Discretionary Administrative Power and Conflicts of Interest in China's IPO Approvals

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Abstract

China's IPO approval process co-opts audit firm representatives into the regulatory decision body, which creates conflict of interest and potential channels for corruption. We show evidence that co-opted auditors (i) do *not* differ in their auditing practice of listed firms from other auditors, but (ii) attract more borderline IPO clients that do not fully comply with the listing requirements, contributing to higher audit revenue growth, (iii) increase the chance of IPO approval for their borderline candidates, which (iv) afterwards underperform regular IPO stocks by 39% in terms of their average two-year buy and hold return. Moreover, (v) these borderline IPO firms show poorer profitability than matched firms, suggesting potential misrepresentation of firm prospects at the IPO stage.

JEL codes: G14, G15, G18, G38, H11, P27
Keywords: regulatory failure, corruption of professional standards, IPO underperformance

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1 Introduction

During the first two decades of the 21st century, the Chinese stock market added a total of 4,154 new companies with a combined market value of RMB $80 trillion ($12 trillion) at the end of 2022, thus far outstripping equity market growth in the rest of the world. Yet, there is a darker side to this rapid market development, which involves the administrative process through which companies are vetted and approved for listing (FT, November 15, 2015). China's IPO process is unique in that all candidate firms require the discretionary approval of a special committee called the *Issuance Examination Committee* (IEC), which undertakes a material evaluation of a company's profit sustainability.[1] A highly problematic feature of the approval process is the selection of senior partners from private audit firms into the IEC as the decision body, which creates a conflict of interest if the audit firm simultaneously works for corporate clients keen on an IPO approval.[2]

While the introduction of the IEC to scrutinize IPO firms aims to screen firms in terms of the sustainability of their profits and thereby protect less informed market participants, it also provides supervisory officials with discretionary power to manipulate the listing process. As pointed out by Wu Jinglian, a famous Chinese economist, the frequent interference of administrative power in China's business world is conducive to market distortions and corruption, and even more so if the state seeks cooperation with the private sector (Naughton, 2013, Chapter 6). China's management of the IPO approval process is a particularly insightful example of the negative consequences of discretionary administrative power that is insufficiently checked by independent judiciary review and operates outside a system of modern administrative law.[3] The economic consequences of such unchecked discretionary administrative power are generally difficult to identify due to measurement problems concerning the economic costs of corrupted administrative decisions and the lack of a counterfactual. The conflicted IPO process presents an exceptional setting, where both the nature of the conflict of interest can be precisely de-

[1] The Issuance Examination Committee is also referred to as Public Offering Review Committee or Regulatory Approval Committee.

[2] The specific commissioner is barred from working on IPO related activity according to CSRC regulation (see "Measures of the China Security Regulatory Commission for the Issuance Examination Committee"issued by the CSRC in 2006, and amended in 2009, 2016, and 2017). Yet, this provision is unlikely to eliminate the conflict of interest given the commissioner's long-term relationship with his audit firm.

[3] For example, the British common law tradition does not allow for private parties to participate in administrative committee decisions and would invalided all decisions taken in the manner of the IEC (see Willian Wade, and C.F. Forsyth, 2014).

termined and the long-run consequences of each IPO decision can be traced based on market values of the respective company. Therefore, a study of the Chinese IPO process holds more general economic significance regarding the developmental impasse in China's economy due to discretionary administrative power.

The main goal of this paper is to show the various consequences of conflict of interest characterizing audit firms and the IPO process. First, we analyze which audit firms were selected into the IEC, how their professional standards differed from audit firms without IEC representation, and how selection influenced their relative revenue growth. Second, we focus on the IPO firms, their selection of different IPO auditors with and without representation in the IEC, and how their choice influences their IPO approval rates. Lastly, we measure the post-IPO performance of conflicted and non-conflicted IPOs in terms of their valuation over a two-year period following the IPO.

To undertake such a comprehensive analysis, we use data on 109 different auditing firms, their representation in the IEC committees of China's main board and the ChiNext board, and their performance in the audit market. These data are complemented by accounting data on all 2,965 IPO candidates, the respective IPO approval decision, and the post-IPO performance for corporations approved for public listing. Our analysis singles out all "borderline IPO candidates" that do not fulfill all the formal requirements for a listing, but seek to further their IPO prospects by selecting an auditing firm connected to the IEC committee. The main economic victims of discretionary administrative power are (uninitiated) investors in IPO firms for which we can measure the relative value loss of their investment.

We highlight the following five main findings. First, we find that auditor "toughness" measured using already listed client companies, does not differ across IEC selected and non-selected auditors at either the audit firm level or individual commissioner level if we control for client characteristics that vary across auditors. There appears to be no negative selection bias concerning the intrinsic conscientiousness or professionalism of selected IEC commissioners with auditing background.

Second, audit firms with representation on the IEC attract more IPO clients that do not fully comply with the formal listing requirements, and thus achieve much higher audit revenue growth. The relative client growth by auditors with IEC representation is strongest in the event year in which appointment into IEC occurs. This means that conflicted auditors exploit their

political advantage economically, and become more dominant in the profession. For example, audit firms with IEC representation in at least one year grew their revenue by an average 19% per year over the period 2003-2019 compared to only 9% for those never selected for the IEC. This implies enormous economic benefits to political connections.[4]

Third, the representation of an auditor increases the chance of IPO approval after controlling for the characteristics of the IPO candidates. For example, borderline IPO candidates not in full compliance with the listing requirements increase their chances of an IPO approval by 7.2 percentage points relative to the unconditional IPO rejection rate of 19%. The effect of having a politically connected auditor on a firm's IPO approval chances is therefore economically large.

Fourth, borderline IPO candidates with conflicted auditors show a large underperformance relative to regular IPO stocks that reaches -39% for the two-year buy and hold return.[5] Moreover, we find that the negative performance effect for these non-compliant firms with IEC-connected auditors is particularly dominant in the upper tail of the post-IPO performance distribution around the 90% performance quantile. This means that the approved borderline IPO candidates are typically not a negative outlier in terms of post-IPO performance, but almost never an IPO firm that performs well.

Fifth, our analysis reveals that borderline IPO candidates with conflicted auditors experience a notable average decrease in accounting profitability by 1.2 percentage points of return on assets at the upper 90% quantile of the performance distribution, when compared with the benchmark firms. In other words: the infrequency of a positive stock return performance among borderline IPO candidates is matched by a corresponding infrequency of profitability improvements at the two-year horizon. This is consistent with more pre-IPO earning manipulations among borderline IPO candidates. At the same time, having connected auditors does not appear to help the very worst non-compliant firms to enter the public market as we find no evidence of long-run stock market or accounting underperformance at the low end of the performance distribution.

To rationalize the concentration of the negative performance effects in the upper tail or the respective distributions, we argue that conflicted decision-makers seek to limit the adverse

[4] These annual growth rates are the geometric average of the growth rates depicted in Figure 3.

[5] We exclude the first two weeks of stock market trading because of evidence for initial IPO underpricing in the Chinese market, which dissipates in the first two weeks after the IPO. However, if we measure the buy and hold return after the second day of listing, the respective first-year stock underperformance is even larger at -32%.

consequences of their regulatory advocacy for the sake of their reputation. Particularly large negative post-IPO performance may attract public or political scrutiny, which compromises the audit firm's reputation. Previous research finds that damage to audit firm's reputation will trigger a negative stock return for the firms they audited (Weber, Willenborg and Zhang, 2008), lead to a lower chance of IPO approval for its client (Yuan *et al.*, 2019), and cause client defection (Skinner and Srinivasan, 2012). Regulatory advocacy is, therefore, likely to be selective and will focus on borderline firms that do not exceed the lower tail risk of other listed companies in terms of the observable post-IPO stock returns or accounting profitability. This endogeneity in regulatory advocacy implies that the adverse performance effects of conflicts of interest are more detectable within the higher performance quantiles than in the lower tails. Therefore, some of our analyses rely on quantile regressions to isolate the effects of selective advocacy by conflicted decision-makers.

China's equity market is characterized by an extremely low average equity market return in the last 30 years against the background of impressive overall economic development. Dimson *et al.* (2023) rank China's real equity market premium as the second lowest (after Argentina) among all emerging markets. Allen, Qian, Shan, and Zhu (2023) provide a detailed analysis and comparison to stock returns for Chinese firms listed outside mainland China. We note that the initial intent of a merit-based firm selection for listings promoted by the China Security Regulatory Commission (CSRC) was to boost equity returns and reduce investment risk for retail investors. With hindsight, this policy appears to have performed poorly against a western model where regulatory authorities focus on the adequacy and transparency of the information provided by the issuer. Our analysis suggests that the conflicts of interest in China's IPO selection and approval process directly contributed approximately -0.6% annually to the disappointing investment returns of China's stock market in the last 20 years. However, indirect effects stemming from the loss of investor confidence in market integrity could account for a larger effect that is difficult to quantify.

Our analysis of the Chinese IPO process can also be linked to broader questions about the performance of Chinese state institutions that allow for considerable discretionary administrative power and often confound private and public interests. As the conflict of interest in the case of IEC membership was easy to discern, it is natural to ask why the Chinese security regulator was nevertheless seeking close collaboration with selected representatives of the private

auditing industry? First, a frequently expressed objective of the market regulator was investor protection. Here, the appointment of accounting professionals could improve the information available to the IEC. Granting insider privileges to a selected number of audit firms was then a reward for information, network benefits, and possibly other rents the market supervisor was seeking. Second, state bureaucracy in China operates in a more unstable environment than its western counterpart due a lack of administrative law that sets clear boundaries for administrative behavior. The appointment of senior private auditors to the IEC creates a network of valuable relationships that can help the market supervisor to obtain critical information (also on adversaries), reinforce its own power, and better fulfill any political mission.

While discretionary power and outreach to the auditing profession could help the China Securities Regulatory Commission (CSRC) to comply with any potential political mission as well as to accommodate pressure from powerful corporate interest, such organizational features engender considerable costs in terms of social capital. First, it prevents Chinese supervisory agencies from attaining a high level of professionalism embedded in administrative law.[6] Instead, the agency and its employees become tolerant of conflicts of interest and susceptible to corruption. For example, various corruption cases involve members of the IEC committee (Huang *et al.*, 2021), namely auditors such as Xiaobo Sun and Jianmin Han prosecuted in 2017, and CSRC officials such as Jian Cao and Yongfeng Lin prosecuted in 2021 and 2022, respectively. Second, administrative outreach like the participation of auditing firm members in the IEC spreads conflict of interest to professional organizations and society at large. This tends to corrupt professional and ethical standards and erodes trust in (still tolerated) civil society institutions. Paradoxically, investor trust-the very objective of the IPO vetting process-is undermined by the means of its implementation.

Auditors are arguably a cornerstone of external validation of firm accounts and their ethical standards are crucial to the information diffusion of public markets. Major accounting scandals like Worldcom and Enron highlighted the fragility of such standards even in developed countries, and led to the creation of the Public Company Accounting Oversight Board (PCAOB) under the Sarbanes-Oxley Act in 2002. However, critical parts of the inspection report by the PCAOB are (by statute) kept secret, which limits the effectiveness of auditor supervision. Some

[6] According to the sociologist Max Weber, modern bureaucratic organizations are characterized by six features, namely hierarchy of authority, meritocratic promotion, clear division of labor, strict rules and proceedures, and impersonal relationships. The latter two principles may not consistantly apply to the Chinese bureaucracy.

academic research points to significant positive valuation effects for larger and less compliant firms (Chhaochharia, V., and Y. Grinstein, 2007) as well as less uncertainty in IPO pricing (Johnson, J., and J. Madura, 2009) after the audit reform. Yet, financial misrepresentation that is potentially sanctionable by regulators remains widespread and appears to concern 22% of Compustat-listed firms (Abdullah *et al.*, 2023). This suggests that issues of audit integrity and quality are not problems specific to China.

While some correlation evidence in this paper has inevitably alternative interpretations, we argue that the combined evidence provides a coherent and consistent overall picture of the agency conflicts in China's IPO process. We also note that the IPO process was reformed after 2019 toward a more market-oriented system, which suggests that it no longer complies with the anticorruption aspiration of the current political leadership. A revised Securities Law intends to abolish the previous listing approval system with the criterion of sustained profitability and shift the emphasis toward comprehensive and truthful information disclosure (Lennox and Wu, 2022; China Briefing, 2023). However, the fundamental control by regulatory authorities has not been entirely relinquished, validating the relevance and significance of our research in the current context.

2 Related Literature

From its inception, the IPO examination process in China has been the subject of criticism, primarily due to the perceived ambiguity of its standards. As reported by the investigative media platform Caixin (Caixin, 2013), the committee's primary evaluation criterion is the sustainability of firm profits. The latter are hard to forecast so this criterion allows for considerable discretion. Auditors' specialized professional knowledge implies that they could exercise considerable influence upon the decision-making process in the IEC.

An older economic literature on the microeconomics of public administration has highlighted the combination of administrative discretion and large economic stakes of regulator decision as conducive to corruption (Becker and Stigler, 1974). The Chinese IPO approval process fulfills both criteria and therefore presents a particularly pertinent case study. Some aspects of our analysis is found in previous work. Prior work by Yang (2013) already suggests that IPO approval chances increase if there is a link between the audit firm and the members of the IEC.

He argues that such links are particularly consequential for smaller audit firms for which countervailing reputational concerns are less pertinent. Furthermore, IEC connected audit firms appear to secure substantially higher fees from IPO applicants and command a greater share of the IPO market. Liu *et al.* (2022) confirm the positive impact of IEC connections on audit firms' market share and the IPO approval rates of their clients. Consistent with our selective advocacy hypothesis, they aruge that IEC-connected audit firms strategically avoid clients of poor observable quality to mitigate reputational and legal risks. Unlike our research, they do not find statistically significant differences in post-IPO performance because their analysis does not condition on quality differences within the group of connected firm, i.e. the non-compliant firm group. Our analysis shows that non-compliant firms hiring connected auditors exhibit drastically worse post-IPO performance than compliant firms. Moreover, such underperformance is concentrated in the higher performance quantiles in line with the selective advocacy hypothesis. Brockman *et al.* (2019) examine the seasoned equity offerings (SEOs) in China and find that SEO applications are more likely to receive approval if there are ties between the applicant's law or audit firm and the IEC. Our own analysis extends this earlier work on the private benefits of regulatory representation to a much larger firm sample and relates agency conflicts by auditors more comprehensively to auditor selection, auditor performance, IPO approval chances, and long-run client underperformance. Specifically, we show that despite selective advocacy, conflicted IPO firms exhibit significantly worse long-term performance, which is suggestive of inefficient initial pricing.

