.1421	0.1129***	-0.1260	-0.0359	-0.2405
	(5.26)	(-1.37)	(2.77)	(-0.70)	(-0.14)	(-0.91)
Year FE	YES	YES	YES	YES	YES	YES
Industry FE	YES	NO	YES	NO	NO	NO
Firm FE	NO	YES	NO	YES	YES	YES
Observations	7,492	7,492	2,204	2,204	973	1,231
Adj. R <sup>2</sup>	0.131	0.257	0.167	0.293	0.276	0.316

**TABLE 4: Lower Financing-Pressure Channel**

This table reports the results of lower financing pressure channel analysis. In Panel A, the sample firms are partitioned into sub-samples based on the sample median values of the cost of debt (COD) in the year before Rule 18. In Panel B, the sample firms are partitioned into sub-samples based on the sample median values of foreign capital importation degree compiled by Fan, Wang, and Zhu (2011). The dependent variable is the absolute value of discretionary accruals estimated from the performance-adjusted model (Kothari et al., 2005). Please see Appendix B for variable definitions. The p-values are based on standard errors clustered by firm. \*, \*\*, \*\*\* indicate statistical significance at the 10 percent, 5 percent, and 1 percent levels, respectively.

**Panel A: Conditional on the Cost of Debt**

VARIABLES	High COD	Low COD	High COD	Low COD
<i>OFFICIAL</i> × <i>POST</i>	<b>-0.0134**</b> (-2.55)	<b>-0.0261***</b> (-5.07)	<b>-0.0134***</b> (-2.60)	<b>-0.0277***</b> (-5.40)
	(Diff: Z value=1.72*)		(Diff: Z value=1.97**)	
<i>POST</i>	0.0062 (0.99)	0.0019 (0.34)	0.0210* (1.70)	-0.0115 (-0.80)
<i>OFFICIAL</i>	0.0104** (2.40)	0.0057 (1.31)		
Other Controls	Included	Included	Included	Included
Year FE	YES	YES	YES	YES
Industry FE	YES	YES	NO	NO
Firm FE	NO	NO	YES	YES
Observations	977	993	977	993
Adj. R <sup>2</sup>	0.186	0.242	0.266	0.318

**Panel B: Conditional on Foreign Capital Importation**

VARIABLES	High FCI	Low FCI	High FCI	Low FCI
<i>OFFICIAL</i> × <i>POST</i>	<b>-0.0282***</b> (-5.14)	<b>-0.0115**</b> (-2.51)	<b>-0.0294***</b> (-5.26)	<b>-0.0089*</b> (-1.89)
	(Diff: Z value=2.35**)		(Diff: Z value=2.80***)	
<i>POST</i>	0.0056 (0.78)	-0.0012 (-0.21)	0.0129 (0.98)	-0.0086 (-0.77)
<i>OFFICIAL</i>	0.0116*** (2.61)	0.0074* (1.88)		
Other Controls	Included	Included	Included	Included
Year FE	YES	YES	YES	YES
Industry FE	YES	YES	NO	NO
Firm FE	NO	NO	YES	YES
Observations	1,031	1,173	1,031	1,173
Adj. R <sup>2</sup>	0.206	0.177	0.277	0.315

**TABLE 5: Lax-Regulation Channel**

This table reports the results of the lax regulation channel analysis. In Panel A, the sample firms are partitioned into sub-samples based on the sample median values of judicial efficiency ranking developed by Word Bank in *Doing Business in China Report*. In Panel B, the sample firms are partitioned into sub-samples based on the sample median values of firm size in the year before Rule 18. The dependent variable is the absolute value of discretionary accruals estimated from the performance-adjusted model (Kothari et al. 2005). Please see Appendix B for variable definitions. The p-values are based on standard errors clustered by firm. \*, \*\*, \*\*\* indicate statistical significance at the 10 percent, 5 percent, and 1 percent levels, respectively.

