Do Blockades to PCAOB Inspections Suggest Lower Audit Quality?
The Case of Chinese Companies Listed in the U.S.

Abstract

Recently, the SEC adopted rules for the Holding Foreign Companies Accountable Act which bars trading of securities of companies whose auditors are not inspected by the PCAOB. Currently, the PCAOB is unable to inspect the audit work papers of Chinese audit firms that audit U.S.-listed Chinese companies with a total market capitalization of about $2 trillion as of May 2021. Using a sample of 439 pairs of Chinese and U.S. companies matched on industry, company size, and year, we do not observe a significant difference across multiple audit quality proxies. Further, the proportion of companies audited by the Big 4 auditors is higher for the U.S.-listed Chinese companies than their U.S. counterparts. We also find that earnings informativeness is marginally higher for U.S.-listed Chinese companies. Overall, our findings suggest that the lack of inspection by the PCAOB does not result in lower audit quality. Our finding of insignificant differences in audit quality between U.S.-listed Chinese companies and U.S. companies could be due to greater audit efforts by Chinese auditors to bridge the perception gap in audit quality resulting from the lack of inspections by the PCAOB.

Keywords: *PCAOB inspections; China; earnings quality; audit quality; ERC.*

"Robust inspections and investigations of registered public accounting firms auditing U.S. public companies are core to the PCAOB's mandate under the Sarbanes-Oxley Act. This is true whether such firms are located inside or outside of the United States."

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1 Introduction

The mission of the Public Company Accounting Oversight Board (PCAOB) is to protect investors through informative, accurate, and independent audit reports (Duhnke 2020). To fulfill this mission, the PCAOB conducts inspections of U.S. audit firms as well as non-U.S. audit firms registered with the PCAOB.[1] The PCAOB has inspected non-U.S. registered audit firms since 2005 in over 50 non-U.S. jurisdictions with the exception of China. This also includes Hong Kong-based audit firms that performed audits of U.S.-listed Hong Kong companies.[2] This begs the question what are the audit quality implications of the obstacles to inspect PCAOB-registered Chinese audit firms? The primary objective of this study is to examine whether the Chinese companies listed in the U.S. whose auditors are not inspected by the PCAOB have lower audit quality than U.S. companies. We also examine whether earnings informativeness varies between U.S.-listed Chinese companies and U.S. companies to shed light on investors' perception of audit quality of U.S.-listed Chinese companies.

Our study has several motivations. First, as of May 2021, there were 248 Chinese companies listed on U.S. stock exchanges with a total market capitalization of $2.1 trillion or about

[1] Under Section 106(a) of the Sarbanes-Oxley Act of 2002 (SOX), foreign public accounting firms that provide audit reports for U.S. issuers are required to register with the PCAOB and are subject to PCAOB inspections in the same manner as U.S. registered firms. Firms located in foreign jurisdictions are inspected to assess their compliance with the Sarbanes-Oxley Act, the rules of the Board, the rules of the Securities and Exchange Commission (SEC), and professional standards in connection with their performance of audits, issuance of audit reports, and related matters involving issuers and brokers and dealers. See https://pcaobus.org/oversight/inspections/non-us-firm-inspections.

[2] In 2013, the PCAOB signed a Memorandum of Understanding on audit oversight with the China Securities Regulatory Commission and the Ministry of Finance. However, currently, the Chinese government has prevented Chinese-based audit firms from complying with U.S. law on audit inspections (U.S.-China Economic and Security Review Commission 2021).

5 percent of total market capitalization of U.S. firms.[3] The significant presence of Chinese companies in U.S. exchanges reflects the fact that China is the largest emerging market economy and the world's second largest economy (Duhnke 2020). Thus, an analysis of audit quality of Chinese companies is important in its own right.

Second, accounting practices of Chinese companies have also caught the attention of regulators. Driven by concerns about Chinese reverse mergers (PCAOB 2011), in 2010, the House Financial Services Committee complained to the SEC about a general lack of rigor in the auditing of Chinese companies. In 2019, Luckin Coffee, dubbed "China's Starbucks", raised $561 million from its IPO launch on NASDAQ and had a peak market capitalization of $12 billion. However, it was revealed that the company manipulated revenue, operations and customer traffic data causing a collapse of its stock price and was delisted from NASDAQ.[4] Luckin Coffee's accounting scandal highlights risks faced by U.S. investors and others, especially when there is lack of oversight from the PCAOB.[5]

Finally, in December 2021, the SEC adopted rules for the Holding Foreign Companies Accountable Act (HFCAA) which bars trading of securities of companies whose auditors are not inspected for three consecutive years by the PCAOB (Gensler 2021). Also, foreign issuers will be required to disclose the level of foreign government ownership in those companies. This legislation was primarily aimed at U.S.-listed Chinese companies whose auditors are not inspected by the PCAOB. The fear of delisting of Chinese stocks has erased $1 trillion in value (Turner 2021). The potential exit of Chinese companies from U.S. exchanges could challenge the U.S.'s position as

[3] See https://www.uscc.gov/sites/default/files/2021-05/Chinese_Companies_on_U.S._Stock_Exchanges_5-2021.pdf.
[4] See https://www.uscc.gov/sites/default/files/2021-05/Chinese_Companies_on_U.S._Stock_Exchanges_5-2021.pdf.
[5] In addition, U.S. authorities face substantial difficulties in bringing enforcing actions against Chinese companies and persons, such as directors and officers of Chinese companies and similarly, U.S. investors have limited legal remedies, such as class action lawsuits in emerging markets, including China (Duhnke 2020).

the top choice for raising capital. The passing of HFCAA is consistent with the notion that U.S.-listed Chinese companies have lower audit quality than their U.S. counterparts. However, to the best of our knowledge, prior research has not systematically examined whether there is a significant difference in audit quality between U.S.-listed Chinese companies whose auditors are not inspected by the PCAOB and U.S. companies. Our goal is to inform members of the U.S. Congress, the SEC, and others by providing empirical evidence on the audit quality of U.S.-listed Chinese companies using multiple control groups and several measures of audit quality.

Ex ante, is not clear whether U.S.-listed Chinese companies have a lower audit quality than their U.S. counterparts. On the one hand, prior research finds that PCAOB inspections enhance financial reporting credibility and audit quality (Lamoreaux 2016; DeFond and Lennox 2017; Gipper et al. 2020; Lee et al. 2020). Thus, the lack of inspections of China-based auditors by the PCAOB suggests that the lack of monitoring could result in lower audit quality. On the other hand, the lack of inspections by the PCAOB does not necessarily imply lower audit quality for several reasons. Chinese companies listed on U.S. stock exchanges operate in the *same* financial reporting environment as their U.S. counterparts – compliance with U.S. GAAP and Sarbanes-Oxley Act, audits by the Big 4 auditors, greater exposure and scrutiny by information intermediaries, and a litigious environment. Prior research finds that companies cross-listed in the U.S. have less earnings management and report more conservatively than non-cross-listed firms (Lang et al. 2003), consistent with the "bonding hypothesis" (Coffee 2002). Further, given the impasse between the Chinese government and the PCAOB, auditors of U.S.-listed Chinese companies are incentivized to step up audit efforts to uphold audit quality in absence of inspections by the PCAOB. In particular, both the PCAOB and the SEC staff have met with representatives from the six largest U.S. audit firms to emphasize the importance of maintaining audit quality across their

global networks, including China. In addition, Chinese authorities have implemented several reforms with implications for accounting and auditing (see Section 2). For example, audit firms have been restructured from limited liability entities to special general partnerships. Prior research suggests that audit quality is enhanced when accounting firms assume unlimited liability (Chan and Pae 1998; Muzatko et al. 2004). Another example is the anti-corruption reform which has weakened the political connections of public companies and resulted in an increase in financial reporting quality (Hope et al. 2020). Thus, it is an empirical question whether there is a difference in audit quality between U.S.-listed Chinese companies and U.S. companies.

To examine the effect of the lack of inspections by the PCAOB on audit quality of U.S.-listed Chinese companies, we construct a sample of 439 pairs of Chinese (including Hong Kong-based) and U.S. companies matched on company size, industry, and year and conduct tests of differences in audit quality between the two groups of companies. We find that the proportions of U.S.-listed Chinese companies and the U.S. companies audited by the Big 4 auditors are, respectively, 80.6 percent and 67.7 percent.[6] Further, the mean value of audit fees over total assets is 0.002 for both the U.S.-listed Chinese companies and the U.S. companies (difference not significant at the 0.10 level), indicating that auditors spend similar efforts for both groups of companies. Across multiple audit quality proxies – absolute abnormal accruals, earnings predictability, accounting conservatism, meeting or beating of earnings benchmarks, and financial statement divergence score, we do not observe a significant difference between U.S.-listed Chinese companies and the U.S. companies. Further, though we find that the likelihood of a restatement is *lower* for U.S.-listed Chinese companies, suggesting higher audit quality, we acknowledge that less frequent restatements can be a sign of opportunistic reporting. We find some evidence that

[6] Auditors of Chinese companies in our sample are registered with the PCAOB.

investors perceive earnings of U.S.-listed Chinese companies to be *more* informative than the earnings of U.S. companies. We obtain consistent results by using two alternate control groups consisting of all U.S. companies and a sample of U.S.-listed Chinese companies whose auditors *are* inspected by the PCAOB, respectively. Finally, we find some evidence that accounting and auditing reforms by Chinese authorities have enhanced Chinese companies' audit quality.

Overall, our findings suggest that the lack of inspection by the PCAOB does not result in lower audit quality and that investors' do not perceive that lack of inspection impairs audit quality of U.S.-listed Chinese companies. Our finding of insignificant differences in audit quality between clients of Chinese auditors and clients of U.S. auditors could be due to greater audit efforts by Chinese auditors to bridge the perception gap in audit quality in absence of inspections by the PCAOB. However, we caution that despite using multiple proxies to measure audit quality, our measures are output-based and may not capture differences in audit quality at the audit input or process levels between U.S. and Chinese audit firms and thus, our findings do not suggest that inspections of Chinese audit firms of U.S.-listed Chinese companies are not needed.

Our study contributes to the literature on audit quality of Chinese firms (Ghosh et al. 2017) as well as the effect of PCAOB inspections on audit quality (Lamoreaux 2016; Dang et al. 2017; DeFond and Lennox 2017; Krishnan et al. 2017; Mohapatra et al. 2022) by providing empirical evidence that despite the lack of inspections by the PCAOB, audit quality of U.S.-listed clients of Chinese audit firms is similar to the audit quality of a sample of matched-clients of U.S. audit firms. Put it differently, our findings suggest that clients of U.S. audit firms that are inspected by the PCAOB do *not* exhibit higher quality relative to clients of Chinese audit firms. Our findings are important because prior research has not examined whether the PCAOB inspections enhance

audit quality of clients of U.S. audit firms.[7] This is because as Lamoreaux (2016, 313) states, "*a rigorous analysis of the impact of the inspection program on audit quality is difficult, as all auditors of public companies in the United States are subject to inspection and there is no variation in inspection access for the PCAOB*." Our setting allows us to use U.S.-listed Chinese companies whose auditors are not inspected by the PCAOB as counterfactuals to shed light on the impact of the PCAOB inspections on audit quality of clients of U.S. auditors. We believe our findings are relevant to the U.S. Congress, the PCAOB, the SEC, auditors, investors, and others who are interested in the audit quality of U.S.-listed Chinese companies and especially, how it compares with those of U.S. companies.