Zhang *et al.* (2024) claim that audit firms leverage their IEC connections to access private regulatory information, thus attracting more clients and increasing their market share measured by their IPO audit revenue. The authors argue that the launch of a new public disclosure system in 2015 diminishes the value of this information source and leads to a declining market share for IEC-connected audit firms. But we are sceptical that improved public disclosure eliminated the benefits of hiring connected auditors with their backdoor channels. The persistence of bribary cases after 2015 supports such scepticism.

Huang, Yan, and Chan (2021) provide direct evidence on the characteristics of firms attempting to exert undue influence over the IPO process. Drawing on court records, the authors compile a list of 70 pre-IPO firms found to have bribed two IEC members for the ChiNext board. This research finds that bribing firms are generally younger and smaller, exhibit more

volatile operating activities, and compensate underwriters and management more generously than their peers. Moreover, these firms display higher IPO prices, lower first-day returns, and poorer long-term post-IPO performance. Our work shows long-term post-IPO underperformance for a much larger sample of firms not limited to those (70 cases) for which corruption of the IPO process was established in court. We use their data to create a dummy variable where court records identify (*ex-post*) evidence of corruption.

Historians of constitutional law have highlighted the important role of administrative law and judiciary independence in checking discretionary executive power (Friedrich, 1953, Chapters VI, X, and XII). This channel also appears to operate in China, notwithstanding the limited independence of its judiciary. Miao *et al.* (2023) study a wave of municipal leadership consolidation in China, during which the chief of the police department was appointed to the position of adjunct supervisor of the local courthouse. The authors find that private businesses reduced their investment by around 14% and attribute this effect to the anticipation of more unchecked rent extraction by the local police force. Some common law jurisdictions also empower investors to purse the private enforcement of security law through class action litigation and thus reduce the reliance on regulatory action. Barko *et al.* (2023) suggest that such litigation in the US appears to be an effective mechanism against corporate fraud.

Delegation of regulatory authority to private entities is not unique to China and generally motivated by information asymmetry, complexity, and public resource constraints. Involvement of private entities like accountants can potentially improve decision quality and reduce the analytical and resource burden for the public agency. Therefore, governments have resorted to co-regulation in various contexts (Balleisen and Eisner, 2009; Freeman, 1997; Saurwein, 2011). The downside of this approach is that private actors prioritize their own interests and can manipulate or even capture the regulatory process.

While most research on corruption sees China's public administration as subject to the same incentive problems as public administrations elsewhere, Xueguang Zhou (2021) develops a theory of organizational behavior specific to China's public administration. He argues that public administration with "Chinese characteristics" operates in a perpetual tension between modern rule-bound procedural decision processes and a politicized mode of operation receptive to instructions from the political authorities. The latter requires flexibility and discretion as core principles geared toward political responsiveness. From this perspective, the large discretionary

power of the IEC is not just an organizational outlier, but a representative feature of Chinese state organization in general. Clearly, more research is needed to understand the comparative strength and weakness of China's public administration and its effects on the economy.

Although this study primarily focuses on the role of auditors in the IPO process, other work has focused on the screening role of investment banks (or underwriters). Research on the IPO process in the US indicates that underwriter reputation measured by market share, past IPO stock performance, or rankings in tombstone advertisements tends to be associated with less IPO underpricing and better long-term stock returns (Carter and Manaster, 1990; Carter, Dark, and Singh, 1998; Megginson and Weiss, 1991; Michaely and Shaw, 1994). Similiar research for China provides more mixed results and points to the importance of political connections. For example, Su and Brookfield (2013) find that underwriters' market share is negatively associated with IPO underpricing in a sample from 1995 to 2007. In contrast, Qian, Ritter, and Shao (2023) analyze a more recent sample from 2009 to 2012 and find that IPO underpricing insignificantly correlates with underwriters' ratings issued by the Securities Association of China. Chen, Shi, and Xu (2014) show that underwriters with greater ownership by the central government gained a higher market share. While these studies suggest that underwriter choices may have additional confounding effects, we stress that our results are robust if the underwriter's reputation is incorporated into analysis.

3 Institutional Background

3.1 Audit Firms and Regulatory Representation

China's accounting profession developed in parallel to the economic liberalization that followed the demise of doctrinal Marxism at the end of the Mao period. The creation of the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE) at the end of 1990s required the dissemination of certified accounts and provided a further impulse to the development of a modern accounting and auditing profession in China. Following the establishment of the Chinese Institute of Certified Public Accountants (CICPA), the national organization of the accounting profession, the number of public accountants grew rapidly over the following decades to reach approximately $300,000$ at the end of 2017, of which more than $260,000$ have a CPA

qualification (CICPA, February 5, 2018, Overview of the Accountancy Profession in China). Thus, China counts roughly 147 professional accountants per million inhabitants compared to 1,235 in the US or 9,778 in Australia (Wu and Ying, 2016).

Notably, only a subset of accounting firms is permitted to provide assurance services for an IPO, as undertaking this business requires a specialized securities license. Futhermore, the Chinese stock market regulator makes a second distinction between audit firms that are eligible to be represented on its Issuance Examination Committee (IEC) and those that are not. Public sources suggest three criteria for IEC-eligibility (China's Central Government Website, 2008). First, eligible firms need to be among the top 35 accounting firms according to the "Comprehensive Evaluation of the Top 100 Accounting Firm" published by the Chinese Institute of Certified Public Accountants (CICPA). Second, accounting firms should hold a licence to undertake security business. Third, their total firm revenue should exceed RMB 40 million.

Initially, the IEC is responsible for listings on the main board of both the Shanghai and Shenzhen Stock Exchanges. With the creation of the ChiNext board in 2009, a second separate IEC was created to approve listings in this new market. The latter is comparable to the NASDAQ market and focuses more on smaller technology-oriented companies. During the period 2003-19, the IEC for the main board is on average composed of 25 members, of which seven represent agents of China's Security Regulatory Commission (CSRC), seven are senior partners from private auditors, and the remaining commissioners come mostly from other government and investment institutions. The IEC for the ChiNext is larger with an average of 35 members, of which five represent market supervisors, and 12 come from private audit firms. A total of 168 individual auditors have been recommended to IEC from 2003 to 2019, of which 92 were selected by the CSRC and 76 were not.

There is very little public information about the exact nature of the selection process for commissioners. The China Security Regulatory Committee (CSRC) presumably enjoyed discretion in its choice of commissioners. In Section 4.1, we seek to develop measures of audit firm performance that allow us to compare selected and non-selected auditors.

3.2 Discretionary IPO Approvals

In 2003, the China Securities Regulatory Commission (CSRC) required a new IPO approval process that delegated ultimate discretionary authority for the IPO approval to the Issuance Examination Committee (IEC). This committee became the ultimate gatekeeper for corporate access to the Chinese stock market—a process that generates and redistributes enormous economic rents to corporate executives and initial investors alike. For each IPO application, the CSRC selects seven IEC commissioners to participate in the review meeting and publishes their names on its official website five days prior to the review date. Approval requires at least five affirmative votes from the seven commissioners. To mitigate conflicts of interest, commissioners must recuse themselves if they or their affiliated institutions have provided services, such as auditing or consulting, to the IPO applicant within the past two years. However, court disclosures from bribery cases reveal that non-voting IEC members could still influence voting commissioners through private discussions and backdoor channels.

The CSRC issued formal listing requirements for both the main board and the ChiNext board. For the main board, these criteria require a minimum net profit of RMB 30 million over the past three years, either a minimum net operating cash flow of RMB 50 million or a minimum operating income of 300 million over the past three year; a total capital stock of RMB 30 million; and an intangible asset proportion below 20%. Firms are classified as fully compliant only if they meet all five threshold, reflecting adherence to strict financial and operational benchmarks. We provide a more complete description of the listing requirements in the Internet Appendix A.

In our sample, 179 main board firms (9% of applicants) are non-compliant, with 156 failing to meet the operating cash flow standard. Operating cash flow is widely regarded as a more robust metric compared to earnings and more difficult to manipulate. Similarly, the ChiNext board requires firms to meet thresholds for net profit, profit growth rate, income, income growth rate, and net assets. Of the ChiNext applicants, 220 firms are non-compliant — mostly because of the revenue growth criterion. These non-compliant firms are likely to represent more financial risk as their operational performance and growth prospects are weaker.

4 Measurement Issue

4.1 Measuring Audit Firm Toughness

The ethical and professional standards of the auditing professions are difficult to measure and short-comings are often revealed only *ex post* as illustrated in the Worldcom and Enron cases, which triggered a major regulator reform of the auditing profession in the US (Peregrine and Elson, 2021). One way to discern an auditor's strict adherence to professional standards is to measure the frequency of so-called "modified audit opinions" (MOPs), which point out material misstatements in the corporate accounts (Chan and Wu, 2011).

We source information on all MOPs for Chinese listed firms from the CSMAR database. Let $\textit{Modified Audit Opinion}_{a,c,t} \in \{0,1\}$ denote any accounting objections by auditor a against the accounts of corporation c in year t, and let the dummy variable $\textit{Audit}_{a,c,t} \in \{0,1\}$ measure if corporation c is indeed the audit client of auditor a in year t. We define the professional "toughness" of auditor a as the relative frequency of accounting objections over all audits in the period 2003-19. Formally, we have

$$\textit{Auditor Toughness}_a = \frac{\sum_t \sum_c \textit{Modified Audit Opinion}_{a,c,t}}{\sum_t \sum_c \textit{Audit}_{a,c,t}}.$$

For the 109 audit firms in our sample, the mean (median) value of $\textit{Auditor Toughness}_a$ is 0.10 (0.07). The range is from a minimum of zero to a maximum value of 0.4; it is zero for auditors who never registered any objection to the audited accounts. We highlight that this measure of audit firm conduct can be distorted if the matching process between firm clients and auditors is non-random. For example, firms with dubious accounting practices might select audit firms known for their leniency, which implies that the measured toughness overstates the actual auditor toughness conditional on the firms encountered.

Next, we define an unbiased measure of auditor toughness that accounts for the assorted matching between auditors and certain firm types. This more general approach takes the $N_a N_c N_t \times 1$ outcome vector $\textit{Modified Auditor Opinions}_{a,c,t}$ and regresses it not only on a stacked $N_a N_c N_t \times N_c$ (dummy) matrix $\textit{Audit}_{a,c,t}$, which produces the relative frequency as the OLS coefficient, but also includes a set of control variables $X_{c,t}$ for the firm characteristics as well

as client firm and year fixed effects. The linear regression

$$\textit{Modified Auditor Opinions}_{a,c,t} = \textit{Audit}_{a,c,t}\gamma_c + X_{c,t}\beta + \theta_c + \lambda_t + \epsilon$$

then produces (conditional) auditor fixed effects, and we define the *Conditional Auditor Toughness*$_c = \gamma_c$. The Internet Appendix B compares unconditional and conditional measures of auditor toughness in Figure B1. The unconditional *Auditor Toughness*$_c$ plotted on the x-axis and the *Conditional Auditor Toughness*$_c$ on the y-axis are qualitatively different as illustrated by the vertical difference from the 45 degree line. The scatter plot is indicative of assortive matching between IPO candidates and audit firms.

4.2 Measuring Post-IPO Performance

A large finance literature is concerned with the long-run correction of initial IPO mispricing. This paper links the long-run stock performance to the conflict of interest of audit firms represented on the IEC. The auditor plays a crucial role in producing and certifying public information about the fundamental value of the IPO firm and long-run stock performance can used to gauge the veracity of this information.

To measure long-run performance, we use the two-year cumulative abnormal return (*CAR2*) and alternatively the two-year buy and hold abnormal return (*BHAR2*), defined as

$$CAR2_c = \sum_{d=5}^{5+504} (Dailyreturn_{c,d} - Benchmarkreturn_d), \quad (1)$$

$$BHAR2_c = \prod_{d=5}^{5+504} (1 + Dailyreturn_{c,d}) - \prod_{d=5}^{5+504} (1 + Benchmarkreturn_d), \quad (2)$$

respectively. We measure (cum dividend) returns from the (end of the) fifth trading day ($d = 5$) after the issuance over the following 504 (252×2 years) trading days after issuance relative to the daily return on a benchmark portfolio ($Benchmarkreturn_d$). To construct a matched benchmark return, we double sort all A-listed Chinese stocks by Industry and Size. We form 5 quintiles based on the magnitude of assets in the year prior to IPO. Companies within the same quantile and belonging to the same industry classification according to the Wind database are classified as benchmark firms.

5 Sample Selection and Summary Statistics

5.1 Audit Firm Data

We retrieve data on audit firms and their client firms from the WIND and CSMAR databases, covering the period from 2003 to 2019. Our sample includes a total of 109 audit firms. As shown in Table 1, 90 of these firms have conducted at least one IPO audit, while the remaining 19 have never participated in any IPO audits. The firms that conduct IPO audits are generally larger; on average, an IPO audit firm employs 328 auditors, services 37 listed client firms, and audits approximately RMB 1392 billion in book assets annually.

According to the China Securities Regulatory Commission (CSRC), only 74 of the 90 IPO audit firms are eligible to nominate senior partners as commissioners on IEC. We obtained detailed information on the eligibility and selection of IEC commissioners and their affiliations from the CSRC website. Our analysis of the commissioners' backgrounds reveals that only 50 audit firms have successfully recommended at least one commissioner for the IEC, thereby securing representation. The remaining 24 firms have never been successful in this regard.

5.2 IPO Candidate Firm Data

We identify 2,965 Chinese IPO candidates from WIND and CSMAR databases for the period 2003-19. As reported in Table 2, Panel A, 67% of these candidates apply for IPOs on the main board, while the remaining 33% seek listings on ChiNext. State-owned enterprises (SOEs) represent 19.1% of all IPO candidates. Generally, these IPO candidate firms are profitable, with an average ROA of 14.4%. The fact that all these candidate firms report positive ROA highlights the critical role of profitability in successful IPOs in China. In addition, Chinese IPO candidate firms are highly leveraged, with the median book leverage ratio of 45.4%.