**Panel A: Conditional on Judiciary Efficiency**

VARIABLES	High Judiciary Efficiency	low Judiciary Efficiency	High Judiciary Efficiency	low Judiciary Efficiency
<b><i>OFFICIAL</i>×<i>POST</i></b>	<b>-0.0329***</b> (-5.15)	<b>-0.0123***</b> (-2.87)	<b>-0.0328***</b> (-5.12)	<b>-0.0108**</b> (-2.50)
	<i>(Diff: Z value=2.67***)</i>		<i>(Diff: Z value=2.85***)</i>	
<i>POST</i>	0.0134 (1.51)	-0.0002 (-0.04)	0.0241 (1.64)	-0.0146 (-1.36)
<i>OFFICIAL</i>	0.0118** (2.58)	0.0059 (1.57)		
Other Controls	Included	Included	Included	Included
Year FE	YES	YES	YES	YES
Industry FE	YES	YES	NO	NO
Firm FE	NO	NO	YES	YES
Observations	777	1,427	777	1,427
Adj. R <sup>2</sup>	0.174	0.191	0.240	0.326

**Panel B: Conditional on the Cost of Lawsuits**

VARIABLES	BIG	SMALL	BIG	SMALL
<b><i>OFFICIAL</i>×<i>POST</i></b>	<b>-0.0131***</b> (-3.23)	<b>-0.0308***</b> (-4.88)	<b>-0.0122***</b> (-3.11)	<b>-0.0327***</b> (-5.24)
	<i>(Diff: Z value=2.36**)</i>		<i>(Diff: Z value=2.77***)</i>	
<i>POST</i>	-0.0052 (-1.28)		0.0028 (0.26)	0.0066 (0.46)
<i>OFFICIAL</i>	0.0081** (2.07)	0.0104** (2.35)		
Other Controls	Included	Included	Included	Included
Year FE	YES	YES	YES	YES
Industry FE	YES	YES	NO	NO
Firm FE	NO	NO	YES	YES
Observations	1,288	916	1,288	916
Adj. R <sup>2</sup>	0.192	0.201	0.292	0.323

**TABLE 6: Controls for Personal Characteristics of Resigned and Incoming Directors**

This table reports results of regressions that are similar to Column 3 of Table 3 but with controls for personal characteristics of resigned and incoming directors added. Please see Appendix B for variable definitions. The p-values are based on standard errors clustered by firm. \*, \*\*, \*\*\* indicate statistical significance at the 10 percent, 5 percent, and 1 percent levels, respectively.

VARIABLES	Resigned	Incoming	Resigned and Incoming
<i>OFFICIAL</i> × <i>POST</i>	<b>-0.0207***</b> (-5.61)	<b>-0.0206***</b> (-5.59)	<b>-0.0206***</b> (-5.59)
<i>INDUM</i>	0.0020 (0.50)		0.0025 (0.63)
<i>RANK</i>	0.0029 (0.77)		0.0032 (0.85)
<i>INREGION</i>	-0.0095 (-1.45)		-0.0100 (-1.52)
<i>MALE</i>	-0.0018 (-0.32)		-0.0017 (-0.32)
<i>RETIRED</i>	0.0008 (0.19)		0.0015 (0.35)
<i>INDUM_EXPT</i>		-0.0043 (-1.17)	-0.0051 (-1.33)
<i>ACC_EXPT</i>		0.0038 (1.08)	0.0043 (1.24)
<i>BANK</i>		-0.0060 (-1.19)	-0.0047 (-0.90)
<i>LAWYER</i>		0.0020 (0.44)	0.0027 (0.60)
<i>POST</i>	0.0034 (0.74)	0.0028 (0.62)	0.0032 (0.71)
<i>OFFICIAL</i>	0.0168** (2.17)	0.0087** (2.34)	0.0160** (2.00)
Other Controls	YES	YES	YES
Year & Industry FE	YES	YES	YES
Observations	2,204	2,204	2,204
Adj. R <sup>2</sup>	0.177	0.176	0.178

**TABLE 7: The Effects of Non-Official Directors' Resignations**

In this table, we use firms with resigned directors from universities, publicly-funded organizations or SOEs as treated group. We define *NOFFICIAL* as an indicator variable which equals to 1 if the firm has resigned director from non-government organizations and 0 otherwise. The dependent variable is the absolute value of discretionary accruals estimated from the performance-adjusted model (Kothari et al. 2005). Please see Appendix B for variable definitions. The p-values are based on standard errors clustered by firm. \*, \*\*, \*\*\* indicate significance at the 10 percent, 5 percent, and 1 percent levels, respectively.