The next section summarizes related research, provides information on accounting and auditing reforms by Chinese authorities, and develops our hypothesis. Section 3 describes the research design and empirical models. Section 4 describes our sample, followed by the results in Section 5. Section 6 concludes.

2 Institutional background, related research, and hypothesis

2.1 PCAOB inspections

The Sarbanes-Oxley Act (SOX) of 2002 established the PCAOB as a nonprofit corporation via Section 101(Mohapatra et al. 2022). To implement its role as the watchdog for audit firms, the PCAOB incorporates four key programs: (1) registration with the PCAOB; (2) inspections; (3) standard setting; and (4) enforcement (Abbott et al. 2013). Section 106(a) of the Sarbanes-Oxley

[7] DeFond and Lennox (2017) provide evidence that the PCAOB inspections improve the quality of internal control audits taking advantage of variations in the content of PCAOB inspection reports. However, *all* audit firms in their sample are required to be inspected by the PCAOB and they do not examine whether inspections *per se* improve audit quality. Our study differs from Lamoreaux (2016) and Krishnan et al. (2017) by focusing on a single country (U.S.) allowing us to hold the financial reporting environment constant for the clients of U.S. and Chinese audit firms. While Mohapatra et al. (2022) examine whether registration with the PCAOB improves the audit quality of Chinese audit firms, we examine whether the lack of PCAOB inspection of registered Chinese audit firms impairs audit quality. Also, Dang et al. (2017), Ghosh et al. (2017), and Mohapatra et al. (2022) do not compare the difference in audit quality between companies audited by Chinese audit firms and U.S. audit firms.

Act of 2002 (SOX) requires foreign public accounting firms that provide audit reports for U.S. issuers to register with the PCAOB; further, the PCAOB must conduct regular inspections of registered accounting firms, both domestic and foreign, and, based on its evaluation of the quality of work performed on selected audit engagements, provide a report for each auditor (PCAOB 2016; Bishop et al. 2013; Krishnan et al. 2017).

2.2 Prior research on PCAOB inspections and audit quality

A handful of studies have examined the effect of PCAOB inspections on financial reporting quality and audit quality. Lamoreaux (2016) examines the effect of PCAOB inspections of auditors of foreign SEC registrants and finds that relative to foreign auditors who are not subject to inspection, auditors subject to inspection provide higher audit quality. Krishnan et al. (2017) examine the first-time adoption of PCAOB inspection and document enhanced audit quality. The results in DeFond and Lennox (2017) are consistent with the PCAOB inspections improving the quality of internal control audits by prompting auditors to remediate deficiencies in their audits of internal controls. Lee et al. (2020) suggest that more frequent PCAOB inspections help to improve working capital accrual reliability. Gipper et al. (2020) provide evidence that the PCAOB's audit oversight enhance financial reporting credibility. There is also some evidence that the PCAOB's inspections may have some unintended consequences. Stuber and Hogan (2021) cast doubt on the efficacy of PCAOB inspections in improving estimate accuracy and suggest that firms are managing inspection risk to the potential detriment of audit quality.

Some other studies examine the influences of PCAOB inspections on foreign registrants and reach similar conclusions. Shroff (2020) examines the effect of the PCAOB international inspection program on companies' financing and investing decisions and finds that the value of PCAOB inspections in mitigating financing frictions for non-U.S. companies. Lamoreaux et al.

(2020) find foreign SEC registrants with auditors from countries that allow PCAOB inspections enjoy a lower cost of capital relative to foreign SEC registrants with auditors from countries that prohibit inspections.

2.3 China's accounting and auditing reforms

Below, we summarize reforms undertaken by Chinese authorities to enhance financial reporting and audit quality. Compared to their U.S. counterparts, Chinese companies listing in the U.S. are subject to dual monitoring. Besides being monitored by the U.S. capital market regulators, these Chinese companies are also regulated by Chinese authorities, including tax, legal, accounting, auditing departments and others. As a result, China's reforms in accounting and auditing have a significant impact on reporting by Chinese companies. In the past twenty years, Chinese authorities have taken a series of reforms to regulate companies' operations. First, the Chinese government revised accounting laws in 2017 and set higher standards on professionalism and ethics of corporate accounting practitioners, including a lifelong prohibition system (Committee of National People's Congress of China 2017). The securities law was amended in 2019 to increase penalties for financial fraud (Committee of National People's Congress of China 2019). Second, the Chinese accounting standards (CASC) started to converge with the International Financial Reporting Standards (IFRS) in 2005. By 2008, the CASC were recognized with mutual equivalence by Hong Kong and the European Union authorities (Ministry of Finance of China 2007; 2008). These reforms are likely to enhance accounting quality of Chinese companies.

Third, reforms have also taken place in the Chinese audit industry. For instance, to facilitate the development of local accounting firms, the Ministry of Finance and the State Administration for Industry and Commerce of China jointly issued guidelines to transform accounting firms from limited liability entities to special general partnerships (Ministry of Finance of China and State

Administration for Industry and Commerce of China 2010). As of December 31, 2013, all 40 accounting firms that provide public accounting services have been restructured completely. Prior research suggests that audit quality and social welfare are higher when accounting firms assume unlimited liability (Chan and Pae 1998; Muzatko et al. 2004). Besides, Chinese accounting firms have sought to cooperate more with global peers in recent years through joining the international alliance or registering with the PCAOB. We also conduct tests to examine whether Chinese companies' audit quality has improved following the accounting and auditing reforms.

Besides the reforms in financial and accounting areas, China's anti-corruption campaign has also impacted firms' financial reporting quality. Specifically, the Communist Party of China (CPC) issued "Rule 18" on October 19, 2013, mandating party members and government officials above certain ranks being prohibited from holding any part-time or full-time position in any enterprise. Hope et al. (2020) document that Rule 18 has effectively weakened the political connections of the firms that previously hired officials as directors, and the financial reporting quality of these companies increased after Rule 18.

2.4 Hypothesis

On the one hand, findings of prior research discussed in Section 2.2 collectively support the notion that PCAOB inspections enhance audit quality. Thus, *ceteris paribus,* obstacles to PCAOB inspections could have an adverse effect on audit quality of U.S.-listed Chinese companies. On the other hand, there are other factors that could contribute to audit quality of U.S.-listed Chinese companies despite the lack of inspections. First, U.S.-listed Chinese companies are subject to the *same* institutional mechanisms as their U.S. counterparts, i.e., compliance with U.S. GAAP, audits by the Big 4 auditors, greater exposure and scrutiny by information intermediaries, and a litigious environment. Second, the accounting and auditing reforms by Chinese authorities

discussed in Section 2.3 are likely to enhance the quality of financial reporting and auditing. Third, cross-listing is another mechanism augmenting Chinese firms' financial reporting quality. Coffee (2002) explores the cross-listing by foreign issuers onto U.S. exchanges during the 1990s and posits that issuers migrate to U.S. exchanges because by voluntarily subjecting themselves (bonding hypothesis) to the U.S.'s higher disclosure standards and greater threat of enforcement, they partially compensate for weak protection of minority investors under their own jurisdictions' laws and thereby achieve a higher market valuation. Consistent with this notion, Lang et al. (2003) find that companies cross-listed in the U.S. have less earnings management and report more conservatively than non-cross-listed firms. Ke et al. (2015) find that financial reporting and audit quality are weaker for Chinese companies listed only in China compared to Chinese companies cross-listed in Hong Kong, suggesting that cross-listing in a stronger institutional environment enhances audit quality. Similarly, Ghosh et al. (2017) examine the audit quality of companies cross-listing shares as American Depositary Receipts (ADRs) and document higher audit quality and market evaluation for Chinese ADRs than other emerging market ADRs. Fourth, Duhnke (2020) reports that the PCAOB staff have discussed with senior members of the six largest U.S. audit firms as well as representatives of their global networks on maintaining consistent audit quality across their global networks, including China. The members of the SEC staff have also met with audit firm representatives to discuss quality in emerging markets (Clayton 2019). These actions are likely to incentivize Chinese auditors and possibly their U.S.-listed clients to step up audit effort to mitigate concerns about audit quality resulting from the absence of PCAOB inspections. Further, Chinese accounting firms providing public accounting service to the U.S.-listed companies are registered with the PCAOB, and prior research finds that PCAOB registration *per se* improves Chinese firms' audit quality in the absence of inspection (Mohapatra et al. 2022).

In light of the above opposing arguments on the possible effect of lack of PCAOB inspection of Chinese auditors on audit quality of U.S.-listed Chinese companies, we state our hypothesis in null form as follows:

Hypothesis: *There is no difference in audit quality between U.S.-listed Chinese companies and their U.S. counterparts.*

3 Research Design

To test our hypothesis, we use a matched-sample of U.S.-listed Chinese companies and U.S. companies and look for differences in audit quality using a multivariate regression model. Next, we describe our audit quality measures. We also employ two alternate control groups, including a sample of Chinese companies whose auditors are inspected by the PCAOB.

3.1 Audit quality measures

We employ four measures of output-based measures of audit quality used in prior research (DeFond and Zhang 2014): performance-matched abnormal accruals, predictability of future earnings or cash flows using current earnings, Basu (1997)'s measure of accounting conservatism, and financial restatements. As part of additional analyses, we use three more measures: meeting or beating of earnings benchmarks, Amiram et al. (2015)'s financial statement divergence score, and earnings informativeness. Our last measure is a measure of investor perception of audit quality while the other measures capture actual audit quality.

3.2 Empirical models

3.2.1 Abnormal accruals

Abnormal accruals are widely used in accounting literature to measure the extent of earnings management, suggesting lower audit quality (e.g., Ashbaugh et al. 2003; Ashbaugh-Skaife et al. 2008; Larcker and Richardson 2004). Abnormal accruals capture managerial distortions induced by the application of the accounting rules or earnings management (Dechow

et al. 2010). Thus, if PCAOB's inspections motivate auditors to constrain earnings management, we would observe higher levels of abnormal accruals for the companies whose auditors are not inspected relative to the companies whose auditors are inspected by the PCAOB. Consistent with Kothari et al. (2005), we estimate abnormal accruals *(ABACC)* from the modified jones model with prior period ROA to control for firm performance. In Appendix A, we present model (1a) used to estimate the abnormal accruals.