Approximately 19% of all firms choose an auditor with IEC representation. The unconditional IPO approval rate is 81%. IFurthermore, 84.5% of firms are in full compliance with all the listing requirements ($D_Compl_{c,t} = 1$) whereas the remaining 15.5% are not ($D_Non\text{-}Compl_{c,t} = 1$). We cannot determine the compliance status for 215 firms (approximately 7%) due to partially missing accounting data[7].

[7]These firms also have a high rejection rate with 200 out of 215 firms not being approved for an IPO

Table 2, Panel B reports the post-IPO performance for the successfully listed firms. The two-year mean abnormal returns CAR2 and BHAR2 are 11.7% and 0.5%, respectively. In contrast to the positive stock return, the newly listed firms exhibit a decrease in ROA, with a mean difference of -0.074 between the ROA one year post-listing and the ROA one year pre-listing within the sample.

6 Analysis

6.1 Which Auditors Acquire Regulatory Representation?

We focus on the selection of senior auditors into the IEC and examine who are most likely to be selected? It is unclear a priori on whether touch auditors or lenient auditors have a high chance of being chosen. On the one hand, three arguments suggest that more lenient (i.e, less tough) auditors might be more likely to obtain representation on the IEC. First, tough auditing firms worried about conflicts of interest and their reputation could be more reluctant to endorse their own senior partners as IEC members even if such representation generates positive business externality for the auditing firm. The accounting literature has highlighted reputational concern as an important element influencing accounting practice (Mayhew, 2001). Second, lenient auditors could be more willing to endorse borderline IPO candidates that may not fulfill all the standard compliance criteria for an IPO. They could monetize political connections and decision power in the IEC for the borderline IPO candidates for which such support is pivitol. Thus, lenient auditor tend to derive larger benefits from political connections. Both arguments suggest that lenient auditors should be overrepresented in the IEC. Third, from the point of view of the supervisory agency, the benefit of cooperation with the private sector consists in information exchange and private sector cooperation in case the agency is required to pursue specific political objectives outside the regular administrative process. Intrinsic leniency of a commissioner may correlate with a higher willingness to broadly cooperate with the supervisory authorities beyond the IEC mandate.

On the other hand, reputational concerns by the supervisory agency may push against the nomination of very lenient auditors. The regulatory bodies have an interest in avoiding scandalous IPO approvals in which non-compliant firms promoted by connected auditors produce

extreme stock market underperformance. Any unconstrained exploitation of political connections may undermine the image of the stock market regulator and its reputation within the party-state. Finally, professional leniency may not be an intrinsic quality of a personality type but situational in nature. In this sense, toughness in the auditing practice of listed firms may have no predictive value for an auditor's willingness to be tough and principled when it comes to IPO advocacy. If these latter aspects dominate, we should not find any relationship between our measure of professional "toughness" and IEC representation.

We summarize these considerations in the following hypothesis:

Hypothesis 1: Auditor Toughness and IEC Representation

(i) If the empirical measure of auditor toughness captures an intrinsic personality or firm type, we expect tough auditors to be underrepresented on the IEC as political connections are of lower value to them.

(ii) If auditor toughness is situationally determined and/or reputational concerns matter for the IEC nominations, we expect to find no negative selection effects for IEC representation.

Table 1 provides a first simple test of Hypothesis 1 at the audit firm level. Among the 74 accounting firms eligible for IEC representation, the 50 firms chosen at least once show a statistically lower *Auditor Toughness* than the 24 firms never selected over the period 2003-19. The difference between the two groups of accounting firms is economically large and statistically significant: Audit firms selected into the IEC require account restatement in only 7.9% of their audits compared to 15.7% for the non-selected accounting firms. The difference is statistically significant at the 5% level. This means that the outside group issues modified audit opinions more frequently than the inside group of audit firms co-opted into the regulatory decision body.

In Table 3, we extend the binary comparison of audit firms with at least one IEC member in any year or none into a more comprehensive analysis that treats each committee appointment as a separate choice. Between 2003 and 2019, a total of 18 different IECs are formed with a total of 557 appointments, of which 171 are appointments of senior auditors from private auditors.[8] Prior to 2017, the main board for listings and the ChiNext exchange have separate

[8] Here we count renewal of membership in the IEC as a new appointment.

IECs, which are merged into a single committee for both markets after 2017. In a number of years, the IEC was reappointed without any change to its composition. Table 3 conveys such reappointments with a different committee number, but the same committee creation year. For example, tenth and eleventh IEC for the main board in the periods 2010-11 and 2011-12, respectively, have an identical composition with the same year of committee creation, namely 2010. For our statistical analysis, we treat reappointments as repeated choices of the same auditor for IEC representation, which results in a total of 171 IEC appointments for private sector auditors. In the absence of publicly disclosed information regarding the sixth IEC Main, we identified 23 eligible firms from the top 35 auditing firms ranked by CICPA in 2003 as the non-selected comparison. At the individual level, selected IEC members come from accounting firms with an average *Auditor Toughness* of 0.069 compared to 0.098 for all other firms in the choice set. Again, we find a tendency to pick representatives from auditors with a lower *Auditor Toughness* score, which is now statistically significant at the 1% level.

In Figure 1, we measure the *Auditor Toughness* separately for two periods 2003-11 and 2012-19 for a sample of 25 audit firms with data for every year in 2003-19.[9] We find that the rank correlation over time is 0.667 and statistically significant at the 1% level. But we also notice that a fitted line is much flatter than the 45 degree line, which is consistent with decreasing toughness over time. An alternative interpretation is that firm compliance with accounting standards improved over time and therefore accounting objections became less frequent in the later period. Such temporal variation suggests a conditional analysis when it comes to comparing the frequency of modified audit opinions. Moreover, assortative matching between audit firms and clients invalidates the unconditional analysis.

We therefore undertake a conditional analysis of auditor toughness and extend the analysis to the individual professional toughness of the selected commissioner. In particular, we define three dummy variables equal to 1 (and zero otherwise) (i) if the head accountant certifying the corporate accounts personally serves (in any year) on the IEC as a commissioner ($D_IEC\ Commissioner_{c,t}$), (ii) if the auditing firm is at any time represented (by any audit firm member) on the IEC ($D_IEC\ Auditor_{c,t}$), and (iii) if the auditing firm is eligible for such representation ($D_IEC\ Eligible\ Auditor_{c,t}$). We then regress the $N_a N_c N_t \times 1$ dummy vector identifying any

[9] Tracking auditing firms over the 16-year data window is complicated by the fact that 68 accounting firms licenced to audit listed firms were involved in mergers.

Modified Audit Opinion$_{a,c,t}$ onto the three aforementioned dummy variables and various controls characterizing the audit firm clients. The coefficients on the three dummy regressors thus capture conditional frequencies for issuing modified audit opinions.

Table 4 reports OLS regressions without and with control variables for the audited firm. Making the audit outcome the dependent variable increases the statistical power to no less than 36,475 observations and provides a simple way to control for client characteristics. The control variables include a firm's return on assets ($ROA_{c,t}$) and its (log) asset size (*Log Assets*$_{c,t}$) in RMB, firm leverage (*Leverage*$_{c,t}$), account receivables relative to assets (*Receivables*$_{c,t}$), the inventory ratios (*Inventory*$_{c,t}$), the current ratio (*Current Ratio*$_{c,t}$), a dummy for negative income in three consecutive years (*D_Loss*$_{c,t}$), a, dummy for a listing age of more than three years (*D_Listing Age*$_{c,t}$), a dummy variable marking listings for the ChiNext board (*D_ChiNext*$_{c,t}$), and a dummy variable for state-owned enterprises (*D_SOE*$_{c,t}$). Columns (3) and (6) also include both client firm fixed effects and year fixed effects.

The evidence in Column (1) excludes conditioning variables and shows a statistically significant negative correlation between the frequency audit objections and the dummy for IEC selection. The point estimate of -0.041 for *D_IEC Selected Firm*$_{c,t}$ is large and suggests an audit objection rate only half of that of other audit firms, which accords with the findings in Tables 1 and 3. But this strong bias toward less (unconditional) toughness disappears completely as we add client and year fixed effects in Columns (2)-(3) and additional control variables in Columns (4)-(6). We conclude that audit firms with IEC commissioners are equally tough in their treatment of already listed firms as other IEC-eligible auditors.

The OLS specifications in Columns (4)-(6) show that the dummy variable *D_IEC Eligible Firm*$_{c,t}$ correlates strongly with the conditional frequency of audit objections and therefore suggests a lower conditional leniency. The coefficient is large at 2% relative to a mean audit objection rate of approximately 8.3%. This confirms previous evidence in the accounting literature that larger and more reputed audit firms tend to issue more modified audit opinions (DeAngelo, 1981; Defond *et al.*, 2000; Chan and Wu, 2010).

Finally, we note that the dummy variable for the individual commissioner (*D_IEC Commissioner*$_{c,t}$) is also statistically insignificant. The 76 individual auditors serving on the IEC are responsible for auditing $2,595$ listed firm accounts and their share of modified audit opinions is at 5.89% not statistically different from the professional standard. Hence, we reject the first

part of Hypothesis 1 of differential toughness both for the IEC-selected auditors as well as for their audit firms. As the unconditional analysis in Tables 1 and 3 shows, IEC-selected audit firms issue on average fewer modified audit opinions, but the difference is fully accounted for by the different firm characteristics of their audit clients. Generally, firms with better accounting standard compliance pick more reputed auditors. We find no evidence that the selected IEC commissioners were intrinsically different from other eligible auditors in upholding professional audit standards.

6.2 Listing Requirement Compliance and Auditor Choice

Next we examine the auditor choice of IPO candidates. If the representation of (former) audit firm members on the IEC provides an advantage in obtaining a positive IPO approval decision, we expect IPO candidates to make a rational choice of auditing firms with IEC representation. This should enable the respective auditor to grow faster than competitors and also to become more profitable. The marginal benefit of having a politically connected auditor should be even larger if the IPO candidate does not fulfill all the listing requirements, so that supervisory discretion becomes relatively more important. We summarize this hypothesis as follows:

Hypothesis 2: Auditor Choice

(i) Firms with IPO intentions are more likely to choose an audit firm with IEC representation and particularly so if they risk not fulfilling the standard IPO listing requirements.

(ii) A higher rate of client acquisition by the auditing firm should coincide intertemporally with the selection of its senior auditor into the IEC.

In Table 5, Columns (1)-(3), we consider the auditor choices by all listed firms and IPO candidates. A total of 3,636 listed firms and 2,965 IPO candidates select auditors among the 109 available auditing firms, which produces more than 4.3 million dyadic choices. For the dependant variable we define $D_IEC\ Auditor_{a,c,t}=1$ if and only if the auditor a has firm c as its client in year t, and is also represented on the IEC in year t, and zero otherwise. Out of the 2,965 IPO candidate firms, 817 selected auditors who were represented in the IEC at the time

of filing for an IPO. On average, it takes 432 days between the IPO filing and the IPO decision, which implies that an auditor on the IEC at the moment of filing might no long sit on the IEC when the listing decision is taken. Of the 817 auditor choices with IEC representation at the day of the IPO filing, a total of 403 (49.3%) stayed in the IEC committee until the IPO decision was made. These 403 firms represent a substantial proportion (70.8%) of the 569 candidate firms having their auditors sit in the IEC at the time of the IPO decision.

A politically connected auditor (i.e. with IEC representation) is primarily beneficial to IPO candidates marked by the dummy $D_Pre\text{-}IPO_{c,t}$. Column (1) shows that the pre-IPO firms select auditors with IEC representation relatively more frequently. IEC representation increases an auditor's chance of being selected by any of the 3,636 listed firms and 2,965 pre-IPO candidates by approximately 2%. In a market with only 74 IPO-eligible auditors, the average unconditional likelihood of selection is 1.35%. A marginal 2% increase is therefore economically large.

Table 5, Columns (4)-(6) consider auditor choices only among IPO candidates. This reduces the sample to 266,850 possible (one-time) choices between IPO candidates and the 90 IPO-licensed auditors. In this sample, the same IPO candidate appears only once and not as a listed firm again choosing an auditor in a later year. We separate IPO candidates into those in compliance with the listing requirements ($D_Compl_c = 1$) and those that are not ($D_Non\text{-}Compl_c = 1$). For non-compliant IPO candidates, the political connectedness of the auditor should matter more in auditor choice. This hypothesis is confirmed by the much higher propensity of non-compliant IPO candidates to select auditors with IEC representation. The marginal effect of non-compliance for the OLS specification in Column (5) is 2.7% and therefore economically very large as the selection probability approximately triples. Logit regression in Columns (3) and (6) confirm the statistically significant effect of IPO status and non-compliance with listing requirements on auditor choice even after controlling for the firm characteristics of the respective corporate clients.

It is also instructive to compare the long-run growth of audit firms with and without IEC representation. Figure 2 shows the evolution of number of listed clients for auditors with IEC representation grows steadily from initially 20 to almost 120, whereas for auditors without IEC representation or ineligible for IEC representation, the same number stagnates at or below 20 listed firm clients. Figure 3 depicts the corresponding revenue evolution for the three types of

auditing firms with a log scale for average yearly revenue. The average geometric growth rate of revenue for the period 2003-19 is approximately 19% for audit firms with IEC representation, and only 9% for the two other groups. The auditor group with IEC representation were therefore able to develop much faster and increase their relative market share of listed firm clients and revenue.

An alternative explanation for the strong economic relationship between IEC representation and auditor success is that the regulator selects the most competent auditing firms for the IEC, which also happen to have the highest growth rates. To exclude this incidental effect, the second part of Hypothesis 2 predicts a close intertemporal link between IEC selection and new client acquisition by the auditing firm in which the new commissioner was a senior partner. Figure 4 shows the results of an event study that depicts an auditor's average number of non-compliant IPO clients before and after selection into the IEC, where year "zero" denotes the year of IEC selection. This is also the exact year of an abnormal increase in IPO clients for selected auditors relative to those auditors that are not selected. The event evidence suggest a causal relationship between committee selection and client acquisition rather than the committee selection based on long-run auditor performance. In other words, IEC representation provides a tangible commercial advantage to the audit firm in which the new IEC member was a senior partner. In other words, political connections to the IEC distort the competition for auditing services in a drastic manner.