VARIABLES	(1)	(2)
<i>NOFFICIAL</i> × <i>POST</i>	<b>0.0028</b> (0.65)	<b>0.0029</b> (0.69)
<i>POST</i>	0.0049 (1.35)	0.0025 (0.24)
<i>NOFFICIAL</i>	-0.0022 (-0.68)	
Other Controls	Included	Included
Year FE	YES	YES
Industry FE	YES	NO
Firm FE	NO	YES
Observations	2,000	2,000
Adj. R <sup>2</sup>	0.148	0.270

**TABLE 8: Potential Confounding Events -- Eight-Point Regulation**

This table presents regression results after controlling for the potential confounding effects of the Eight-Point Regulation. In Model (1) and (2), we add Entertainment and Traveling Costs (ETC) as a control variable. In Model (3) and (4), we exclude observations of the year 2012 from our sample to assure that our sample is after the Eight-point Regulation. The dependent variable is the absolute value of discretionary accruals estimated from the performance-adjusted model (Kothari et al. 2005). Please see Appendix B for variable definitions. The p-values are based on standard errors clustered by firm. \*, \*\*, \*\*\* indicate significance at the 10 percent, 5 percent, and 1 percent levels, respectively.

VARIABLES	(1)	(2)	(3)	(4)
<i>OFFICIAL</i> × <i>POST</i>	<b>-0.0206***</b> (-5.61)	<b>-0.0205***</b> (-5.54)	<b>-0.0173***</b> (-3.96)	<b>-0.0179***</b> (-4.19)
<i>ETC</i>	-0.0326 (-0.79)	-0.0817 (-0.81)		
<i>POST</i>	0.0024 (0.53)	0.0056 (0.61)	0.0002 (0.04)	-0.0087 (-0.94)
<i>OFFICIAL</i>	0.0092*** (3.04)		0.0059 (1.47)	
Other Controls	Included	Included	Included	Included
Year FE	YES	YES	YES	YES
Industry FE	YES	NO	YES	NO
Firm FE	NO	YES	NO	YES
Observations	2,202	2,202	1,663	1,663
Adj. R <sup>2</sup>	0.176	0.298	0.197	0.347

**TABLE 9: Potential Confounding Events—Market Liberalization**

This table reports the regression results controlling the confounding effect of market liberalization. In model (1) and (2), we include an indicator variable equal to one if the stocks are opened to direct trade by Hong Kong and international investors after the liberalization reform. In model (3) and (4) we exclude observations in the year 2015 from our sample to assure that our sample is prior to the Market Liberalization. The dependent variable is the absolute value of discretionary accruals estimated from the performance-adjusted model (Kothari et al. 2005). Please see Appendix B for variable definitions. The p-values are based on standard errors clustered by firm. \*, \*\*, \*\*\* indicate significance at the 10 percent, 5 percent, and 1 percent levels, respectively.

VARIABLES	(1)	(2)	(3)	(4)
<b><i>OFFICIAL</i>×<i>POST</i></b>	<b>-0.0208***</b>	<b>-0.0206***</b>	<b>-0.0171***</b>	<b>-0.0155***</b>
	<b>(-5.60)</b>	<b>(-5.51)</b>	<b>(-3.97)</b>	<b>(-3.73)</b>
<i>Market Liberalization</i>	-0.0039	-0.0001		
	(-0.76)	(-0.01)		
<i>POST</i>	0.0044	0.0055		
	(0.85)	(0.59)		
<i>OFFICIAL</i>	0.0091***		0.0092***	
	(3.02)		(3.05)	
Other Controls	Included	Included	Included	Included
Year FE	YES	YES	YES	YES
Industry FE	YES	NO	YES	NO
Firm FE	NO	YES	NO	YES
Observations	2,204	2,204	1,676	1,676
Adj. R <sup>2</sup>	0.175	0.296	0.165	0.312

**TABLE 10: Placebo Analysis**

This table presents the results of a placebo test. To run a pseudo test, we artificially pick 2010 and 2011 as post event year, while 2008 and 2009 as pre-event year. The dependent variable is the absolute value of discretionary accruals estimated from the performance-adjusted model (Kothari et al. 2005). Please see Appendix B for variable definitions. The p-values are based on standard errors clustered by firm. \*, \*\*, \*\*\* indicate significance at the 10 percent, 5 percent, and 1 percent levels, respectively.

VARIABLES	(1)	(2)
<i>OFFICIAL</i> × <i>POST</i>	<b>-0.0023</b> (-0.40)	<b>0.0004</b> (0.08)
<i>POST</i>	-0.0047 (-0.96)	0.0070 (0.64)
<i>OFFICIAL</i>	0.0035 (0.83)	
Other Controls	Included	Included
Year FE	YES	YES
Industry FE	YES	NO
Firm FE	NO	YES
Observations	1,577	1,577
Adj. R <sup>2</sup>	0.160	0.220