Following Dechow and Dichev (2002) and Dechow et al. (2010), we use both abnormal accruals (*ABACC*) and their absolute values (*Abs_ABACC*) as the dependent variables and include control variables consistent with Aobdia (2019). We estimate the following model to test whether the level of abnormal accruals are higher for Chinese companies relative to their U.S. counterparts:

$$\begin{aligned} ABACC\ or\ Abs\_ABACC = {} & \beta_0 + \beta_1 NOINSP + \beta_2 SIZE + \beta_3 FGNINCOME + \beta_4 GEOSEG \\ & + \beta_5 BUSSEG + \beta_6 BTM + \beta_7 LEVERAGE + \beta_8 LITIGATION \\ & + \beta_9 CFO + \beta_{10} Std\_CFO + \beta_{11} SALESGR + \beta_{12} ICMW + \beta_{13} BIG4 \\ & + \beta_{14} INSHOLD + \beta_{15} CLI\_IMP + IND\_FE + YEAR\_FE + \varepsilon \end{aligned} \quad (1b)$$

See Appendix B for variable definitions. The variable of interest is *NOINSP* which equals 1 for Chinese companies (treatment group) and 0 for U.S. companies (control group) whose auditors are inspected by the PCAOB. To ensure all control companies are under PCAOB inspection, we restrict the control group to U.S. registrants. If the lack of PCAOB inspections leads to lower audit quality, i.e., higher levels of abnormal accruals, we would expect β_1 to be positive and significant. Turning to the control variables, we first control firm size *(SIZE)*. To control business complexity, we include foreign income *(FGNINCOME)*, the number of geographic segments *(GEOSEG),* and the number of business segments *(BUSSEG)*. We also control variables related to firm risk, including book to market ratio *(BTM)*, leverage ratio *(LEVERAGE)*, an indicator variable for whether the firm operates in a high-litigation industry *(LITIGATION)*, cash flows from operations *(CFO)* as well as its standard deviation *(Std_CFO)*,

sales growth *(SALESGR)*, and an indicator variable of internal control material weakness *(ICMW)*. Consistent with prior studies, we also identify whether the auditor is one of the Big 4 or not *(BIG4)*. In addition, we control institutional ownership (*INSTHOLD*), as well as client importance *(CLI_IMP)* that represents the proportion of non-audit fees paid by an individual audit client (Chen et al. 2018). In all models, we include industry and year dummies to control industry and year effects and cluster standard errors at the firm level.[8]

3.2.2 Earnings and cash flows predictability

Our second measure is earnings persistence, which is a critical feature of high-quality earnings. Persistent earnings are viewed as desirable because they are recurring; more persistent earnings yield better inputs to quality valuation models and hence are of higher quality than less persistent earnings (Francis et al. 2004; Penman and Zhang 2002). In a recent study, Jia and Li (2021) find firm performance sustainability is positively related to earnings persistence and has a positive effect on the association between earnings and future cash flows. Following Kang et al. (2012), we employ both future earnings and future cash flows to examine earnings persistence. Control variables are consistent with Chen et al. (2018). We estimate the model as follows,

$$\begin{aligned} EARN \text{ or } CFO = {} & \gamma_0 + \gamma_1 LAGEARN + \gamma_2 NOINSP + \gamma_3 NOINSP \times LAGEARN + \gamma_4 LNMVE \\ & + \gamma_5 LNMVE \times LAGEARN + \gamma_6 SALESGR + \gamma_7 SALESGR \times LAGEARN \\ & + \gamma_8 SPI + \gamma_9 SPI \times LAGEARN + \gamma_{10} DIVDUM + \gamma_{11} DIVDUM \times LAGEARN \\ & + \gamma_{12} LOSS + \gamma_{13} LOSS \times LAGEARN + \gamma_{14} BIG4 + \gamma_{15} BIG4 \times LAGEARN \\ & + \gamma_{16} CLI\_IMP + \gamma_{17} CLI\_IMP \times LAGEARN + IND\_FE + YEAR\_FE + \varepsilon \end{aligned} \quad (2)$$

See Appendix B for variable definitions. Based on prior research, if earnings are persistent, the coefficients on *LAGEARN* in model (2) will be positive and significant. The coefficient of *NOINSP×LAGEARN* in model (2) captures any cross-sectional difference in the earnings

[8] For the industry classification, we use Fama & French 12 industry groups based on Kenneth R. French's division criteria. Source: Kenneth R. French Data Library: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/Data_Library/det_12_ind_port.html

persistence across treatment companies and control companies. Specifically, if the lack of PCAOB inspections results in lower earnings persistence, we would observe a negative and significant coefficient on *NOINSP×LAGEARN*, suggesting lower audit quality. Likewise, higher quality earnings are useful to predict future cash flows. A negative and significant coefficient on *NOINSP×LAGEARN* suggests that the companies' earnings are of lower ability to predict future cash flows when their auditors are not inspected by the PCAOB.

3.2.3 Accounting conservatism

Our third measure of audit quality is accounting conservatism. Basu (1997) finds that earnings are timelier in recognizing bad news than good news in periods of high auditor liability exposure, indicating that auditors enforce conditional accounting conservatism. In this sense, if the lack of PCAOB inspections motivates auditors to relax prudence and fail to force audit clients to record impairments of inventory, long-lived asset, and goodwill on a timely basis, we would observe a difference in conservatism between treatment companies and control companies. We follow Manchiraju et al. (2021) and estimate the following model:

$$\begin{aligned} EARN = {} & \theta_0 + \theta_1 D + \theta_2 RET + \theta_3 D\times RET + \theta_4 NOINSP + \theta_5 NOINSP\times D + \theta_6 NOINSP\times RET \\ & + \theta_7 NOINSP\times D\times RET + \theta_8 SIZE + \theta_9 SIZE\times D + \theta_{10} SIZE\times RET + \theta_{11} SIZE\times D\times RET \\ & + \theta_{12} MTB + \theta_{13} MTB\times D + \theta_{14} MTB\times RET + \theta_{15} MTB\times D\times RET + \theta_{16} LEVERAGE \\ & + \theta_{17} LEVERAGE\times D + \theta_{18} LEVERAGE\times RET + \theta_{19} LEVERAGE\times D\times RET \\ & + IND\_FE + YEAR\_FE + \varepsilon \end{aligned} \quad (3)$$

See Appendix B for variable definitions. In model (3), *D* is an indicator variable that equals 1 if the stock return *(RET)* is negative and 0 otherwise. The θ_2 reports the timeliness of good news; the $\theta_2+\theta_3$ reports the timeliness of bad news; and the θ_3 is the incremental timeliness of earnings for bad news compared to good news (Basu 1997; Manchiraju et al. 2021). Based on Basu (1997), the coefficients on *RET* and *D×RET* are both positive because of the accounting conservatism. In model (3), the variable of interest is *NOINSP×D×RET*. A negative coefficient on *NOINSP×D×RET*

suggests a lower accounting conservatism and, thus, lower audit quality for the treatment companies whose auditors are not inspected by the PACOB.

3.2.4 Restatements

Our fourth measure of audit quality is accounting restatement., i.e., a revision of previously issued financial statements due to errors, fraud, or misapplication of GAAP. Prior literature suggests that accounting restatement provides direct evidence of poor financial reporting quality and that restatements also imply the audits of the originally issued financial statements were of low quality (Palmrose and Scholz 2004; Francis et al. 2013). Admittedly, the absence of a restatement does not necessarily imply high earnings quality since some material misstatements could remain undetected as a result of a low earnings quality (Chen et al. 2018). However, accounting restatement is still regarded as an objective and visible measure of audit quality (Christensen et al. 2016). Following prior studies, we estimate the following logistic regression to examine the likelihood of a restatement and PCAOB's inspection status:

$$\begin{aligned} RESTATEMENT = {} & \rho_0 + \rho_1 NOINSP + \rho_2 RSST\_ACCR + \rho_3 CHREC + \rho_4 CHINV + \rho_5 CHCS + \\ & \rho_6 CHROA + \rho_7 AUDTENURE + \rho_8 AUDCHG + \rho_9 AUDFEE + \\ & \rho_{10} INFLUEN + \rho_{11} BIG4 + \rho_{12} BTM + \rho_{13} ISSUE + \\ & \rho_{14} MERGER + \rho_{15} LEVERAGE + \rho_{16} LOSS + \\ & \rho_{17} LNMVE + IND\_FE + YEAR\_FE + \varepsilon \end{aligned} \quad (4)$$

See Appendix B for variable definitions. The variable of interest is *NOINSP*. If the lack of PCAOB inspection on auditors results in a higher likelihood for firms to restate the financial statements subsequently, we would observe a significant and positive coefficient on *NOINSP*. Turning to the control variables, we follow Francis et al. (2013) and Chen et al. (2018) and control for accruals *(RSST_ACCR)*, changes in receivables *(CHREC)*, changes in inventories *(CHINV)*, changes in cash sales *(CHCS)*, change in ROA *(CHROA)*, and auditor tenure *(AUDTENURE)*, auditor turnover *(AUDCHG)*, audit fees *(AUDFEE)*, client influence *(INFLUEN)*, Big 4 indicator

(BIG4), book to market ratio *(BTM)*, and an indicator variable for issuing debt or equity (*ISSUE*). Also, we follow DeFond et al. (2015) and include loss indicator *(LOSS)*, firm market value of equity *(LNMVE)*, leverage ratio *(LEVERAGE)*, and an indicator variable for merge and acquisition *(MERGER)*.

4. Sample

4.1 Sample selection

The PCAOB disclosed the list of firms whose audit reports were issued by PCAOB-registered firms in a jurisdiction where local authorities deny PCAOB's access to conduct inspections.[9] As of July 30, 2021, this list was composed of 1,064 firm-year observations, including 770 Chinese mainland observations and 294 Hong Kong observations (PCAOB 2021a). In this list, some firms appear more than once in a single year due to the quarterly reporting. Our analysis is based on annual financials and our dataset has 1,010 observations spanning from years 2014 through 2021. Next, we gather the necessary data from *Compustat* for 456 observations for which information is available to estimate the abnormal accruals model. Then we match these samples with *Audit Analytics* to retrieve audit fees and internal control material weakness data and, as a result, the sample size shrinks to 452. Lastly, we retrieve institutional ownership from *Thomson Financial/Refinitiv* database, and the final treatment group includes 439 firm-year observations spanning from years 2014 through 2020.

To identify the control companies, we select from the entire U.S. population of companies on *Compustat*. The PCAOB has started the international inspection program in 2004 and gradually obtained access to non-U.S. audit firms for more than 50 non-U.S. jurisdictions (PCAOB 2021b). To ensure the control group to be composed of registrants whose auditors are subject to PCAOB

[9] See https://pcaobus.org/oversight/international/denied-access-to-inspections

inspections, we select only U.S. companies to construct our pool of control companies. We begin with a control group consisting of 15,154 firm-years spanning from 2014 through 2020 for the abnormal accruals model without missing variables. After matching with *Audit Analytics* and *Thomson Financial/Refinitiv* databases, the pool of control group shrinks to 13,834 firm-years. Next, we match each treatment company with a U.S. counterpart from the control pool on three attributes: year, industry (Fama-French 12 industry groups), and similar size (total assets). Thus, our dataset for the abnormal accruals model is composed of 878 unique firm-years (439 Chinese and U.S. pairs). Table 1 reports the sample selection process for the abnormal accruals model. We use the above matching process to construct samples for the earnings persistence model, accounting conservatism model, and accounting restatement model, and their respective sample sizes are, 1,190, 1,114, and 1,116 observations. We winsorize all continuous variables at the 5th and 95th percentiles to reduce the impact of outliers.[10]

[Insert Table 1 About Here]

4.2 Descriptive statistics

Table 2 provides descriptive statistics for the variables used in the abnormal accruals model. Panel A reports the descriptive statistics for the full sample. The mean value of abnormal accruals is -3.1 percent of beginning assets. About 74.1 percent of the sample firms are audited by Big 4 auditors. The average pretax income from foreign operations is about 29.3 percent of the total pretax income. The average numbers of geographic and business segments are 3.17 and 2.60, respectively. The mean growth in sales is about 5.2 percent. About 4.1 percent of sample firms are reported material weakness in internal control. The mean institutional shareholdings at the

[10] As a robustness check, we replicate our tests after winsorizing at the top and bottom 1 percent and obtain consistent results.

beginning of the year is about 40.7 percent. The mean value of non-audit fees is about 11.3 percent of the total fees.