6.3 Regulatory Representation and IPO Approval Chances

This section examines IPO approval chances. Seeking an auditing firm with IEC representation and possibly paying higher audit fees is rational if this increases the chance of IPO approval. Any boost in the approval chances should be observable mostly for those companies that are borderline cases that do not comply with all the formal listing requirements. Our third conjecture is therefore the following:

Hypothesis 3: IPO Approval Chances

Regulatory representation by accounting firms increases ceteris paribus the chances of their clients' IPO approval if they are at the margin of approval.

Our data set on IPO candidates features a total of 2,965 firms, for which we define a dummy $D_IPO\text{-}Approval_c = 1$ if their IPO was approved and zero otherwise. The rejection rate for IPO candidates is 19% (i.e. 568 cases). In the 568 cases of rejection, 249 firms made a second bid for IPO approval and we treat such repeated candidacy simply as a new separate bid.

Table 6 presents OLS and Logit regressions with the IPO approval dummy as the dependent variable. The dependence of the approval chances on the auditor type is captured by the dummy variable $D_IEC\ Auditor_c$, which distinguishes auditors with and without IEC representation at the time of a firm's IPO candidacy, respectively. We include in all regressions industry fixed effects and time fixed effects for every committee tenure. Columns (1)-(2) present the OLS regressions without and with control variable for the IPO candidate, respectively. In particular, asset size ($Log\ Assets_c$) and profitability (ROA_c) of the candidate firm increased the chances of the approval. We mark IPO candidates that are involved in later prosecution for corruption with the dummy variable $D_Bribe_c = 1$; they feature a 11.8 percentage points higher chance of IPO approval. We also note that IPO approval chances are 22.6 percentage points lower in the ChiNext board, whereas SOE status has no statistically significant effect on the listing approval. The Logit regression in Column (3) yields a positive coefficient of 0.245 for the dummy $D_IEC\text{-}Auditor_c$. Its average marginal effect is 2.42 percentage points and statistically significant at the 10% level. Thus, choosing an audit firm with IEC representation tends to improve chances of IPO approval.

Again, we also identify more controversial IPO candidates as those firms that are non-compliant with the listing requirements ($D_Non\text{-}Compl_c = 1$) as opposed to those that do comply ($D_Compl_c = 1$). In Table 4, Columns (4)-(6) interact the dummy for IEC auditor with the two compliance dummies. In the OLS specifications in Columns (4)-(5), the non-compliant clients increase their IPO approval by roughly 7.2 percentage points if the firm's auditor is represented on the IEC committee. The marginal effect of political connections to the regulatory body is therefore particularly large for borderline IPO candidates. The Logit regression in Column (6) confirms this conclusion. The coefficient for the interaction term $D_IEC\ Auditor_c \times D_Non\text{-}Compl_c$ is at 0.725 statistically significant at the 5% level and the corresponding average marginal effect is 7.14 percentage points. Relative to an average rejection rate of 19%, a 7.14% lower marginal rejection rate represents a 37% lower risk of failing to list—again, an economically large effect.

By contrast, the interaction term $D_IEC\ Auditor_c \times D_Compl_c$ is economically and statistically insignificant. This means that firms already compliant with the listing requirements did not increase their approval chances by having a politically connected audit firm. The influence of political connections on the IPO approval decision was therefore conditional on the firm type and played out mostly for borderline cases of formally non-compliant firms.

6.4 Post-IPO Stock Performance and Selective Advocacy

Finance research has explored the post-IPO performance of newly listed firms. For the US market, the evidence on long-run performance relative to the market is controversial (Perera and Kulendran, 2016). Potential explanations for the long-run underperformance include extensive media coverage and investor attention at the IPO stage, which then give way to more rational valuations in the long run (Fang and Peress, 2014). The Chinese market, with its high share of retail investors might be particularly prone to exuberant valuations at the start of the stock listing (Liu, Sherman and Zhang, 2014; Jones, Zhang and Zhang, 2021). Yet, we find that newly listed firms generally outperform the benchmark firms in their first two years of listing by a mean value of 11.7% and 18.2% in terms of their cumulative or buy and hold abnormal return (*CAR2* and *BHAR2*, Table 2, Panel B), respectively. But such general index outperformance by all IPO firms can hide large heterogeneity.

Next, we examine if the conflict of interest by IEC connected auditors is reflected in an average long-run *relative* underperformance among newly listed stocks. Such long-run underperformance can have two sources. First, firms' non-compliance with the general listing standards correlates with a lemon problem that leads to overpricing at the initial IPO stage. Long-run market efficiency then implies a negative price correction reflected in lower two-year returns. Second, the conflicted auditor might also engage in earnings manipulation at the pre-IPO stage. In this case, investors might be misled about the long-run earning prospects of the firm and pay an inflated IPO price. In this second case, we should observe not only a negative long-run stock price correction, but also a systematic downward correction of profitability. This second explanation is examined more closely in Section 6.5.

In Section 6.2, we showed that having an auditor with IEC representation improved the IPO approval chances of borderline firms that are not in full compliance with the formal listing

requirements. This is evidence of advocacy by the respective commissioner within the IEC. Yet, such internal advocacy is likely to have certain limits. A conflicted commission could not push an IPO candidate with very unfavorable earning prospects without a risk of reputational damage. Also, other commissioners might not approve of IPO candidates that had considerable downside risk in their valuation. An advocacy for particular firms within the IEC could therefore only be selective and should only involve firms that do not feature considerably more downside risk than the typical approved IPO firm. Such *selective advocacy* implies that borderline IPO candidates approved by the IEC should not be characterized by a downward shift of the performance distribution, but by a deformation of this distribution in the sense that moderate long-run post-IPO underperformance becomes more frequent, but extreme underperformance is of similar likelihood to the overall distribution of approved IPOs. Empirically, selective advocacy implies that negative performance effects for the borderline approved IPO firms are concentrated in the higher performance quantiles.

Accordingly, we posit the following fourth hypothesis:

Hypothesis 4: Conflict of Interest and Post-IPO Underperformance

(i) Borderline IPO candidates with conflicted auditors on average underperform other IPO stocks in the long run.

(ii) Selective advocacy in favor of better borderline IPO candidates implies that this underperformance is concentrated in the upper performance quantiles of the post-IPO stock returns.

We use the dummy variable $D_IEC\text{-}Auditor_c \in \{0, 1\}$ as the main explanatory variable for the post-IPO performance. It takes on the value of 1 for firms that have chosen an auditor represented on the IEC in the year of the approval decision. As before, we capture the relevance of this connection for a particular IPO approval case by the two dummies $D_Non\text{-}Compl_c$ and D_Compl_c marking non-compliance and compliance with the listing requirements, respectively.

Table 7 provides evidence on the post-IPO performance at the two-year horizon for the cumulative abnormal return (CAR) and the buy and hold abnormal return (BHAR) in Columns (1)-(2) and (3)-(4), respectively. We also include the full set of firm controls to capture confounding effects of firm characteristics. Column (2) suggests that marginally approved firms

with conflicted auditors ($D_IEC\ Auditor_c \times\ D_Non\text{-}Compl_c = 1$) underperform other newly listed firms by 15.4% in their first two years in the public market. The corresponding underperformance in terms of buy and hold returns in Column (4) is −39.5% and statistically significant at the 1% level.

We also note that listings in the ChiNext board perform significantly better with on average a 17.6% higher cumulative abnormal return in their first two years. Also, larger firms tend to disappoint, as revealed by the negative point estimate for $Log\ Assets_{c,t}$. Surprisingly, firms involved in corruption probes ($D_Bribe_c = 1$) show a higher but statistically insignificant post-IPO performance, which contrasts with previous claims in the literature (Huang, Yan, and Chan, 2021). We also note that the results are robust to different time horizons. In Figure 5 we plot the cumulative abnormal return for different types of firms, namely all listed firms (solid black line), listed firms not complying with the listing requirements (dashed black line), connected firms with IEC auditors (solid green line), and connected and non-compliant stocks (dashed green line). The post-IPO performance ranking emerges shortly after the listing with connected and non-compliant stock showing the worst returns. The ranking is highly persistent and independent of the exact horizon of return measurement.

A fully efficient market valuation at the outset of public trading should have produced lower valuations for firms that were only marginally approved and had conflicted auditors. The auditors' conflicts of interest may not have been apparent to retail investors and/or the public documents produced for the IPO did not reflect the lower prospects of the marginally approved IPO candidates. Additional evidence on this issue of earning manipulation prior to the listing by conflicted auditors is presented in Section 6.5.

While the OLS regressions in Table 7 establish an average underperformance among all marginally approved firms with conflicted auditors, it is also interesting to explore which part of the return distribution is particularly affected. As argued above, IEC commissioners are likely to have engaged in selective advocacy by promoting the IPO approval of those non-compliant firms that did not have greater downside performance risk than the average IPO firm. As a consequence, conflict of interest effects should be more pronounced in the upper quantiles of the return distribution.

In Table 8, we replicate the OLS regressions specification in Table 7, Column (2), for quantile regressions at quantiles $q = 0.10, 0.25, 0.50, 0.75, 0.90$. The key coefficient of interest is again

the interaction term $D_IEC\ Auditor_c \times D_Non\text{-}Compl_c$, which marks the relative performance effect for non-compliant firms of auditors with IEC representation. A visual representation of these quantile coefficients across return distribution is provided in Figure 6, which compares the IEC Auditor effect for compliant and non-compliant listed firm in Panels A and B, respectively. We find that the effect of the interaction term on various performance quantiles is very unequal for non-compliant firms with a strong negative effect concentrated in the high performance quantiles. For example, at the quantiles $q = 0.75$ and $q = 0.90$, the relative underperformance in terms of the two-year cumulative abnormal return of non-compliant firms is -15.9 and -31.1 percentage points, respectively.

This means that very few of the newly listed borderline firms with an IEC connection via their auditors performed well compared to the average listed firm. On the other hand, the worst performing firms in this group (at the lower return quantiles) did not statistically underperform the worst performing regularly listed firms. The infrequency of good or very good performance among borderline IPO candidates and a frequency of poorly performing IPOs similar to regular listings is consistent with a selective advocacy channel. Borderline firms with extremely poor long-run earning prospects did not get endorsed by the IEC even if conflicts of interest were at play. Reputational considerations mattered to IEC members even if conflict of interest was rampant.

Finally, we seek to access the overall market impact of the listing approvals that occurred for non-compliant firms with politically connected auditors. A simple counterfactual consists in eliminating these firms from the market and calculating the value-weighted index performance under this scenario. We find that the annual index return is 0.6% higher if such firms do not enter the Chinese A-share index. We conclude that the conflicted IPO selection process contributed over 16 years approximately 9% ($= 1 - 0.994^{16}$) to the long-run underperformance of the Chinese stock market, which is again economically significant.

6.5 Earnings Management around IPOs

Sustainability of profits was one of the stated selection criteria in China's IPO process. It represents the most frequently cited reason for rejecting an IPO application, and which concerns roughly 19% of all IPO applications. This can explain the more pronounced earnings

management found among Chinese IPO candidate firms. As highlighted by Allen, Qian, Shan, and Zhu (2023), the return on assets (ROA) for the average Chinese IPO often drops after the listing—a pattern much more pronounced than in other financial markets. This supports the notion that Chinese IPO firms often resort to earnings management.

The incentives for such earning misrepresentation likely varies among IPO candidates. Firms with weak profitability have the strongest incentives to engage in earning management because it might block the path to a successful IPO. Therefore, we hypothesize that earnings management is more prevalent among non-compliant firms that do not meet the formal approval criteria set out by the CSRC. Crucially, given the discretion of the IEC in the application of these guideline, we expect that borderline firms (in violation of the guidelines) paired with connected auditors (represented on the IEC) are most likely to engage in pre-IPO earnings management. These firms should subsequently experience a more pronounced decline in profitability after the listing.

Again, selective advocacy should matter here as well. A IEC commissioner may not find it in his/her interest to advocate the IPO of a firm featuring a large downside earning risk. Regulatory advocacy and earning manipulation are most effective and are likely to occur if either tips the balance in favor of the IPO approval, but does not involve higher downside profitability risk compared to a regular IPO. This implies that the negative firm profitability effect is again concentrated in the upper quantiles of the distribution for the post-IPO change of the return on assets:

Hypothesis 5: Conflict of Interest and Earnings Management

(i) Marginally approved IPO candidates with conflicted auditors experience a greater profitability decrease than other IPO firms after their listing.

(ii) Selective advocacy implies that this effect should be most pronounced in the upper quantiles of the asset profitability change around the IPO.

To test this last hypothesis, we again undertake quantile regressions analogous to Table 8 with the same control variables. For our accounting measure of profitability change, we use the change in the return on assets, $\Delta ROA_c = ROA_{c,t+1} - ROA_{c,t-1}$, as the difference the between

the ROA in the year $t+1$ following the listing and the year $t-1$ before the listing, where t denotes the year of the IPO for firm c.

Table 9 presents the quantile regression results with ΔROA_c as the dependent variable. The coefficient of interest is again the performance effect for non-compliant firms with connected auditors, namely listed firms marked $D_IEC\ Auditor_c \times\ D_Non\text{-}Compl_c = 1$. The quantiles $q = 0.1$ to $q = 0.75$ in Columns (1) to (5) do not indicate any statistically significant relative profitability decline around the IPO event for this firm group. However, this coefficient becomes negative at -0.012 percentage points and statistically significant at the 1% level for the quantile $q = .90$ in Column (6). At the 90% quantile of the profitability change, non-compliant firms with connected auditors show a relative ROA deterioration by 1.2 percentage points, which is statistically significant at the 1% level. Such a relative deterioration of profitability is also economically significant given a median ROA of 12.9% (Table 2, Panel A). It is consistent with a earning manipulation at the pre-IPO stage. Moreover, the earning manipulation was selective in the sense that it did not contributed to the listing of non-compliant firms with abnormally negative profitability realization after the IPO. Again, reputational concerns could explain why earning manipulation was carried out selectively among the better firms that were non-compliant with the listing requirements, which avoided a higher share of listings with dismal accounting returns.

7 Conclusion

The Chinese IPO market represents an interesting case study of economic success and simultaneous regulatory shortcomings that illustrates the pitfalls of large discretionary administrative power in China. The creation of the Issuance Examination Committee (IEC) was supposed to bring the knowledge of private auditors into the regulatory process of IPO approval, but simultaneously created formidable conflicts of interests that shaped the evolution of the auditing market over the period 2003-2019 and influenced the selection of listed firms in China.

While the China Security Regulatory Commission (CSRC) issued formal listing requirements, the IEC exercised its discretionary power, and often disregarded these "guidelines" when approving non-compliant IPO candidates. We show that auditing firms with (former) senior partners represented on the IEC increase their share of IPO clients, particularly in the

year when such nominations occur, and double their long-run auditing revenue growth relative to peers without IEC representation. This shows the substantial economic benefits of political connections in China.

Reciprocally, approval chances of IPO candidate firms increase if their audit firm is represented on the IEC, and particularly so if the candidate firm does not comply with the CSRC listing requirements. The same "non-compliant" firms that are shepherded through the IPO approval process by politically connected audit firms show considerable underperformance after the listing relative to all other listed companies. The corresponding evidence on earnings management around the listing for the underperforrming firm group is consistent with misprepresentation of earning prospects prior to the IPO. Overall, considerable discretionary power by the IEC combined with the membership of conflicted private sector auditors in the decision body distorted competition in the audit market, influenced the selection process of Chinese firms approved for an IPO, and contributed to the poor investment performance of the Chinese equity market — adding approximately 9% underperformance to the A-share index over a 16-year period.

At a more fundamental level, the distortions and corruption opportunities created by Chinese IPO regulation can be seen as symptomatic of a state bureaucracy that is not subject to any effective judiciary review, and seeks to retain a large degree of discretionary power. Turning China's regulatory state into a fair, predictable, and law-based actor represents a considerable challenge in China's development process.

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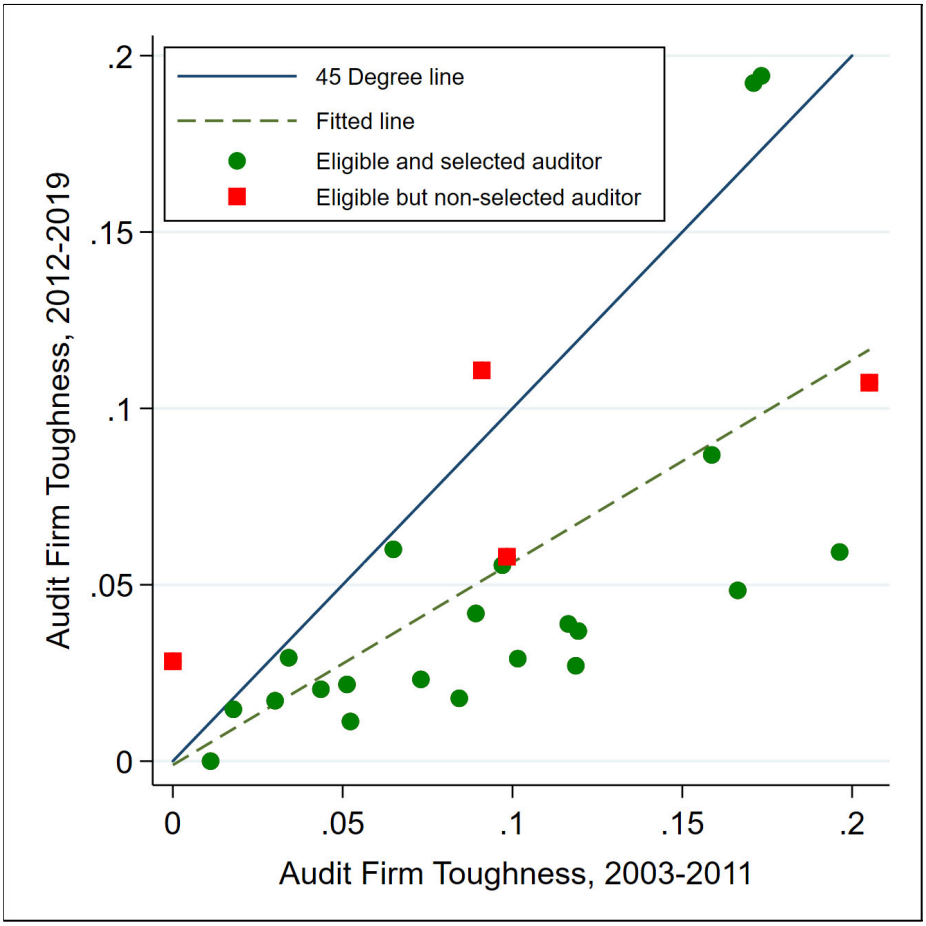


Figure 1: Persistence of *Audit Firm Toughness* across subperiod for 25 auditors with complete data from 2003-2019. The intertemporal rank correlation of (unconditional) *Audit Firm Toughness* is 0.667 and is significant at the 1% level. We distinguish audit firms represented (in any year) in the IEC (green dots) from those that are never represented (red squares).

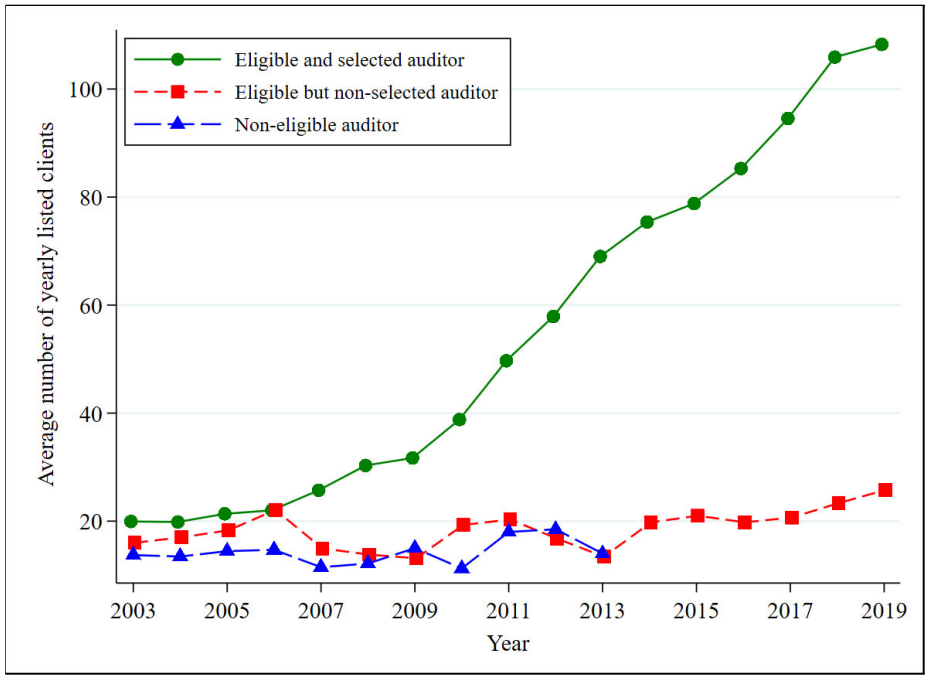


Figure 2: Average number of yearly audits of listed firms by auditor type.

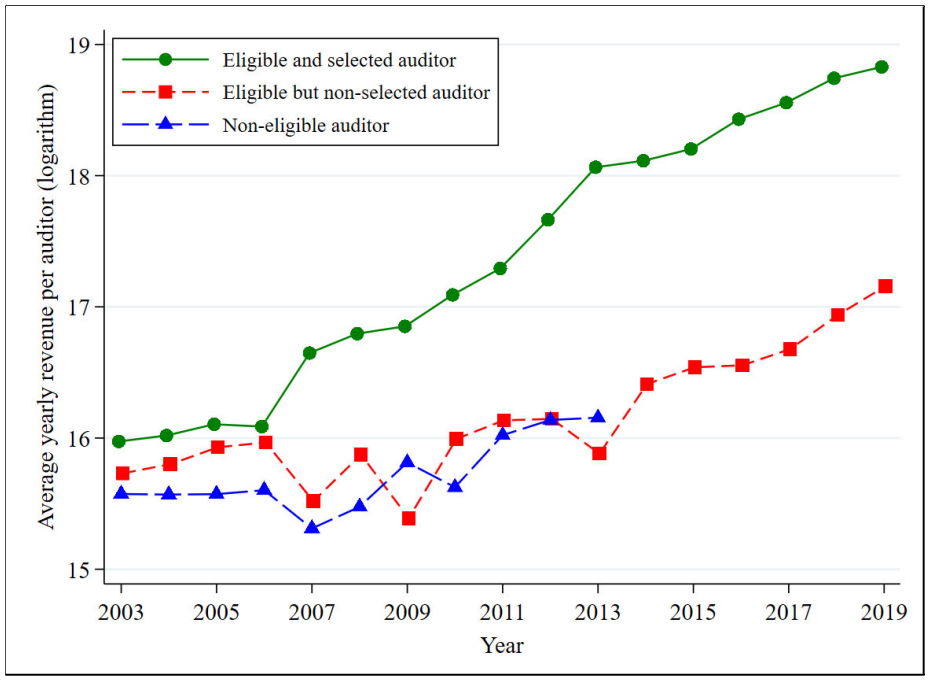


Figure 3: Average yearly revenue by audit type expressed in the logarithm of RMB.

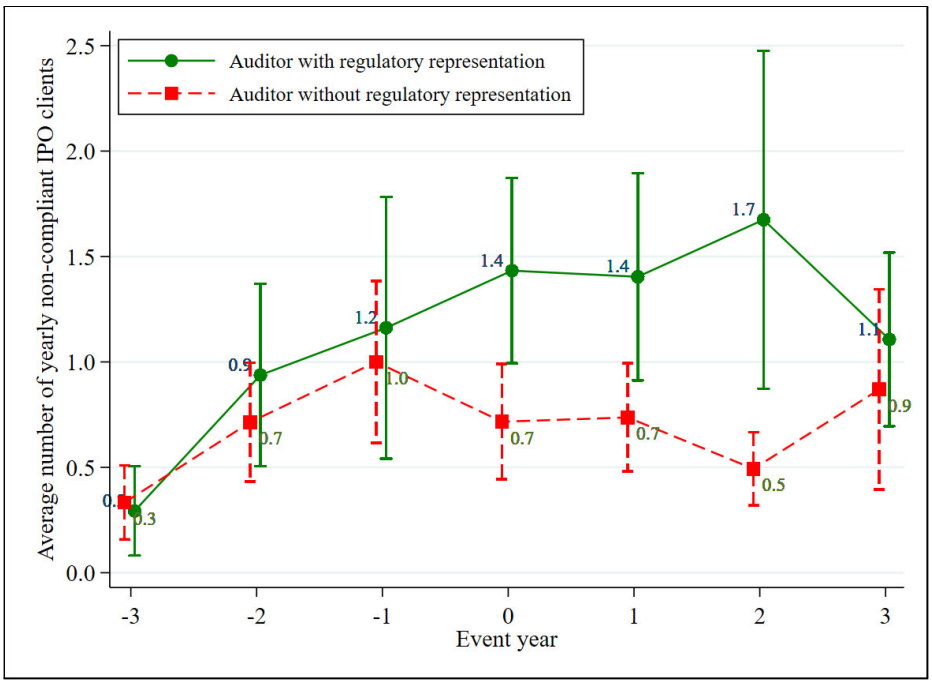


Figure 4: Acquisition of non-compliant IPO clients by auditors around the event of selection into the IEC in year "zero".

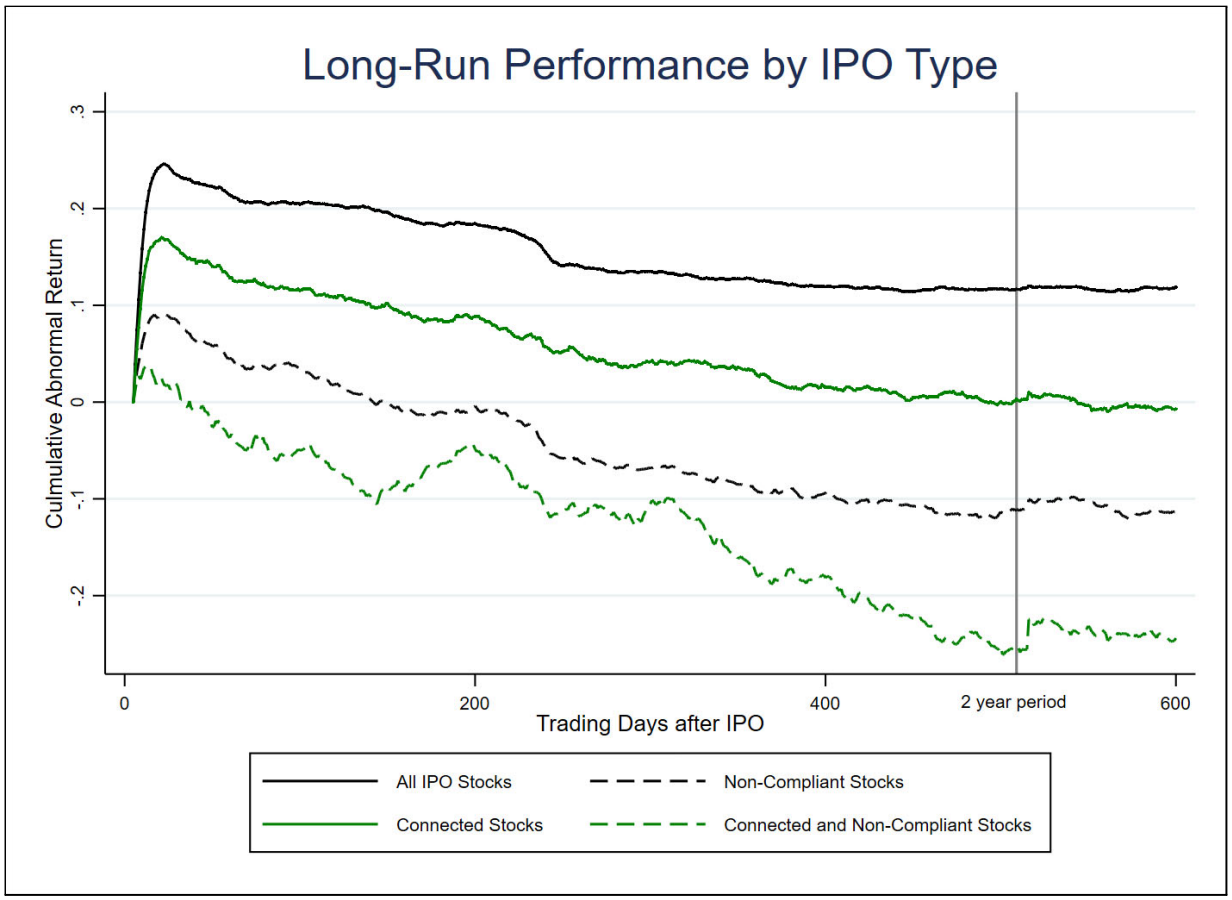


Figure 5: We plot the cumulative abnormal return for four different groups of IPO firms from day five after the listing over the next two years.