Panel B reports the descriptive statistics separately for treatment and control companies, as well as results of tests of difference in mean and median values of the variables in model (1b). Based on the mean and median comparisons, we find there is no significant difference in the abnormal accruals between treatment companies and control companies. Except for firm size, geographic segments, and material weakness, the attributes of treatment companies tend to be significantly different from control companies. We find that the proportion of companies audited by the Big 4 auditors is higher for Chinese companies (80.6 percent *vs.* 67.7 percent for U.S. companies).

In Panel C, we report the mean and median values of audit fees for the treatment and control companies. The mean and median audit fees are about $1.89 million and $1.20 million, respectively for the treatment companies. Corresponding values for the control companies are, $3.35 million and $1.72 million. Both means and medians of audit fees of treatment companies are significantly lower than those of control companies. When we scale audit fees by total assets, the mean difference is no longer significant. However, the median of scaled audit fees for treatment companies is still significantly lower than those of control companies. These results suggest that the majority of Chinese companies in our sample pay lower audit fees than their U.S. counterparts. This could be due to differences in labor costs between the two countries. In addition or alternatively, the Chinese auditors may assign lower risk premiums relative U.S. auditors resulting in lower fees.

[Insert Table 2 About Here]

Table 3 reports the Pearson correlations. We do not find a significant correlation between abnormal accruals and the variable of interest, *NOINSP*. Next, we discuss the results of models (1b), (2), (3), and (4).

[Insert Table 3 About Here]

5. Results

5.1 Abnormal accruals

Table 4 reports the results of testing model (1b) on the association between PCAOB inspections (*NOINSP*) and abnormal accruals (*ABACC*), as well as absolute abnormal accruals (*Abs_ABACC*). We find the coefficient on *NOINSP* is insignificant for both *ABACC* (column 1) and *Abs_ABACC* (column 2), suggesting that abnormal accruals are not significantly associated with the PCAOB inspections, i.e., no significant difference in audit quality between companies whose auditors are inspected and companies whose auditors aren't. Turning to the control variables, in column (1), *FGNINCOME, LITIGATION, BTM,* and *CLI_IMP* are positively associated with *ABACC* (significant at the 0.10 level or better) while *GEOSEG* is negatively associated with *ABACC* (significant at the 0.10 level). In column (2), *FGNINCOME, Std_CFO, ICMW,* and *BIG4* are positively associated with *Abs_ABACC* and *GEOSEG* and *SALEGR* are negatively related to absolute abnormal accruals (significant at the 0.05 level). Thus, we fail to reject our null hypothesis of no difference in audit quality between Chinese companies whose auditors are not inspected by the PCAOB and U.S. companies whose auditors are inspected by the PCAOB.

[Insert Table 4 About Here]

5.2 Earnings and cash flows predictability

Table 5 provides the results of model (2) on the associations between current earnings with future earnings and operating cash flows. The coefficients on *LAGEARN* is not significant in

column 1 and is significant at the 0.01 level in column 2, indicating that current period earnings are informative about future cash flows. Turning to our variable of interest, the coefficient on *NOINSP×LAGEARN* is negative and insignificant in both columns, suggesting that there is no difference in earnings persistence between treatment companies and control companies. Also, there is no difference in earnings predictability for future cash flows between the two groups. Turning to the control variables, we find that *LNMVE* and *SALESGR* are positively associated with both *EARN* and *CFO* while *LOSS* is negatively related (all are significant at the 0.01 level). Once again, these results fail to reject our hypothesis and support the notion that no significant difference in earnings persistence and cash flow prediction between companies whose auditors are inspected and those that aren't inspected by the PCAOB.

[Insert Table 5 About Here]

5.3 Accounting conservatism

Results of the relation between PCAOB's inspection status and accounting conservatism are in Table 6. We present the results in two columns. Column 1 presents the results without the control variables while column 2 presents the results for the full model. The coefficients on *RET* and *D×RET* are both positive and significant in column 1, consistent with accounting conservatism (Basu 1997). The coefficient on the variable of interest, *NOINSP×D×RET* is insignificant, suggesting that there is no difference in the asymmetric timeliness of recognizing bad news in earnings between treatment and control companies. When we estimate the model with controls for company size, market-to-book ratio, and leverage, we continue to find that the coefficient on *NOINSP×D×RET* remains insignificant. Overall, the results suggest that accounting conservatism is not associated with PCAOB's inspection status.

[Insert Table 6 About Here]

5.4 Restatements

Table 7 reports the results of model (4) on the association between the likelihood of restating financial statements and the lack of PCAOB inspections on auditors. We find that the coefficient on *NOINSP* loads negatively significant at 0.01 level, indicating that the treatment companies have a lower likelihood of a restatement. By transforming the coefficient into an odds ratio, we find that the firms whose auditors are not inspected by PCAOB have a 33.78 percent lower likelihood of a restatement, *ceteris paribus*. The difference is both economically and statistically significant. With respect to the control variables, restatements are positively associated with accruals *(RSST_ACCR)* and changes in receivables *(CHREC)*, consistent with Francis et al. (2013). Additionally, the coefficient on *AUDTENURE* is negatively significant at the 0.05 level, suggesting that companies with longer-term auditors have a lower likelihood of a restatement. When we estimate the model separately for the treatment and control companies (results not tabulated), we find that accruals are the primary driver of restatements for Chinese companies while for control companies, the effect of long auditor tenure is more pronounced. Besides changes in receivables *(CHREC),* audit fees *(AUDFEE)* are negatively associated with restatements, consistent with the notion that audit fees are a good proxy for audit risks. Also, U.S. companies with losses are more likely to be associated with restatements.

Given that restatements can be triggered by multiple causes and lead to significantly divergent consequences, Hennes et al. (2008) emphasize the importance of distinguishing errors from irregularities in restatement research. To identify which of these two drive of our results, we follow prior literature and focus on the “Big R” restatements, i.e., those arising from a material inadvertent or fraudulent (intentional) error in a prior period’s (or periods’) financial statements; once a public company ascertains that the error in its previously released financial statements is

material for the period in which it occurred, the company must file an SEC Form 8-K Item 4.02 within four days, warning investors not to rely on the previously issued financial statements (Bartov et al. 2021). Consistent with this notion, we categorize restatements with disclosure of the date of 8-K Item 4.02 in *Audit Analytics* as "Big R"; the remaining restatements are defined as "little r". Next, we examine "Big R" and "little r" subsamples separately. We find that, among the 50 restatements in our sample, nine are "Big R" restatements and all are U.S. observations, suggesting U.S. companies are more likely to be associated with irregularity restatements. Again, we regress within "little r" observations and their counterparts and find a significantly negative coefficient on *NOINSP* (coef. = -0.902, *z*-stats. = -2.132), consistent with the results in Table 7. Thus, we find lower cases of both irregularities and errors associated with Chinese companies.[11]

Overall, results from Tables 4 through 7 consistently indicate that the PCAOB's inspection status is not significantly related to our four primary measures of audit quality and thus, we fail to reject the hypothesis. Thus, our results support the notion that the lack of PCAOB inspections does not suggest lower audit quality for Chinese companies relative to the U.S. companies whose auditors are inspected.

[Insert Table 7 About Here]

5.5 Additional analyses

We also conduct several tests to further explore the effect of PCAOB's inspection status on other audit quality measures. First, we examine whether the treatment companies are more likely to engage in meeting or beating earnings benchmarks, suggesting lower audit quality. Second, we

[11] While the lower likelihood of a restatement is consistent with higher audit quality, Srinivasan et al. (2015) find that U.S.-listed foreign companies, especially those from countries with a weak rule of law are less likely to restate than are companies from strong rule of law countries. They caution that less frequent restatements can be a signal of opportunistic reporting rather than a lack of errors and irregularities. The rate of all restatements are, 2.9 percent and 5.6 percent respectively, for Chinese and U.S. companies (difference significant at the 0.05 level). Further, Chinese companies had only "little r" restatements compared to 73 percent for U.S. companies; the remaining 27 percent are "Big R" restatements.

use Amiram et al. (2015)'s financial statement divergence (*FSD*) score as a measure of financial statement errors. Finally, we examine investor perceptions of earnings of treatment companies whose auditors are not inspected.

5.5.1 Benchmark beating

Prior research documents that managers use accounting discretion to avoid reporting small losses; especially, a statistically large number of firms with small profits or small earnings increases intentionally manage earnings enough to report a small profit or a small earnings increase (Burgstahler and Dichev 1997; Degeorge et al. 1999). Following Frankel et al. (2002) and Chen et al. (2018), we use two benchmarks to examine the association between benchmark beating and the lack of PCAOB inspections: the avoidance of a loss (*BENCHMARK1*) and the avoidance of an earnings decline (*BENCHMARK2*). We estimate the following benchmark model:

$$\begin{aligned} BENCHMARK1 \text{ or } BENCHMARK2 = {} & \pi_0 + \pi_1 NOINSP + \pi_2 LITIGATION + \pi_3 MTB + \pi_4 LNMVE \\ & + \pi_5 CFO + \pi_6 EQUITISSUE + \pi_7 ROA + \pi_8 RET + \pi_9 LOSS + \pi_{10} INSTHOLD \\ & + \pi_{11} CURRENT + \pi_{12} LEVEAGE + \pi_{13} ACCRUAL + \pi_{14} CAPINT + \pi_{15} ZSCORE \\ & + \pi_{16} SHARES + \pi_{17} BLOAT + \pi_{18} FOLLOW + \pi_{19} REVDOWN + \pi_{20} WRITEOFF \\ & + \pi_{21} EARNGR + \pi_{22} BIG4 + \pi_{23} AUDTENURE + \pi_{24} AUDCHG + \pi_{25} CLI\_IMP \\ & + IND\_FE + YEAR\_FE + \varepsilon \end{aligned} \quad (5)$$

See Appendix B for variable definitions. The *BENCHMARK1* and *BENCHMARK2* are indicator variables, representing whether the company manages earnings to avoid a loss and to avoid an earnings decline, respectively. For brevity, we investigate the associations with linear probability models. A positive and significant coefficient *NOINSP* would suggest that the treatment companies are more likely to manage earnings to just meet or beat earnings benchmarks than the control companies. The results are in Panel A, Table 8. We find that the coefficient on *NOSINP* is insignificant in both columns, indicating that the treatment companies do not exhibit a higher tendency to meet or beat earnings benchmarks, suggesting that the lack of PCAOB inspections does not suggest lower audit quality.