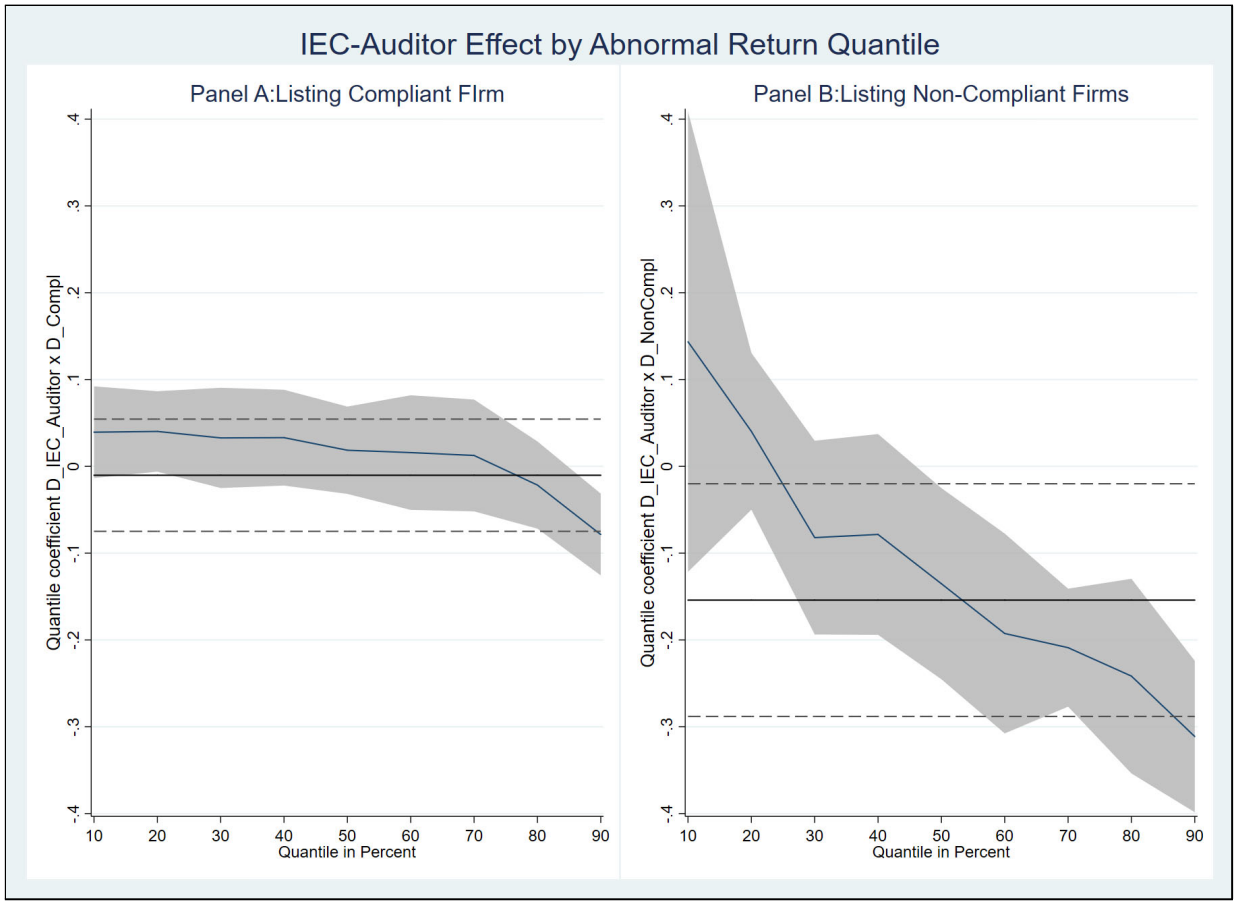


Figure 6: For all quantiles in 10% increments, we plot the effect of an auditor with IEC representation ($D_IEC\ Auditor = 1$) on a firm's one-year post-IPO stock performance measured by the cumulative abnormal return (CAR_c). We plot separate quantile coefficients for firms that comply with the listing requirements ($D_\ Compl = 1$) and those that do not ($D_\ Non\text{-}Compl = 1$), respectively. The grey area denotes a 90% confidence interval around the point estimate. The solid horizontal line shows the OLS point estimate.

Table 1: Auditing Firm Characteristics

For the period 2003-2019, we count 109 audit firms auditing Chinese listed firms. A subsample of 93 auditors is licensed to prepare firm accounts for an IPO approval. Columns (1)-(3) distinguishe IPO-licensed and non-licensed auditors, respectively. A subsample of 74 licensed auditors is also eligible for presenting a senior partner as a candidate to the regulatory committee in charge of IPO approval, namely the Issuance Examination Committee (IEC). Columns (4)-(6) compare IEC-eligible and non-eligible licensed auditors, respectively. Among IEC-eligible auditors, we further distinguish IEC-selected and non-selected auditing firms, which do obtain (for at least one term) or never obtain regulatory representation on the IEC, respectively. We report auditor characteristics such as the average number of yearly firm audits (*Yearly Audits*$_a$), the average number of employees (*Employees*$_a$), the average audit value (*Audit Value*$_a$, measured in billions) of listed firms. Based on accounting objections by the 109 auditors on a total of 36,587 client audits, we infer the (unconditional) *Auditor Toughness*$_a$ for each accounting firm from the relative frequency of modified audit opinions, namely the number of modified audit opinions relative to the number of firm audits. Columns (3), (6), and (9) report differences with the (two-sided) t-tests for the respective difference in means. We mark statistical significance at the 10%, 5%, and 1% level by *, **, and ***, respectively.

Auditor Type:	All Auditors ($N = 109$)			IPO-Licensed Auditors ($N = 90$)			IEC-Eligible Auditors ($N = 74$)		
	IPO-Licensed?		Difference	IEC-Eligble?		Difference	IEC Selected?		Difference
	No	Yes	(2)-(1)	No	Yes	(5)-(4)	No	Yes	(8)-(7)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Averages									
Yearly Audits$_a$	10.6	37.1	26.5**	12.7	42.3	29.66**	20.8	52.7	31.9**
Employees$_a$	94.9	328.5	233.5**	111.9	372.4	260.5***	259.2	426.7	167.5**
Audit Value$_a$	24.2	1151.7	1127.5	37.8	1392.5	1354.8	140.7	1993.5	1852.8
Auditor Toughness$_a$	0.1	0.1	0.0	0.1	0.1	−0.0	0.2	0.1	−0.1**
Observations	19	90		16	74		24	50	

Table 2: Summary Statistics on IPO Candidates Firms

In Panel A, we document the firm characteristics of 2,965 IPO candidates; in Panel B the post-IPO stock performance of 2,336 successfully listed firms in the first year of their listing. The accounting information prior to the IPO approval decision includes the firm's return on assets ($ROA_{c,t}$) and its (log) asset size ($Log\ Assets_{c,t}$) in RMB millions, firm leverage ($Leverage_c$), a dummy variable marking listings for the ChiNext board ($D_\ ChiNext_{c,t} \in \{0,1\}$), and a dummy variable for state-owned enterprises ($D_\ SOE_{c,t}$). The dummy variable $D_\ IEC\text{-}Auditor_c$ marks any IPO candidate firm c that has an auditor with IEC representation. The dummy $D_\ IPO\text{-}Approval_c$ marks successful IPO approval decisions by the IEC. We distinguish firms *not* in compliance with the standard listing requirements for an IPO ($D_\ Non\text{-}Compl_c$ = 1, and 0 otherwise) and those that are in compliance ($D_\ Compl_c$ = 1, and 0 otherwise). For all listed firms in Panel B, we document the post-IPO performance measured as cumulative abnormal return over two years (*CAR2*) or buy and hold abnormal return over two years (*BHAR2*), respectively. Starting from the (end of) day five after the listing ($d = 5$), we define $CAR2_c = \sum_{d=5}^{5+504}(Daily\ return_{c,d} - Benchmarkreturn_d)$ and $BHAR2_c = \prod_{d=5}^{5+504}(1 + Daily\ return_{c,d}) - \prod_{d=5}^{5+504}(1 + Benchmarkreturn_d)$ for 252 trading days within a year. We use matched benchmark portfolio return series constructed from all A-listed Chinese stocks grouped yearly by size into quantiles, and industry respectively. The last row reports the change in the return on assets (ΔROA) from before the IPO to two years later.

	Obs.	Mean	Min	Median	Max	SD
	(1)	(2)	(3)	(4)	(5)	(6)
Panel A: IPO Candidate Firms						
ROA_c	2,855	0.144	0.0097	0.129	0.429	0.0820
$Log\ Assets_c$	2,893	20.43	18.57	20.17	26.04	1.276
$Leverage_c$	2,893	0.456	0.0834	0.454	0.927	0.177
$D_\ ChiNext_c$	2,965	0.330	0	0	1	0.470
$D_\ SOE_c$	2,954	0.191	0	0	1	0.393
$D_\ IEC\text{-}Auditor_c$	2,965	0.192	0	0	1	0.394
$D_\ IPO\text{-}Approval_c$	2,965	0.808	0	1	1	0.394
$D_\ Compl_c$	2,750	0.855	0	1	1	0.352
$D_\ Non\text{-}Compl_c$	2,750	0.145	0	0	1	0.352
Panel B: Two-Year Abnormal Return and Profitability Change Around IPO						
$CAR2_c$	2,336	0.117	−2.700	0.050	3.264	0.687
$BHAR2_c$	2,336	0.005	−9.388	−0.100	11.857	1.001
ΔROA_c	2,341	−0.074	−0.751	−0.057	0.273	0.077

Table 3: IEC Selection and Auditing Firm Statistics

We document the annual selection of auditing firm representatives into the Issuance Examination Committee (IEC) in charge of recommending IPO approvals. For each IEC-eligible auditor, we measure *Auditor Toughness* based on the relative frequency of accounting objections expressed in 34,459 client audits, namely as the ratio of accounting objections to the number of client audits. By committee term, we tabulate for auditors selected into the IEC and those not selected into the IEC, namely the averages for *Auditor Toughness* in Columns (3) and (5), respectively. Before 2017, the main board (Main) and the ChiNext board (ChiNext) operated separate issuance examination committees, but in 2017 both committees were merged into one. A repeated creation year means that the entire IEC was reconfirmed for a second (or even third) term and all IEC members were retained. The last row provides the pooled statistics over all years. Columns (11)-(14) report differences with (two-sided) t-tests for the respective difference in means. We mark statistical significance at the 10%, 5%, and 1% level by *, **, and ***, respectively.

		Eligible firms selected into IEC		Eligible firms *not* selected into IEC		Differences
Committee	Creation Year	Obs.	*Auditor Toughness*	Obs.	*Auditor Toughness*	(3)-(5)
	(1)	(2)	(3)	(4)	(5)	(6)
6th IEC Main	2003	5	0.049	23	0.081	−0.032
7th IEC Main	2004	5	0.062	5	0.074	−0.012
8th IEC Main	2004	5	0.062	5	0.074	−0.012
9th IEC Main	2007	9	0.128	21	0.079	0.049
10th IEC Main	2008	9	0.068	15	0.114	−0.046*
11th IEC Main	2008	9	0.068	15	0.114	−0.046*
12th IEC Main	2010	9	0.071	13	0.095	−0.025
13th IEC Main	2011	9	0.069	6	0.063	0.006
14th IEC Main	2012	9	0.045	9	0.098	−0.053*
15th IEC Main	2012	9	0.045	9	0.098	−0.053*
16th IEC Main	2012	9	0.045	9	0.098	−0.053*
1st IEC ChiNext	2009	14	0.075	24	0.135	−0.061
2nd IEC ChiNext	2009	14	0.075	24	0.135	−0.061
3rd IEC ChiNext	2011	14	0.065	13	0.073	−0.008
4th IEC ChiNext	2012	13	0.062	9	0.076	−0.014
5th IEC ChiNext	2012	13	0.062	9	0.076	−0.014
6th IEC ChiNext	2012	13	0.062	9	0.076	−0.014
17th IEC Comb.	2017	3	0.065	24	0.061	0.005
All committees	Pooled	171	0.069	242	0.098	−0.029***

Table 4: Commissioner Choice and Auditor Toughness

For 36,587 annual certified accounts of Chinese listed companies, we identify with a dummy variable equal to one any *Modified Audit Opinion* for company c in year t and regress this dummy on three dummy variables equal to 1 (and 0 otherwise) (i) if the head accountant certifying the corporate accounts personally serves (in any year) on the IEC as a commissioner ($D_IEC\ Commissioner_{c,t}$), (ii) if the auditing firm is at any time represented (by any audit firm member) on the IEC ($D_IEC\ Auditor_{c,t}$), and (iii) if the auditing firm is eligible for such representation ($D_IEC\ Eligible\ Auditor_{c,t}$). The control variables include a firm's return on assets ($ROA_{c,t}$) and its (log) asset size ($Log\ Assets_{c,t}$) in RMB, firm leverage ($Leverage_{c,t}$), account receivables relative to assets ($Receivables_{c,t}$), the inventory ratios ($Inventory_{c,t}$), the current ratio ($Current\ Ratio_{c,t}$), a dummy for negative income in three consecutive years ($D_Loss_{c,t}$), a, dummy for a listing age of more than three years ($D_Listing\ Age_{c,t}$), a dummy variable marking listings for the ChiNext board ($D_ChiNext_c$), and a dummy variable for state-owned enterprises (D_SOE_c). ***, **, and * denote the 1%, 5%, and 10% significance level, respectively.

Dep. variable:	*Modified Audit Opinion*$_{c,t} \in \{0,1\}$						
	OLS	OLS	OLS	OLS	OLS	OLS	Logit
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
$D_IEC\ Commissioner_{c,t}$	0.002	0.003	−0.003	−0.003	−0.010*	−0.003	0.039
	(0.17)	(0.46)	(−0.49)	(−0.44)	(−1.88)	(−0.55)	(0.30)
$D_IEC\ Auditor_{c,t}$	−0.041***	−0.012*	−0.002	−0.002	0.005	−0.001	−0.077
	(−4.30)	(−1.70)	(−0.29)	(−0.29)	(0.97)	(−0.19)	(−0.52)
$D_IEC\ Eligible\ Auditor_{c,t}$	0.011	0.000	0.014*	0.038***	0.027***	0.020***	0.587***
	(0.82)	(0.04)	(1.76)	(4.22)	(4.72)	(3.33)	(3.20)
Controls							
$ROA_{c,t}$				−0.578***	−0.650***	−0.623***	−5.186***
				(−12.05)	(−13.53)	(−12.94)	(−13.17)
$Log\ Assets_{c,t}$				−0.040***	−0.043***	−0.061***	−0.715***
				(−18.19)	(−18.13)	(−17.66)	(−19.55)
$Leverage_{c,t}$				0.358***	0.364***	0.378***	4.230***
				(17.01)	(16.39)	(17.66)	(19.41)
$Receivables_{c,t}$				−0.142***	−0.098***	−0.115***	−1.394***
				(−7.43)	(−2.90)	(−3.29)	(−2.76)
$Inventory_{c,t}$				−0.196***	−0.295***	−0.273***	−2.670***
				(−16.63)	(−11.02)	(−10.17)	(−8.45)
$Current\ Ratio_{c,t}$				0.010***	0.008***	0.008***	0.103***
				(11.52)	(8.15)	(8.06)	(5.33)
$D_Loss_{c,t}$				0.092***	0.050***	0.048***	0.895***
				(11.13)	(6.67)	(6.54)	(11.03)
$D_Listing\ Age_{c,t}$				0.023***	0.020***	0.009***	1.556***
				(8.92)	(6.73)	(3.18)	(7.11)
$D_ChiNext_c$				−0.014***			−0.603***
				(−4.07)			(−3.70)
D_SOE_c				−0.021***			−0.101
				(−4.82)			(−0.44)
Industry FEs	No	No	No	No	No	No	Yes
Client Firm FEs	No	Yes	Yes	No	Yes	Yes	No
Year FEs	No	No	Yes	No	No	Yes	Yes
Adjusted R^2	0.003	0.331	0.336	0.272	0.458	0.463	
Observations	36,587	36,479	36,479	36,583	36,475	36,475	36,583

Table 5: Auditor Choice and IEC Representation

We use OLS and Logit regressions to explain the choice by 3,636 listed Chinese firms and 2,965 pre-IPO firms between all auditors with or without representation on the Issuance Examination Committee (IEC). We consider all dyadic combinations of firm-years and auditors and define as dependent (dummy) variable $D_IEC\ Auditor_{a,c,t} = 1$ (and 0 otherwise) if and only if the auditor a is selected by corporation c in year t and has IEC representation in year t. The dummy variable $D_Pre\text{-}IPO_{c,t}$ marks firm-years without a listing. For all pre-IPO firms, we distinguish firms *not* in compliance with the standard listing requirements for an IPO ($D_Non\text{-}Compl_{c,t} = 1$, and 0 otherwise) and those that are in compliance ($D_Compl_{c,t} = 1$, and 0 otherwise). The control variables include a firm's return on assets ($ROA_{c,t}$) and its (log) asset size ($Log\ Assets_{c,t}$) in RMB, firm leverage ($Leverage_{c,t}$), a dummy variable marking listings for the ChiNext board ($D_ChiNext_{c,t}$), and a dummy variable for state-owned enterprises ($D_SOE_{c,t}$). Firms marked by the dummy D_Bribe_c are involved (as revealed ex post) in corruption charges related to the IPO process. ***, **, and * denote the 1%, 5%, and 10% significance level, respectively.

Dep. variable:	$D_IEC\ Auditor_{a,c,t} \in \{0,1\}$					
	Pre-IPO and Listed Firms			Pre-IPO Firms		
	OLS	OLS	Logit	OLS	OLS	Logit
	(1)	(2)	(3)	(4)	(5)	(6)
$D_Pre\text{-}IPO_c$	0.006**					
	(2.62)					
$D_Pre\text{-}IPO_c \times D_Compl_c$		0.002	0.018			
		(0.77)	(0.60)			
$D_Pre\text{-}IPO_c \times D_Non\text{-}Compl_c$		0.035***	0.332***	0.042***	0.033***	0.272***
		(5.57)	(5.53)	(5.39)	(4.26)	(4.29)
Controls						
$ROA_{c,t}$	−0.000**	−0.000**	−0.000**		0.207***	1.724***
	(−2.61)	(−2.60)	(−2.22)		(5.90)	(5.73)
$Log\ Assets_{c,t}$	−0.006***	−0.006***	−0.070***		−0.010***	−0.095***
	(−4.11)	(−4.09)	(−4.07)		(−3.17)	(−3.24)
$Leverage_{c,t}$	−0.000	−0.000	−0.001		0.112***	1.028***
	(−1.39)	(−1.36)	(−0.89)		(7.00)	(6.50)
$D_ChiNext_{c,t}$	−0.007**	−0.008**	−0.098**		0.016**	0.123**
	(−2.37)	(−2.58)	(−2.55)		(2.36)	(2.16)
$D_SOE_{c,t}$	0.009***	0.009***	0.113***		0.004	0.038
	(5.64)	(5.61)	(5.65)		(0.93)	(0.89)
Industry FEs	Yes	Yes	Yes	Yes	Yes	Yes
Auditor FEs	Yes	Yes	Yes	Yes	Yes	Yes
Missing Data FEs	Yes	Yes	Yes	Yes	Yes	Yes
Adjusted R^2	0.009	0.010		0.012	0.016	
Observations	4,301,685	4,301,685	4,301,140	266,850	256,140	255,960

Table 6: IPO Approval and IEC Representation

We report OLS and Logit regressions exploring the role of auditor representation on the Issuance Examination Committee (IEC) for the success of the IPO approval. The sample consists 2,965 corporations seeking a listing between 2003 and 2019, of which 568 failed the review by the IEC ($D_IPO\text{-}Approval_c = 0$) and 2,397 corporations passed successfully ($D_IPO\text{-}Approval_c = 1$). We use a dummy variable $D_IEC\text{-}Auditor_c = 1$ to denote firms that have chosen an auditing firm represented on IEC in the year of the approval decision and $D_IEC\ Auditor_c = 0$ for firms with auditing firms without such supervisory representation. The dummy variables D_Compl_c and $D_Non\text{-}Compl_c$ mark pre-IPO firms in compliance or not with the listing requirements for an IPO, respectively. The control variables (measured just before the IPO date) include a firm's return on assets (ROA_c) and its (log) asset size ($Log\ Assets_c$) in RMB, firm leverage ($Leverage_c$), a dummy variable marking listings for the ChiNext board ($D_ChiNext_c$), and a dummy variable for state-owned enterprises (D_SOE_c). Firms marked by the dummy D_Bribe_c are involved (as revealed ex post) in corruption charges related to the IPO process. ***, **, and * denote the 1%, 5%, and 10% significance level, respectively. The average marginal effect for $D_IEC\ Auditor_c$ in Column (3) is 2.42% and the average marginal effect for $D_IEC\ Auditor_c \times D_Non\text{-}Compl_c$ in Column (6) is 7.14%.

Dep. variable:	$D_IPO\text{-}Approval_c \in \{0,1\}$					
	OLS	OLS	Logit	OLS	OLS	Logit
	(1)	(2)	(3)	(4)	(5)	(6)
$D_IEC\ Auditor_c$	0.021	0.022	0.245*			
	(1.42)	(1.65)	(1.78)			
$D_IEC\ Auditor_c \times D_Compl_c$				0.010	0.012	0.146
				(0.66)	(0.83)	(1.04)
$D_IEC\ Auditor_c \times D_Non\text{-}Compl_c$				0.072***	0.072***	0.725**
				(2.73)	(2.70)	(2.25)
Controls						
$D_Non\text{-}Compl_c$		0.001	−0.010		−0.014	−0.124
		(0.04)	(−0.06)		(−0.73)	(−0.81)
ROA_c		0.151*	1.778**		0.152*	1.754**
		(1.98)	(2.20)		(1.98)	(2.18)
$Log\ Assets_c$		0.040***	0.505***		0.039***	0.501***
		(6.06)	(5.73)		(5.97)	(5.66)
$Leverage_c$		−0.125***	−1.368***		−0.123***	−1.352***
		(−2.93)	(−3.04)		(−2.87)	(−3.00)
$D_ChiNext_c$		−0.226***	−0.931***		−0.227***	−0.933***
		(−6.39)	(−4.92)		(−6.44)	(−4.96)
D_SOE_c		0.005	0.055		0.006	0.059
		(0.33)	(0.34)		(0.37)	(0.36)
D_Bribe_c		0.118***	1.688**		0.114***	1.655**
		(3.51)	(2.34)		(3.39)	(2.28)
Industry FEs	Yes	Yes	Yes	Yes	Yes	Yes
Year FEs	Yes	Yes	Yes	Yes	Yes	Yes
Missing Data FEs	Yes	Yes	Yes	Yes	Yes	Yes
Adjusted R^2	0.309	0.300		0.309	0.301	
Observations	2,964	2,845	2,802	2,964	2,845	2,802

Table 7: Conflict of Interest and Post-IPO Performance

We report OLS regressions on the long-run IPO performance of 2,303 listed Chinese stocks as a function of potential conflicts of interest of their auditors during the IPO approval process. Post-IPO performance is measured in Columns (1)-(4) as the two-year cumulative abnormal return ($CAR2_c$) or in Columns (1)-(2) and as the two-year buy and hold abnormal return ($BHAR2_c$) in Columns (3)-(4), respectively. We use a dummy variable $D_IEC\ Auditor_c = 1$ to denote firms that have chosen an auditing firm represented on IEC in the year of the approval decision and $D_IEC\ Auditor_c = 0$ for firms with auditing firms without such supervisory representation. The dummy variables D_Compl_c and $D_Non\text{-}Compl_c$ mark pre-IPO firms in compliance or not with the listing requirements for an IPO, respectively. The control variables include a firm's return on assets (ROA_c) and its (log) asset size ($Log\ Assets_c$) in RMB, firm leverage ($Leverage_c$), a dummy variable marking listings for the ChiNext board ($D_ChiNext_c$), and a dummy variable for state-owned enterprises (D_SOE_c). Firms marked by the dummy D_Bribe_c are involved (as revealed ex post) in corruption charges related to the IPO process. ***, **, and * denote the 1%, 5%, and 10% significance level, respectively.

Dep. variable:	Cumulative Abnormal Return ($CAR2_c$)		Buy and Hold Abnormal Return ($BHAR2_c$)	
	OLS	OLS	OLS	OLS
	(1)	(2)	(3)	(4)
$D_IEC\ Auditor_c$	−0.036		−0.117*	
	(−0.99)		(−1.75)	
$D_IEC\ Auditor_c \times D_Compl_c$		−0.010		−0.055
		(−0.27)		(−0.78)
$D_IEC\ Auditor_c \times D_Non\text{-}Compl_c$		−0.154**		−0.395***
		(−2.12)		(−2.87)
Controls				
$D_Non\text{-}Compl_c$	−0.118***	−0.082**	−0.081	0.002
	(−3.55)	(−2.02)	(−1.29)	(0.02)
ROA_c	−0.938***	−0.937***	−0.949**	−0.948***
	(−4.33)	(−4.34)	(−2.63)	(−2.64)
$Log\ Assets_c$	−0.043***	−0.043***	0.031	0.032
	(−2.76)	(−2.72)	(1.51)	(1.58)
$Leverage_c$	−0.031	−0.037	−0.004	−0.016
	(−0.38)	(−0.45)	(−0.04)	(−0.15)
$D_ChiNext_c$	0.176***	0.177***	0.262***	0.263***
	(5.44)	(5.40)	(4.48)	(4.43)
D_SOE_c	0.099***	0.098***	0.109*	0.106
	(2.93)	(2.88)	(1.66)	(1.61)
D_Bribe_c	0.079	0.087	0.098	0.117
	(1.32)	(1.45)	(0.55)	(0.66)
Industry FEs	Yes	Yes	Yes	Yes
Year FEs	Yes	Yes	Yes	Yes
Missing Data FEs	Yes	Yes	Yes	Yes
Adjusted R^2	0.384	0.385	0.264	0.265
Observations	2,303	2,303	2,303	2,303

Table 8: Quantile Regressions for Stock Returns

We report quantile regressions for quantiles $q = 0.10, 0.25, 0.50, 0.75, 0.90$ for the long-run (two-year) IPO performance of 2,303 listed Chinese stocks as a function of potential conflicts of interest of their auditors during the IPO approval process. Post-IPO performance is measured as the two-year cumulative abnormal return, which is defined as $CAR2_c = \sum_{d=5}^{5+508}(Daily\ return_{c,d} - Benchmarkreturn_d)$. We use a dummy variable $D_IEC\ Auditor_c = 1$ to denote corporations c that have chosen an auditor represented on IEC in the year of the approval decision and $D_IEC\ Auditor_c = 0$ for firms with auditing firms without such supervisory representation. The dummy variables D_Compl_c and $D_Non\text{-}Compl_c$ mark pre-IPO firms in compliance or not with the listing requirements for an IPO, respectively. The control variables (based on accounting data directly prior to the IPO) include a firm's return on assets (ROA_c) and its (log) asset size ($Log\ Assets_c$) in RMB, firm leverage ($Leverage_c$), a dummy variable marking listings for the ChiNext board ($D_ChiNext_c$), and a dummy variable for state-owned enterprises (D_SOE_c). Firms marked by the dummy D_Bribe_c are involved (ex post) in corruption charges related to the IPO process. ***, **, and * denote the 1%, 5%, and 10% significance level, respectively.