[Insert Table 8 About Here]

5.5.2 FSD score

Morgan et al. (1972) suggest that Benford's Law could be used to detect errors in economic data. Amiram et al. (2015) construct a financial statement divergence (*FSD*) score based on the mean absolute deviation statistic as applied to the distribution of the leading digits of the numbers in annual financial statement data and find that the FSD score is a leading indicator of material misstatements and SEC enforcement actions. Amiram et al. (2015) note that the FSD score has several advantages over other commonly used measures of financial reporting quality. It is a parsimonious measure and is not subject to the inherent limitation of accruals-based measures which are possibly related to firm characteristics or business models. We estimate the following model to test whether *FSD* scores are associated with the PCAOB's inspection status:

$$\begin{aligned} FSD\_SCORE = {} & \delta_0 + \delta_1 NOINSP + \delta_2 CHCS + \delta_3 CHROA + \delta_4 DIVDUM + \delta_5 DEBTISSUE \\ & + \delta_6 LNMVE + \delta_7 MTB + \delta_8 PE + \delta_9 SGROW\_PCT + \delta_{10} FIRMAGE + \delta_{11} RETVOL \\ & + \delta_{12} NUM\_ACCTS + IND\_FE + YEAR\_FE + \varepsilon \end{aligned} \quad (6)$$

See Appendix B for variable definitions. *FSD_SCORE* measures the deviation between the empirical distribution of leading digits in firms' financial statements and the theoretical Benford distribution. A higher *FSD_SCORE* would suggest a larger deviation from the Benford distribution and lower audit quality. The mean *FSD_SCORE* in our samples is 0.028, consistent with the mean value of 0.03 in Abbott et al. (2013). The mean *FSD_SCORE* of treatment companies and control companies are 0.029 and 0.028 respectively, and the difference is not significant (mean difference = 0.001, *t*-statistic = 0.011). Results of model (6) are in Panel B, Table 8. We find that the variable of interest *NOINSP* loads insignificant (coefficient = -0.949, *t*-statistic = -0.895), suggesting that the lack of PCAOB inspection does not lead to a divergence in the distribution of leading digits of

the numbers in treatment companies' financial statements compared to their counterparts.[12] In short, these results suggest that treatment companies do not exhibit higher financial statement errors than the control companies.

5.5.3 Earnings informativeness

We also examine how investors perceive the audit quality of companies whose auditors are not inspected by the PCAOB. Dechow et al. (2010) posit that investors' responsiveness to or perception of earnings is a direct proxy for earnings quality since the information in earnings is correlated with the information used by investors in their equity valuation decisions. A positive and significant earnings response coefficient indicates the informativeness of earnings (Kumar and Krishnan 2008). In this regard, if the earnings quality of treatment companies is lower than their counterparts, we would expect a weaker correlation between firms' earnings and investors' perception. Following prior literature (Collins and Kothari 1989; Kumar and Krishnan 2008), we use earnings response coefficient to measure investors' perception on earnings and estimate the following earnings informativeness model:

$$\begin{aligned} CAR = {} & \varphi_0 + \varphi_1 EARN + \varphi_2 LAGEARN + \varphi_3 NOINSP + \varphi_4 NOINSP \times EARN + \varphi_5 BETA \\ & + \varphi_6 BETA \times EARN + \varphi_7 PERSIST + \varphi_8 PERSIST \times EARN + \varphi_9 LNMVE \\ & + \varphi_{10} LNMVE \times EARN + \varphi_{11} MTB + \varphi_{12} MTB \times EARN + \varphi_{13} LOSS + \varphi_{14} LOSS \times EARN \\ & + \varphi_{15} BIG4 + \varphi_{16} BIG4 \times EARN + \varphi_{17} AUDTENURE + \varphi_{18} AUDTENURE \times EARN \\ & + \varphi_{19} AUDCHG + \varphi_{20} AUDCHG \times EARN + \varphi_{21} INFLUEN + \varphi_{22} INFLUEN \times EARN \\ & + \varphi_{23} CLI\_IMP + \varphi_{24} CLI\_IMP \times EARN + IND\_FE + YEAR\_FE + \varepsilon \end{aligned} \quad (7)$$

See Appendix B for variable definitions. The variable of interest in this model is *NOINSP×EARN*. A negative and significant coefficient would suggest a lower earnings informativeness for treatment companies, consistent with lower perceived audit quality in the eyes of investors. Results are in Panel C. We find that the earnings response coefficient as captured by

[12] To ease interpretation, we multiply the FSD score by 1000.

EARN is positive but not significant (coefficient = 0.107, *t*-statistic = 0.493), suggesting a relatively low earnings informativeness of our sample. Importantly, the coefficient on *NOINSP×EARN* is positive and marginally significant (coefficient = 0.168, *t*-statistic = 1.96). This result indicates that the earnings of treatment companies are *more* informative than those of control companies. In short, investors do not perceive the earnings of the companies whose auditors are not inspected by the PCAOB to be of lower quality than the earnings of companies whose auditors are inspected.

5.5.4 Robustness tests

In this section, we perform several robustness tests to assess the validity of our findings to alternate winsorization, alternate specifications, and other factors. First, we winsorize our sample at (1, 99) instead of (5, 95) and reestimate the primary models. Our results continue to hold when we winsorize at (1, 99). Second, we include pair fixed effects in the regression models to test within variations of the pairs of treatment and control companies. In other words, controlling for pair fixed effects can help us tease out any difference between treatment observations and their counterparts. Compared to the models without pair fixed effects, the models controlling pair fixed effects have a higher overall fit (adjusted R-squared). Our findings remain robust when we control pair fixed effects to concentrate on the within variations. Third, to control for audit effort, we include audit fees in our models and obtain consistent results.

Next, we examine whether our results driven by state-owned enterprises *(SOE*).[13] Hou and Moore (2010) find internal monitoring mechanisms are weaker in Chinese state-owned enterprises, and this could potentially affect earnings management. Hope et al. (2020) find that China's anti-corruption campaign has different impacts on financial reporting quality of state-owned enterprises and non-state-owned enterprises. Therefore, we include *SOE* as a control variable in our primary

[13] Indicator variable for state-owned enterprise, equal to 1 if the ultimate controlling shareholder is the state, and 0 otherwise.

models to assess its influence on our findings. In the abnormal accrual sample, 43 observations are Chinese SOEs, and the proportion is about 9.8 percent of the total treatment companies (439 observations). After controlling *SOE* in the abnormal accrual model, the *NOINSP* are not significantly related to either *ABACC* (coefficient = -0.023, *t*-statistic = -0.363) or *Abs_ABACC* (coefficient = 0.074, *t*-statistic = 0.898). Meanwhile, the *SOE per se* is negatively significantly associated with *Abs_ABACC*, suggesting SOEs have higher audit quality. With respect to the earnings persistence model, the variable of interest, *NOINSP×LAGEARN*, remains insignificant (*EARN*: coefficient = -0.005, *t*-statistic = -0.095; *CFO*: coefficient = -0.027, *t*-statistic = -0.422) after controlling *SOE* and *SOE× LAGEARN*. However, *SOE×LAGEARN* is positively and significantly related to *EARN*, suggesting SOEs have higher earnings persistence. Third, in the accounting conservatism model, we add a series of control variables, *SOE*, *SOE×D* and *SOE×D×RET*, and none of them is significantly related to the dependent variable (*EARN*). The variable of interest, *NOINSP×D×RET* remains insignificant (coefficient = 0.024, *t*-statistic = 0.409). Lastly, we control *SOE* in the restatement model, and *NOINSP* remains negatively significant (coefficient = -1.028, *z*-statistic = -2.587) while *SOE* is not significantly related to restatements. In short, our inferences are robust to controlling *SOE*.

5.5.5 Alternate control groups

We reestimate our models for the seven measures of audit quality using two alternate control groups. Our first alternative control group consists of all U.S.-based companies for which the necessary data are available and thus represents a larger pool of U.S. companies to compare with our treatment group. For the abnormal accruals measure, we identify 13,834 companies for the years from 2014 through 2020 for which necessary data are available to estimate models (1a) and (1b). The mean (median) values of total assets for the Chinese and U.S. companies are,

respectively, $12,741.43 million ($1,036.94 million) and $6,515.93 million ($1,029.80 million) indicating that on average, Chinese companies are larger than U.S. companies. We combine these U.S. companies with 439 Chinese companies and estimate model (1b) and the results are in Table 9. The coefficient on *NOINSP* is insignificant for both *ABACC* (column 1) and *Abs_ABACC* (column 2), suggesting that abnormal accruals are not significantly associated with the PCAOB inspections. We summarize the results for the other audit quality measures (results not tabulated). We find that both the coefficients on *LAGEARN* and *NOINSP×LAGEARN* are positive and significant at the 0.05 level, indicating that earnings persistence is higher for Chinese companies. Similarly, we find that the predictive value of current earnings for future cash flows is also higher for Chinese companies (significant at the 0.01 level). We find that accounting conservatism is lower for Chinese companies (significant at the 0.01 level). Next, the likelihood of a restatement is lower for Chinese companies (significant at the 0.01 level), consistent with the results in Table 7. We do not find that Chinese companies are more likely to engage in meeting or beating of earnings benchmarks. We find that FSD scores are lower for Chinese companies (significant at the 0.05 level), suggesting lower financial statement errors. Finally, we do not find a significant difference between Chinese and U.S. companies with regard to earnings informativeness.

[Insert Table 9 About Here]

Our second alternate control group consists of U.S.-listed Chinese companies but unlike our treatment group, audited by auditors that are *not* based in China. In other words, auditors of these Chinese companies are primarily based in the U.S. and in other countries. More importantly, these auditors *are* inspected by the PCAOB. Thus, using this control group, we compare two groups of U.S.-listed Chinese companies but only companies in the control group are subject to PCAOB inspections. Also, this alternate control group differs from our first alternate control group

in that both the treatment and control groups consist of Chinese companies. In other words, by holding the effect of country-specific factors on audit quality constant, we can attribute any observed difference in audit quality to PCAOB inspections. We identify 336 Chinese firm-year observations that listed in the U.S, of which 322 (about 95 percent) are audited by U.S. auditors and the remaining 14 are audited by auditors based in Singapore (3.6 percent), Canada, and Malaysia (under 1 percent).[14] We find that compared to the companies in the treatment group, companies in our second alternate control group are much smaller, more likely to be audited by non-Big 4 auditors and pay higher audit fees scaled by total assets. We reestimate our audit quality measures using this alternate control group and untabulated results indicate that the coefficient on *NOINSP* is insignificant for both *ABACC* and *Abs_ABACC*, suggesting that abnormal accruals are not significantly associated with the PCAOB inspections. Next, we find that both the coefficients on *LAGEARN* and *NOINSP×LAGEARN* are positive and significant at the 0.01 level, indicating that earnings persistence is higher for Chinese companies audited by China-based auditors. Similarly, we find that the predictive value of current earnings for future cash flows is also higher for companies in the treatment group (significant at the 0.05 level), suggesting higher audit quality. We find that accounting conservatism is higher for companies in the treatment group (significant at the 0.05 level). Next, we do not find a significant difference in the likelihood of a restatement between companies in the treatment and control groups. We do not find significant differences between the treatment and control companies with regard to meeting or beating of earnings benchmarks, FSD scores, and earnings informativeness.