Dep. variable:	Cumulative Abnormal Return ($CAR2_c$)				
Quantile:	$q = 0.10$	$q = 0.25$	$q = 0.50$	$q = 0.75$	$q = 0.90$
	(2)	(3)	(4)	(5)	(6)
$D_IEC\ Auditor_c \times D_Compl_c$	0.039	0.028	0.019	0.010	−0.079***
	(1.23)	(0.83)	(0.61)	(0.30)	(−2.74)
$D_IEC\ Auditor_c \times D_Non\text{-}Compl_c$	0.144	0.017	−0.135**	−0.159***	−0.311***
	(0.89)	(0.23)	(−2.02)	(−4.84)	(−5.87)
Controls					
$D_Non\text{-}Compl_c$	−0.229***	−0.168***	−0.057	−0.100***	−0.055
	(−7.51)	(−2.59)	(−1.08)	(−2.94)	(−1.64)
ROA_c	−1.201***	−1.184***	−1.057***	−0.535***	−0.201
	(−11.86)	(−6.54)	(−6.23)	(−2.85)	(−0.83)
$Log\ Assets_c$	−0.055***	−0.052***	−0.059***	−0.028*	0.007
	(−4.63)	(−3.72)	(−5.33)	(−1.91)	(0.37)
$Leverage_c$	−0.047	−0.127	−0.037	−0.031	−0.002
	(−0.55)	(−1.23)	(−0.40)	(−0.32)	(−0.02)
$D_ChiNext_c$	0.102***	0.147***	0.143***	0.217***	0.187***
	(4.07)	(4.42)	(4.38)	(7.50)	(4.99)
D_SOE_c	0.171***	0.134***	0.104***	0.083***	0.033
	(5.58)	(4.56)	(3.42)	(2.93)	(1.33)
D_Bribe_c	0.134**	−0.010	0.186	−0.021	0.253***
	(2.32)	(−0.18)	(1.49)	(−0.32)	(4.52)
Industry FEs	Yes	Yes	Yes	Yes	Yes
Year FEs	Yes	Yes	Yes	Yes	Yes
Missing Data FEs	Yes	Yes	Yes	Yes	Yes
Pseudo R^2	0.224	0.219	0.235	0.255	0.255
Observations	2,303	2,303	2,303	2,303	2,303

Table 9: Quantile Regressions for Change in Profitability

We report quantile regressions for quantiles $q = 0.10, 0.25, 0.50, 0.75, 0.90$ for the long-run (two-year) change in return on assets (ΔROA_c) around the IPO event. We use a dummy variable $D_IEC\ Auditor_c = 1$ to denote corporations c that have chosen an auditor represented on IEC in the year of the approval decision and $D_IEC\ Auditor_c = 0$ for firms with auditing firms without such supervisory representation. The dummy variables D_Compl_c and $D_Non\text{-}Compl_c$ mark pre-IPO firms in compliance or not with the listing requirements for an IPO, respectively. The control variables (based on accounting data directly prior to the IPO) include a firm's return on assets (ROA_c) and its (log) asset size ($Log\ Assets_c$) in RMB, firm leverage ($Leverage_c$), a dummy variable marking listings for the ChiNext board ($D_ChiNext_c$), and a dummy variable for state-owned enterprises (D_SOE_c). Firms marked by the dummy D_Bribe_c are involved (ex post) in corruption charges related to the IPO process. ***, **, and * denote the 1%, 5%, and 10% significance level, respectively.

Dep. variable:	Two-Year Change in Return on Assets (ΔROA_c)				
Quantile:	$q = 0.10$	$q = 0.25$	$q = 0.50$	$q = 0.75$	$q = 0.90$
	(2)	(3)	(4)	(5)	(6)
$D_IEC\ Auditor_c \times D_Compl_c$	0.008	0.003	0.002	−0.003	−0.001
	(1.24)	(0.86)	(0.96)	(−1.26)	(−0.41)
$D_IEC\ Auditor_c \times D_Non\text{-}Compl_c$	0.003	0.006	−0.001	−0.005	−0.012***
	(0.15)	(0.88)	(−0.34)	(−1.32)	(−2.87)
Controls					
$D_Non\text{-}Compl_c$	0.016***	0.001	−0.003	−0.005**	−0.002
	(2.95)	(0.16)	(−1.18)	(−2.50)	(−0.61)
$Log\ Assets_c$	−0.000	0.002	0.006***	0.009***	0.011***
	(−0.10)	(1.05)	(6.95)	(7.87)	(15.94)
$Leverage_c$	0.218***	0.167***	0.117***	0.079***	0.061***
	(12.78)	(14.22)	(16.20)	(12.50)	(11.20)
$D_ChiNext_c$	−0.040***	−0.020***	−0.013***	−0.009***	−0.005
	(−5.57)	(−5.13)	(−5.60)	(−4.22)	(−1.50)
D_SOE_c	0.007	0.017***	0.015***	0.009***	0.005**
	(1.27)	(4.33)	(8.36)	(6.14)	(2.38)
D_Bribe_c	0.038*	−0.003	−0.001	−0.008	−0.008*
	(1.75)	(−0.43)	(−0.19)	(−0.84)	(−1.77)
Industry FEs	Yes	Yes	Yes	Yes	Yes
Year FEs	Yes	Yes	Yes	Yes	Yes
Missing Data FEs	Yes	Yes	Yes	Yes	Yes
Pseudo R^2	0.254	0.246	0.222	0.182	0.138
Observations	2,333	2,333	2,333	2,333	2,333

Internet Appendix

Discretionary Administrative Power and Conflicts of Interest in China's IPO Approvals

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July 23, 2024

Appendix A: Listing Requirements by Market

The **main board listing requirements** published by the CSRC in May 2006 under the title "Measures for the Administration of Initial Public Offering and Listing of Stocks" are as follows:

1. A net profit of over RMB 30 million accumulated over the previous three years, where the non-regular profits or losses are included;
2. A net cash flow of over RMB 50 million accumulated over the previous three years, **or** a business income of over RMB 300 million accumulated over the previous three years;
3. A total capital stock of at least RMB 30 million before issuance;
4. A proportion of intangible assets (upon deduction of land and mining use rights) of no more than 20% of net assets;
5. No uncovered deficit in the previous year.

The **ChiNext board listing requirements** published by the CSRC in January 2009 under the title "Administrative Measures for Initial Public Offerings and Listing on the Second Board" are as follows:

1. Positive profitability in the last two years prior to the listing, and accumulative net profits over the last two years of at least RMB 10 millions *with continuous growth*, **or** a profit in the last year *and a net profit of at least RMB 5 millions in the previous year* and a business income in the previous year of at least RMB 50 millions *and a growth rate of business income in the last two years of at least 30%*. The net profit is calculated on the basis of the amount before or after deducting the non-recurring profits and losses, whichever is smaller.
2. A net assets value of at least RMB 20 millions and no loss to cover in the previous year.
3. A total capital stocks of at least RMB 30 millions in the previous year.

The China Securities Regulatory Committee (CSRC) amended the listing requirements for the ChiNext board in 2014. The part of the text in *Italics* was removed from the listing requirements.

Appendix B: Additional Evidence

Table B1: IPO Approval Statistics by Auditor Type

We document the rejection rate of listing compliant and non-compliant IPO candidates by auditor type. Columns (1)-(3) and Columns (3)-(6) document the IPO rejections and approval for auditors with and without IEC representation, respectively. We exclude 215 out of 2,965 IPO candidates for which listing compliance (or non-compliance) cannot be established because of missing accounting data.

Auditor Type:	With IEC Representation ($D_IEC\ Auditor_c = 1$)			Without IEC Representation ($D_IEC\ Auditor_c = 0$)		
Listing Compliance:	Yes	Non	All	Yes	Non	All
	(1)	(2)	(3)	(4)	(5)	(6)
$D_IPO\text{-}Approval_c$						
$= 0$ (rejection)	63	9	72	248	48	296
$= 1$ (approval)	371	91	462	1,669	251	1.920
All	434	100	534	1,917	299	2,216
Rejection Rate	0.145	0.090	0.134	0.129	0.161	0.134

Table B2: Underwriter Choice and Listing Requirement Compliance

We use OLS regressions to explain the choice by 2,965 IPO candidate firms between 148 underwriters of different reputation. Underwriter reputation is measured alternatively as (i) the market share $Udwrep1_{u,c}$ of underwrite u in all (public and private) issuances in the year prior to the IPO candidacy for client c, (ii) the market share $Udwrep2_{u,c}$ based solely on public issuances, or (iii) a dummy variable $Udw_Rank_{u,c}$ equal to 1 (and 0 otherwise) if the underwriter u ranks in the top 5% in terms of market share by either $Udwrep1_{u,c}$ or $Udwrep2_{u,c}$. The three dependent variables are constructed for all dyadic combinations of pre-IPO firms c and underwriters u. We distinguish firms *not* in compliance with the standard listing requirements for an IPO ($D_Non\text{-}Compl_c = 1$, and 0 otherwise) and those which are in compliance ($D_Compl_c = 1$, and 0 otherwise). The control variables measured in the year of the IPO candidacy include a firm's return on assets (ROA_c) and its (log) asset size ($Log\ Assets_c$) in RMB, firm leverage ($Leverage_c$), a dummy variable marking listings for the ChiNext board ($D_ChiNext_c$), and a dummy variable for state-owned enterprises (D_SOE_c). Firms marked by the dummy D_Bribe_c are involved (as revealed ex post) in corruption charges related to the IPO process. ***, **, and * denote the 1%, 5%, and 10% significance level, respectively.

Dep. variable:	$Udwrep1_{u,c}$		$Udwrep2_{u,c}$		$Udw_Rank_{u,c} \in \{0,1\}$	
	OLS (1)	OLS (2)	OLS (4)	OLS (5)	OLS (5)	OLS (6)
$D_Non\text{-}Compl_c$	0.001	0.000	0.001	0.001	0.003	0.003
	(0.39)	(0.43)	(0.41)	(0.44)	(0.81)	(0.88)
Controls						
ROA_c		0.002		0.002		0.021
		(0.22)		(0.23)		(1.01)
$Log\ Assets_c$		−0.000		−0.000		−0.001
		(−0.34)		(−0.33)		(−0.66)
$Leverage_c$		0.002		0.002		0.010
		(0.40)		(0.40)		(0.70)
$D_ChiNext_{c,t}$		−0.000		−0.000		−0.002
		(−0.63)		(−0.61)		(−0.67)
D_SOE_c		0.000		0.000		0.001
		(0.22)		(0.19)		(0.35)
Industry FEs	Yes	Yes	Yes	Yes	Yes	Yes
Underwriter FEs	Yes	Yes	Yes	Yes	Yes	Yes
Missing Data FEs	Yes	Yes	Yes	Yes	Yes	Yes
Adjusted R^2	0.498	0.498	0.497	0.497	0.327	0.331
Observations	124,990	118,797	124,990	118,797	438,820	421,208

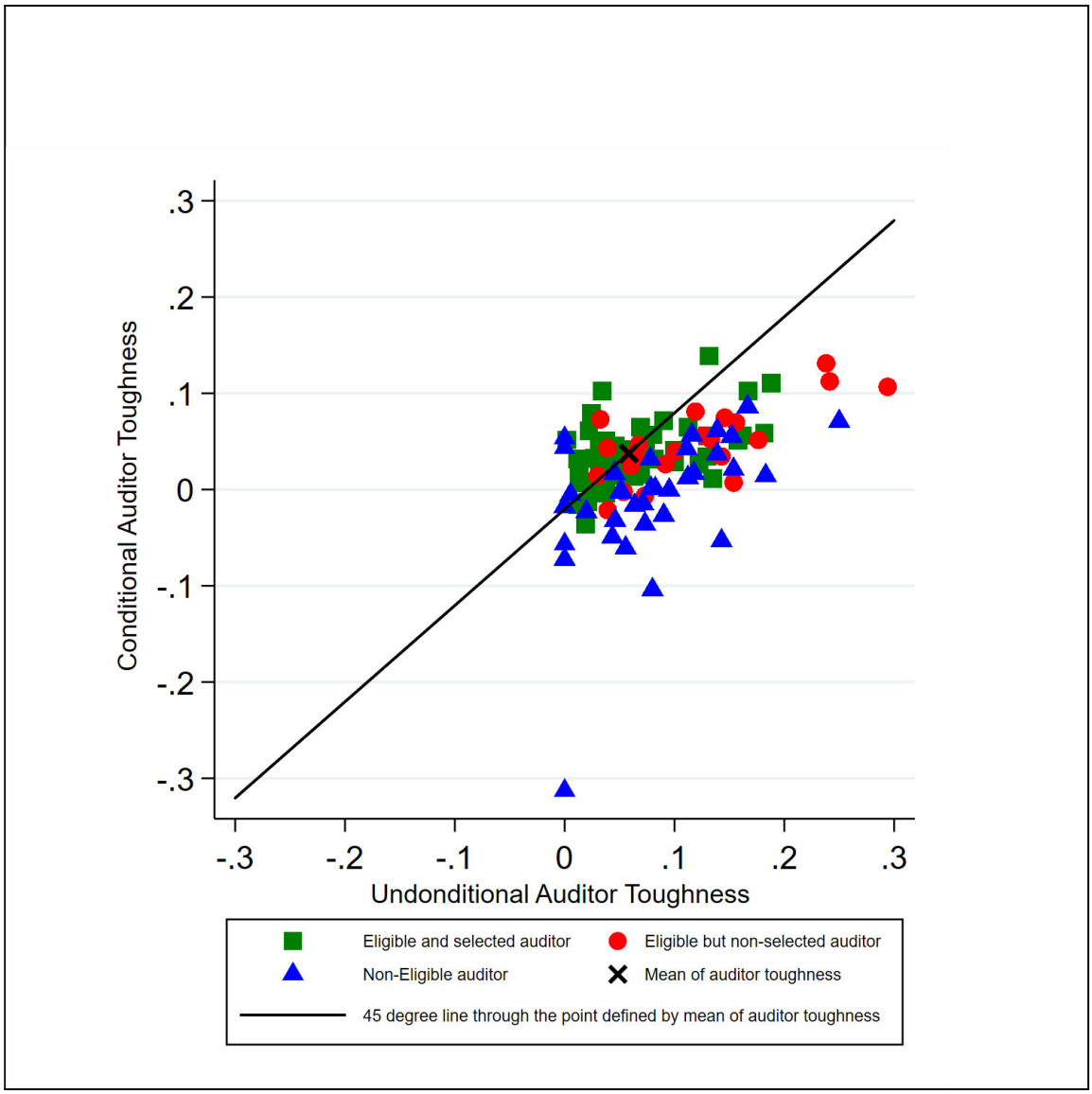


Figure 1: We plot the *Conditional Audit Firm Toughness* against the (unconditional) *Audit Firm Toughness* by auditor type. The control variables are the same as in Table 4.