[14] We identify U.S.-listed Chinese companies from the website of U.S-China Economic and Security Review Commission (https://www.uscc.gov/research/chinese-companies-listed-major-us-stock-exchanges). As of May 5, 2021, there are 248 Chinese companies listed on major U.S. exchanges. Then, we use *Audit Analytics* to identify auditors' locations of these Chinese companies. Thirty-eight percent (94 companies) are audited by non-Chinese auditors. For our sample period (years from 2014 through 2020), 336 observations are available in *Audit Analytics*.

We provide a summary of the results using the three control groups in Table 10. We find that out of 21 cases (7 audit quality measures × 3 control groups), we do not find a significant difference in audit quality between the treatment and control groups in 13 cases (about 62 percent); audit quality is *higher* for the treatment group in 7 cases (about 33 percent); and audit quality is lower in only one case (about 5 percent). Collectively, the results strongly suggest that the lack of PCAOB inspections does not appear to result in lower audit quality for U.S.-listed Chinese companies whose auditors are not inspected by the PCAOB.

[Insert Table 10 About Here]

5.5.6 Accounting and auditing reforms in China and audit quality

As discussed in Section 2.3, Chinese authorities have implemented a series of reforms in accounting and auditing areas. These reforms could be the driver to enhance Chinese companies' financial reporting quality and audit quality. We examine the impact of these reforms on audit quality of Chinese companies. Specifically, we compare our seven audit quality measures of U.S-listed Chinese companies between the pre-reform and post-reform periods. China has implemented its new accounting standards (CASC) at the beginning of the year 2007 to converge with IFRS (Ministry of Finance of China 2006). Given the lack of comparability between the old and new accounting standards, we begin with 2007 as the first year of the pre-reform period. Next, we choose the year 2012 as the cutoff to separate the pre and post reform periods since the majority of Chinese audit firms have completed restructuring from limited liability to special general partnership by 2012. Although Chinese authorities officially announced the completion as of December 31, 2013, Chinese researchers find most audit firms completed the restructuring procedures by 2012 (Ministry of Finance of China, and China Securities Regulation Commission 2014; Liu and Wang 2014). Following prior research, we use the year 2012 as the cutoff year. Thus,

our pre-reform period represents years 2007 through 2012 while the post-reform period represents years 2013 through 2020. Results indicate that for four of the audit quality measures (predictability of earnings, accounting conservatism, restatement, and likelihood of managing earnings to avoid loss), audit quality is higher for the post-reform period relative to the pre-reform period (results not tabulated). We find that both abnormal accruals and absolute abnormal accruals are higher during the post-reform period, suggesting lower audit quality. For FSD score and earnings informativeness, we do not find a significant difference in audit quality between the two periods. Taken together, there is some evidence that the accounting and auditing reforms had a favorable effect on the audit quality of Chinese companies.

5.5.7 Effect of company size

Our final test examines whether our results are driven by company size. The evidence at a more granular level is meaningful to both investors and regulators. We partition our sample of Chinese companies at the median value of beginning assets. We find significant differences in company size between these groups; the mean value of beginning assets are, respectively, $38,556 million and $305 million for larger and smaller Chinese companies. Untabulated results suggest some evidence of higher audit quality for larger Chinese companies as indicated by lower absolute values of abnormal accruals and lower likelihood of managing earnings to meet/beat benchmarks. Next, we separately compare audit quality proxies for larger and smaller Chinese companies with their U.S. counterparts. We find some evidence of higher audit quality for Chinese companies as opposed to their U.S. counterparts. As discussed earlier, Chinese companies have a lower likelihood of restatements driven by larger Chinese companies (see Table 7). Further, we find that higher earnings informativeness (see Panel C, Table 8) is driven by smaller Chinese companies. Additionally, smaller Chinese companies also have lower FSD scores.

6. Conclusion

While a number of Chinese companies are listed in the U.S. stock exchanges, Chinese authorities have not allowed the PCAOB to inspect the audit work papers of Chinese audit firms of U.S.-listed companies. The lack of transparency caused by these obstacles has put U.S. investors at risk and naturally, the PCAOB, the SEC, and others have expressed concerns about the quality of financial reporting and auditing of U.S.-listed Chinese companies. Using multiple proxies as well as control groups, we find that the audit quality of U.S.-listed Chinese companies is similar to those of U.S. companies. In other words, our findings do not suggest that the lack of inspections by the PCAOB impairs audit quality of U.S.-listed Chinese companies. However, we acknowledge that our measures of audit quality may not capture differences in audit quality from input or process perspectives (Knechel et al. 2016). Our findings are reassuring to members of the U.S. Congress, the SEC, investors and other market participants. Our findings do not support delisting of Chinese companies from U.S. exchanges due to concern over audit quality. However, we caution that our results do not imply that Chinese audit firms do not need inspection by the PCAOB. It is likely that inspections could enhance audit quality, audit efficiency, and the reputation of Chinese audit firms. In addition, cooperation from the Chinese authorities could strengthen economic and political ties between the world's two largest economies.

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Appendix A: Estimation of abnormal accruals

Following Dechow et al. (1995) and Kothari et al. (2005), we estimate the following total accrual model to calculate abnormal accruals. We restrict our sample to at least ten observations for each industry (two-digit SIC code) and year combination to permit the computation of discretionary accruals.

$$TACC=\alpha_0+\alpha_1\left(\frac{1}{LAGAT}\right)+\alpha_2(\Delta SALES-\Delta AR)+\alpha_3 PPE+\alpha_4 LAGROA+\varepsilon \quad (1a)$$

where,

TACC = Total accruals, calculated as income before extraordinary items less cash flow from operations excluding extraordinary items and discontinued operations, scaled by the beginning of year total assets;

LAGAT = Total assets at the end of the prior year;

⊿SALES = Change in sales from the prior year to the current year, scaled by the beginning assets.

⊿AR = Change in accounts receivable from the prior year to the current year, scaled by the beginning assets;

PPE = Property, plant, and equipment of the current year, scaled by the beginning assets;

LAGROA = Return on assets calculated as the prior-year income before extraordinary items divided by total assets at the beginning of the prior year.

The residual from model 1a is our estimate of abnormal accruals (*ABACC*).

Appendix B: Variable definitions

Dependent Variables		
ABACC	=	Abnormal accruals estimated from model (1a);
Abs_ABACC	=	Absolute value of abnormal accruals estimated from model (1a);
BENCHMARK1	=	An indicator variable that is equal to 1 if the firm manage earnings to avoid a loss, i.e. the firm's net income in the current year divided by the market value of equity at the beginning of the prior year is at least 0 and <0.02, and 0 otherwise;
BENCHMARK2	=	An indicator variable that is equal to 1 if the firm manage earnings to avoid an earnings decline, i.e. the change in the firm's net income from the prior year to the current year divided by the market value of equity at the beginning of the prior year is at least 0 and <0.01, and 0 otherwise;
CAR	=	The market-model-based cumulative residual stock relative to the CRSP equally weighted NYSE, AMEX, NASD market index, aggregated over the one-year period beginning with the fourth month of the current fiscal year t; market model parameters are estimated over the year preceding the annual return window;
CFO	=	Cash flow from operations scaled by beginning assets;
EARN	=	Earnings before extraordinary items for the current year scaled by beginning assets;
FSD_SCORE	=	The sum of the absolute difference between the empirical distribution of leading digits in annual financial statements and their theoretical Benford distribution, divided by the number of leading digits;
RESTATEMENT	=	An indicator variable that is equal to 1 if the firm subsequently restates the year t financial statement, and 0 otherwise;
Independent Variables		
ACCRUAL	=	Total accruals (IBC – OANCF + XIDOC) scaled by beginning assets;
AUDCHG	=	An indicator variable that is equal to 1 if the firm has an auditor change in current year, 0 otherwise;
AUDFEE	=	Firm's audit fees scaled by the beginning assets;[15]
AUDTENURE	=	The natural log of the number of years that the auditor has audited the firm's financial statements;
BETA	=	Systematic risk, estimated as the slope coefficient from a market-model regression of daily stock returns on the equally weighted NYSE, AMEX, NASDQ market index return over fiscal year;
BIG4	=	An indicator variable that is equal to 1 if the firm is audited by Deloitte & Touche, Ernst & Young, KPMG, or PricewaterhouseCoopers, and 0 otherwise;
BLOAT	=	The lagged value of book equity plus debt, minus cash, scaled by sales;
BTM	=	Book value of assets divided by market value of equity;
BUSSEG	=	The number of business segments;
CAPINT	=	Gross PP&E divided by total net sales;
CFO	=	Cash flow from operations scaled by beginning assets;

(continued)

[15] For the sake of interpretation, the *AUDFEE* is scaled by beginning assets and then times one thousand.

CHCS	=	Change in cash sales, measured as (cash sales$_t$ – cash sales$_{t-1}$ / Cash Sales$_{t-1}$, where cash sales = total revenue – (total receivables$_t$ – total receivables$_{t-1}$);
CHINV	=	The change in inventory scaled by average total assets;
CHREC	=	The change in accounts receivable scaled by average total assets;
CHROA	=	Change in ROA, measured as (ROA$_t$ – ROA$_{t-1}$);
CLI_IMP	=	Proportion of the non-audit fees paid by an individual client to the total fees of the auditor;
CURRENT	=	The ratio of current assets to current liabilities;
D	=	An indicator variable that is equal to 1 if the market-adjusted returns are negative, and 0 otherwise;
DEBTISSUE	=	Indicator variable that equals 1 if the company issued debt in that year;
DIVDUM	=	An indicator variable that is equal to 1 if the firm pays dividends in current year, and 0 otherwise;
EARN	=	Earnings before extraordinary items for the current year scaled by beginning assets;
EARNGR	=	An indicator variable that is equal to 1 if change in income is positive, and 0 otherwise;
EQUITISSUE	=	An indicator variable that is equal to 1 if the firm issued equity during year t and 0 otherwise;[16]
FGNINCOME	=	The absolute value of pretax income from foreign operations divided by the absolute value of pretax income;
FIRMAGE	=	The number of years since the firm appears in the CRSP monthly stock return file;
FOLLOW	=	The number of individual analysts per the I/B/E/S detail file issuing EPS forecasts in current year;
GEOSEG	=	The number of geographic segments;
ICMW	=	An indicator variable that is equal to 1 if a material weakness is reported for the year, per Audit Analytics, and 0 otherwise;
IND_FE	=	Industry dummies based on the Fama & French 12 industry classification;
INFLUEN	=	Ratio of a company's total fees relative to the aggregate annual fees generated by the local office that audits the company;
ISSUE	=	An indicator variable that is equal to 1 if the company issued debt or equity in that year;
INSTHOLD	=	Annual institutional share holdings at the beginning of the year;
LAGEARN	=	Earnings before extraordinary items for the prior year scaled by beginning assets of the prior year;
LEVERAGE	=	The issuer's total debt (short-term plus long-term debt) divided by total assets;
LITIGATION	=	An indicator variable that is equal to 1 if the firm operates in a high litigation industry (with SIC of 2833–2836, 3570–3577, 3600–3674, 5200–5961, 7370–7374, and 8731–8734), and 0 otherwise;

(continued)

[16] To mitigate the concern that equity increases due to exercise of stock option or warrants for employee compensation, we follow Begenau and Salomao (2019) to regard only equity issuance larger than 3% of market value as equity issuance.

LNMVE	=	The natural log of market value of equity at the beginning of the year;
LOSS	=	An indicator variable that is equal to 1 if the firm reports a loss in the current year, and 0 otherwise;
MERGER	=	An indicator variable that is equal to 1 if the firm is engaged in a merger or acquisition, and 0 otherwise;
MTB	=	The ratio of market value of equity and book value of equity;
NOINSP	=	An indicator variable that is equal to 1 if the issuer's audit firm is not inspected by PCAOB, and 0 otherwise;
NUM_ACCTS	=	The number of financial statement accounts used to calculate FSD Scores.
PE	=	Price-to-earnings ratio, measured as closing price at the end of fiscal year / earnings per share;
PERSIST	=	Earnings persistence, specified as 1 when the absolute value of change in earnings, i.e. (EARN - LAGEARN), is above industry median, and 0 otherwise.
RET	=	Market-adjusted annual stock returns;
RETVOL	=	Standard deviation of monthly stock returns in the last year;
REVDOWN	=	An indicator variable that is equal to 1 if the last quarter's average forecast of EPS per I/B/E/S in current year was less than the first quarter average, and 0 otherwise;
ROA	=	Return on assets, measured as income divided by average total assets;
RSST_ACCR	=	The change in noncash working capital plus the change in noncurrent operating assets plus the change in net financial assets scaled by average total assets (Richardson et al. 2005);
SALESGR	=	Change in sales deflated by beginning assets;
SGROW_PCT	=	The percent of change in revenue over last year;
SHARES	=	The number of shares used to calculate EPS;
SIZE	=	The natural log of the issuer's total assets at the year-end;
SPI	=	Special items scaled by beginning assets;
Std_CFO	=	Standard deviation of the issuer's cash flow from operations scaled by beginning assets, computed from year t-3 to year t;
WRITEOFF	=	An indicator variable that is equal to 1 if special items is negative, and 0 otherwise;
YEAR_FE	=	Year dummies;
ZSCORE	=	Altman's Z-score (Altman 1968) is calculated as −4.3 - 4.5×net income scaled by total assets + 5.7×total liabilities scaled by total assets - 0.004×current assets/current liability.

Table 1: Sample construction for abnormal accruals model

	Sample Size	
	Treatment Group (Observations disclosed in the PCAOB list on 07/29/2021)	**Control Group** (All U.S. observations in *Compustat*)
Analysis period spans from fiscal year 2014 to fiscal year 2020	1,064	55,076
Less:		
• Duplicated observations at client-year level	-54	N/A
• Client-year observations not in *Compustat*	-158	N/A
• Client-year observations with variables for abnormal accrual model not available in *Compustat*	-396	-39,922
• Client-year observations with variables for abnormal accrual model not available in *Audit Analytics*	-4	-389
• Client-year observations with variables for abnormal accrual model not available in *Thomson Financial*	-13	-931
Samples available for abnormal accrual model	439	13,834
Final samples after 1:1 matching	439	439

The treatment group consists of Chinese companies (including Hong Kong) listed in U.S. stock exchanges. This table reports the sample selection process for the abnormal accruals model. Sample period covers years 2014 through 2020.

Table 2: Descriptive statistics for abnormal accruals model

Panel A: Descriptive statistics for the full sample (N=878)

Variable	Mean	Standard deviation	Quartile 1	Median	Quartile 3
ABACC	-0.031	0.65	-0.116	0.012	0.165
SIZE	7.182	2.136	5.642	6.994	8.576
FGNINCOME	0.293	0.457	0.000	0.009	0.475
GEOSEG	3.174	2.185	2.000	2.000	4.000
BUSSEG	2.600	1.658	1.000	3.000	4.000
BTM	0.696	0.608	0.231	0.495	0.965
LEVERAGE	0.198	0.168	0.037	0.176	0.319
LITIGATION	0.404	0.491	0.000	0.000	1.000
CFO	0.074	0.099	0.014	0.077	0.136
Std_CFO	0.072	0.072	0.024	0.043	0.090
SALESGR	0.052	0.187	-0.036	0.036	0.129
BIG4	0.741	0.438	0.000	1.000	1.000
ICMW	0.041	0.198	0.000	0.000	0.000
INSTHOLD	0.407	0.365	0.006	0.352	0.761
CLI_IMP	0.113	0.115	0.005	0.076	0.187

This table reports the descriptive statistics of the variables used in the abnormal accruals model (1b). The sample consists of 439 pairs of U.S.-listed Chinese companies (including Hong Kong) and U.S. companies. See Appendix B for variables definitions. Data are pooled across years 2014 through 2020.

Panel B: Descriptive statistics for Chinese and U.S. companies

	Chinese companies (N = 439)		U.S. companies (N = 439)		Tests of Differences	
	Mean	Median	Mean	Median	Mean Diff (*t*-statistics)	Median Diff (*z*-statistics)
ABACC	-0.007	0.011	-0.055	0.012	-1.102	-1.086
SIZE	7.147	6.945	7.217	7.053	0.486	0.546
FGNINCOME	0.230	0.000	0.356	0.124	4.142***	7.032***
GEOSEG	2.825	2.000	3.524	3.000	4.800***	1.578
BUSSEG	2.346	2.000	2.854	3.000	4.591***	4.680***
BTM	0.832	0.610	0.559	0.432	-6.808***	-4.799***
LEVERAGE	0.168	0.113	0.228	0.223	5.334***	5.847***
LITIGATION	0.494	0.000	0.314	0.000	-5.520***	-5.430***
CFO	0.065	0.061	0.083	0.085	2.822***	2.915***
Std_CFO	0.098	0.067	0.046	0.032	-11.580***	-11.446***
SALESGR	0.064	0.047	0.041	0.028	-1.859*	-1.896*
BIG4	0.806	1.000	0.677	1.000	-4.438***	-4.391***
ICMW	0.039	0.000	0.043	0.000	0.340	0.340
INSTHOLD	0.338	0.214	0.476	0.566	5.728***	5.317***
CLI_IMP	0.091	0.050	0.134	0.117	5.640***	6.923***

This table reports the descriptive statistics and sample difference test statistics of variables used in the abnormal accruals model (1b) for treatment companies (including Hong Kong companies) and control companies. See Appendix B for variable definitions. Data are pooled across years 2014 through 2020. ***, **, and * indicate, respectively, statistical significance at the 0.01, 0.05, and 0.10 levels (two-tails).

Panel C: Descriptive statistics for Chinese and U.S. companies

	Chinese companies (N = 439)		U.S. companies (N = 439)		Tests of Differences	
	Mean	Median	Mean	Median	Mean Diff (*t*-statistics)	Median Diff (*z*-statistics)
AUDIT FEES ($M)	1.891	1.203	3.351	1.724	6.867***	4.912***
AUDIT FEES/TA	0.002	0.001	0.002	0.002	0.646	3.046***

This table reports the descriptive statistics and test of differences in mean and median audit fees (in millions of $) and audit fees over total assets between samples of treatment companies and control companies. Data are pooled across years 2014 through 2020. ***, **, and * indicate, respectively, statistical significance at the 0.01, 0.05, and 0.10 levels (two-tails).

Table 3: Pearson correlations for variables in abnormal accrual model

Variables	1)	2)	3)	4)	5)	6)	7)	8)	9)	10)	11)	12)	13)	14)	15)	16)
1) *ABACC*	1.000															
2) *NOINSP*	0.037	1.000														
3) *SIZE*	-0.045	-0.016	1.000													
4) *FGNINCOME*	0.072 **	-0.139 ***	0.052	1.000												
5) *GEOSEG*	-0.088 ***	-0.160 ***	0.091 ***	0.418 ***	1.000											
6) *BUSSEG*	-0.018	-0.153 ***	0.282 ***	0.031	0.152 ***	1.000										
7) *BTM*	0.089 ***	0.224 ***	-0.182 ***	-0.015	-0.067 **	0.053	1.000									
8) *LEVERAGE*	0.002	-0.177 ***	0.303 ***	0.037	0.103 ***	0.112 ***	-0.084 **	1.000								
9) *LITIGATION*	0.064 *	0.183 ***	0.012	0.072 **	0.050	-0.198 ***	-0.117 ***	-0.125 ***	1.000							
10) *CFO*	-0.105 ***	-0.095 ***	0.307 ***	-0.046	0.004	0.059 *	-0.291 ***	-0.070 **	0.016	1.000						
11) *Std_CFO*	0.002	0.364 ***	-0.304 ***	-0.179 ***	-0.130 ***	-0.246 ***	-0.062 *	-0.205 ***	0.195 ***	-0.167 ***	1.000					
12) *SALESGR*	-0.030	0.063 *	0.109 ***	-0.086 **	-0.073 **	-0.020	-0.314 ***	0.006	0.153 ***	0.305 ***	0.128 ***	1.000				
13) *BIG4*	-0.024	0.148 ***	0.557 ***	0.068 **	0.105 ***	0.112 ***	-0.219 ***	0.070 **	0.131 ***	0.160 ***	-0.009	0.105 ***	1.000			
14) *ICMW*	0.022	-0.011	-0.050	0.057 *	0.020	-0.033	0.063 *	0.021	-0.030	-0.052	-0.055 *	-0.050	-0.035	1.000		
15) *INSTHOLD*	-0.128 ***	-0.190 ***	0.359 ***	0.060 *	0.094 ***	0.088 ***	-0.252 ***	0.044	0.055 *	0.230 ***	-0.162 ***	0.186 ***	0.293 ***	0.042	1.000	
16) *CLI_IMP*	0.038	-0.187 ***	0.243 ***	0.098 ***	0.105 ***	0.048	-0.224 ***	0.245 ***	-0.008	0.069 **	-0.109 ***	0.043	0.143 ***	-0.017	0.155 ***	1.000

This table presents the Pearson correlation matrix for variables in Abnormal accrual models. See Appendix B for variable definitions. Data are pooled across years 2014 through 2020. ***, **, and * indicate, respectively, statistical significance at the 0.01, 0.05, and 0.10 levels.

Table 4: Results of regression of abnormal accruals on PCAOB inspection status

	Dependent Variables			
	ABACC (1)		Abs_ABACC (2)	
Variables	**Coef.**	**t-stat.**	**Coef.**	**t-stat.**
NOINSP	**-0.023**	**-0.384**	**0.043**	**0.531**
SIZE	-0.025	-1.647	-0.014	-0.623
FGNINCOME	0.189	3.009***	0.158	1.950*
GEOSEG	-0.024	-1.907*	-0.052	-3.129***
BUSSEG	0.012	0.809	0.016	0.854
BTM	0.087	1.942*	-0.029	-0.489
LEVERAGE	0.007	0.042	0.209	0.897
LITIGATION	0.374	4.860***	-0.031	-0.338
CFO	-0.345	-1.234	-0.063	-0.175
Std_CFO	-0.382	-0.908	1.434	2.435**
SALESGR	0.126	0.934	-0.459	-2.524**
ICMW	0.002	0.015	0.303	2.132**
BIG4	0.051	0.798	0.157	1.950*
INSTHOLD	-0.093	-0.981	0.164	1.215
CLI_IMP	0.391	1.976**	-0.373	-1.542
_cons	-0.062	-0.482	0.442	2.763***
Industry FE	Yes		Yes	
Year FE	Yes		Yes	
Clustering	Firm		Firm	
Observations	878		878	
Adjusted R^2	0.113		0.223	

This table presents the results of a regression of abnormal accruals (*ABACC*) or absolute value of abnormal accruals (*Abs_ABACC*) on *NOINSP* and control variables for a sample of 439 U.S.-listed Chinese companies and 439 U.S. companies. See Appendix A for the calculation of abnormal accruals. *NOINSP* is an indicator variable that equals 1 if the issuer's audit firm is not inspected by the PCAOB, and 0 otherwise. See Appendix B for definitions of other variables. ***, **, and * indicate, respectively, statistical significance at the 0.01, 0.05, and 0.10 levels (two-tails).

Table 5: Results of predictability of current earnings (cash flows) on future earnings (cash flows) conditioned on PCAOB inspection status

	Dependent Variables			
	EARN (1)		CFO (2)	
Variables	**Coef.**	**t-stat**	**Coef.**	**t-stat**
LAGEARN	0.099	1.076	0.456	4.467***
NOINSP	-0.015	-2.467**	-0.011	-1.469
NOINSP× LAGEARN	**-0.016**	**-0.275**	**-0.024**	**-0.370**
LNMVE	0.005	2.814***	0.008	3.315***
LNMVE×LAGEARN	0.017	1.090	0.018	0.845
SALESGR	0.097	4.079***	0.122	5.287***
SALESG×LAGEARN	0.245	1.898*	-0.280	-1.487
SPI	0.970	4.876***	0.049	0.260
SPI×LAGEARN	-2.286	-2.084**	-0.104	-0.065
DIVDUM	-0.001	-0.115	0.009	1.062
DIVDUM×LAGEARN	0.231	2.928***	0.032	0.365
LOSS	-0.118	-11.734***	-0.051	-5.151***
LOSS×LAGEARN	0.529	7.681***	0.014	0.195
BIG4	0.013	1.699*	0.011	1.212
BIG4×LAGEARN	-0.214	-3.197***	-0.201	-2.623***
CLI_IMP	-0.021	-0.757	-0.016	-0.458
CLI_IMP×LAGEARN	-0.265	-0.951	0.216	0.848
_cons	0.018	1.592	0.002	0.129
Industry FE	Yes		Yes	
Year FE	Yes		Yes	
Clustering	Firm		Firm	
Observations	1190		1190	
Adjusted R^2	0.754		0.607	

This table presents the results of a regression of earnings (*EARN*) or operating cash flow (*CFO*) on prior year earnings (*LAGEARN*), *NOINSP*, and their interaction, as well as control variables and interactions of control variables and *LAGEARN* for a sample of 595 U.S.-listed Chinese companies and 595 U.S. companies. *NOINSP* is an indicator variable that equals 1 if the issuer's audit firm is not inspected by the PCAOB, and 0 otherwise. See Appendix B for definitions of other variables. ***, **, and * indicate, respectively, statistical significance at the 0.01, 0.05, and 0.10 levels (two-tails).

Table 6: Results of accounting conservatism conditioned on PCAOB inspection status

	Dependent Variables			
	EARN (1)		EARN (2)	
	Coef.	**t-stat.**	**Coef.**	**t-stat.**
D	-0.002	-0.186	-0.013	-0.420
RET	0.030	1.848*	0.050	1.082
D×RET	0.125	2.518**	0.152	1.418
NOINSP	-0.030	-2.042**	-0.040	-2.797***
NOINSP×D	0.016	0.829	0.010	0.491
NOINSP×RET	-0.026	-1.078	-0.023	-0.937
NOINSP×D×RET	**-0.006**	**-0.103**	**-0.045**	**-0.730**
SIZE			0.012	4.127***
SIZE×D			0.003	0.699
SIZE×RET			0.003	0.495
SIZE×D×RET			-0.010	-0.696
MTB			0.000	0.136
MTB×D			0.001	0.111
MTB×RET			-0.007	-1.690*
MTB×D×RET			0.019	1.407
LEVERAGE			-0.113	-3.103***
LEVERAGE×D			-0.007	-0.126
LEVERAGE×RET			-0.003	-0.052
LEVERAGE×D×RET			-0.183	-1.156
_cons	0.040	5.534***	-0.030	-1.338
Industry FE	Yes		Yes	
Year FE	Yes		Yes	
Clustering	Firm		Firm	
Observations	1114		1114	
adj. R^2	0.129		0.212	

This table presents the results of a regression of earnings (*EARN*) on market-adjusted annual stock returns (*RET*), an indicator variable for negative returns (*D*), *NOINSP*, two-way interactions of each two of the three variables, and the three-way interactions, as well as control variables and two-way and three-way interactions with *RET* and *D* for a sample of 557 U.S.-listed Chinese companies and 557 U.S. companies. *NOINSP* is an indicator variable that equals 1 if the issuer's audit firm is not inspected by the PCAOB, and 0 otherwise. See Appendix B for definitions of other variables. ***, **, and * indicate, respectively, statistical significance at the 0.01, 0.05, and 0.10 levels (two-tails).

Table 7: Results of logistic regression of restatements on PCAOB inspection status

	Dependent Variables	
	RESTATEMENT	
	Coef.	**z-stat.**
NOINSP	**-1.085**	**-2.731*****
RSST_ACCR	1.670	1.671*
CHREC	13.043	2.010**
CHINV	-6.787	-0.438
CHCS	-0.269	-0.637
CHROA	0.510	0.282
AUDTENURE	-0.527	-2.209**
AUDCHG	0.343	0.608
AUDFEE	-0.104	-1.284
INFLUEN	-0.570	-0.653
BIG4	-0.011	-0.024
BTM	0.079	0.232
ISSUE	0.453	0.912
MERGER	0.547	1.541
LEVERAGE	-0.393	-0.427
LOSS	0.247	0.700
LNMVE	-0.143	-1.022
_cons	-1.290	-0.949
Industry FE	Yes	
Year FE	Yes	
Observations	1116	
Pseudo. R^2	0.112	

This table presents the results of a logistic regression of accounting restatement (*RESTATEMENT*) on *NOINSP* and control variables for a sample of 558 U.S.-listed Chinese companies and 558 U.S. companies. Column (1) presents the logistic regression results of the full sample. Column (2) and (3) presents the logistic regression results of Chinese companies and U.S. companies separately. *NOINSP* is an indicator variable that equals 1 if the issuer's audit firm is not inspected by the PCAOB, and 0 otherwise. See Appendix B for definitions of other variables. ***, **, and * indicate, respectively, statistical significance at the 0.01, 0.05, and 0.10 levels (two-tails).

Table 8: Additional analyses

Panel A: Meeting or beating earnings benchmarks

	Dependent Variables			
	BENCHMARK1 (1)		BENCHMARK2 (2)	
	Coef.	t-stat.	Coef.	t-stat.
NOINSP	**-0.001**	**-0.035**	**0.003**	**0.081**
LITIGATION	-0.034	-1.014	-0.022	-0.560
MTB	0.001	0.115	0.012	2.645***
LNMVE	-0.025	-2.343**	0.040	3.227***
CFO	-0.488	-1.988**	0.386	1.785*
EQUITISSUE	-0.036	-1.310	-0.033	-0.999
ROA	-0.564	-2.048**	-0.423	-1.970**
RET	-0.055	-2.385**	-0.065	-2.492**
LOSS	-0.322	-8.939***	0.000	0.012
INSTHOLD	0.049	1.021	0.046	0.901
CURRENT	0.002	0.268	-0.012	-1.292
LEVERAGE	0.101	0.921	-0.026	-0.165
ACCRUAL	-0.310	-1.309	0.337	1.329
CAPINT	0.005	0.455	0.017	1.753*
ZSCORE	-0.014	-0.859	-0.035	-1.853*
SHARES	0.000	2.022**	-0.000	-0.888
BLOAT	-0.002	-0.128	-0.003	-0.205
FOLLOW	0.001	0.563	-0.005	-1.974**
REVDOWN	0.002	0.065	0.037	1.215
WRITEOFF	0.025	1.223	-0.007	-0.257
EARNGR	-0.075	-3.612***	0.248	9.754***
BIG4	0.047	1.526	-0.032	-0.946
AUDTENURE	-0.027	-1.379	0.023	1.281
AUDCHG	-0.065	-1.203	0.110	1.669*
CLI_IMP	-0.165	-1.976**	0.090	0.996
cons	0.396	4.022***	-0.365	-4.310***
Industry FE	Yes		Yes	
Year FE	Yes		Yes	
Clustering	Firm		Firm	
Observations	862		862	
adj. R^2	0.123		0.208	

This table presents the results of regression of the avoidance of a loss (*BENCHMARK1*) or the avoidance of an earnings decline (*BENCHMARK2*) on *NOINSP* and control variables for a sample of 431 U.S.-listed Chinese companies and 431 U.S. companies. *NOINSP* is an indicator variable that equals 1 if the issuer's audit firm is not inspected by the PCAOB, and 0 otherwise. See Appendix B for definitions of other variables. ***, **, and * indicate, respectively, statistical significance at the 0.01, 0.05, and 0.10 levels (two-tails).

Panel B: FSD Score

	Dependent Variables	
	FSD_SCORE	
	Coef.	**t-stat.**
NOINSP	**-0.949**	**-0.895**
CHCS	1.280	0.698
CHROA	2.112	0.439
DIVDUM	-0.689	-0.956
DEBTISSUE	0.652	0.790
LNMVE	0.102	0.457
MTB	-0.093	-0.683
PE	-0.021	-2.126**
SGROW_PCT	-4.687	-2.039**
FIRMAGE	-0.005	-0.176
RETVOL	-5.877	-0.867
NUM_ACCTS	-0.209	-7.656***
_cons	56.970	15.191***
Industry FE	Yes	
Year FE	Yes	
Clustering	Firm	
Observations	698	
adj. R^2	0.172	

This table presents the results of regression of the financial statement divergence score (*FSD*) on *NOINSP* and control variables for a sample of 349 U.S.-listed Chinese companies and 349 U.S. companies. *NOINSP* is an indicator variable that equals 1 if the issuer's audit firm is not inspected by the PCAOB, and 0 otherwise. See Appendix B for definitions of other variables. ***, **, and * indicate, respectively, statistical significance at the 0.01, 0.05, and 0.10 levels (two-tails).

Panel C: Earnings informativeness

	Dependent Variable	
	CAR	
	Coef.	**t-stat.**
EARN	0.107	0.493
LAGEARN	-0.071	-1.991**
NOINSP	-0.000	-0.044
NOINSP×EARN	**0.168**	**1.960***
BETA	-0.008	-1.292
BETA×EARN	0.115	1.897*
PERSIST	0.002	0.459
PERSIST×EARN	-0.033	-0.592
LNMVE	0.006	2.782***
LNMVE×EARN	-0.004	-0.182
MTB	0.000	0.220
MTB×EARN	-0.027	-2.485**
LOSS	0.007	0.734
LOSS×EARN	-0.143	-1.306
BIG4	-0.012	-1.386
BIG4×EARN	-0.094	-1.043
AUDTENURE	0.004	0.790
AUDTENURE×EARN	-0.003	-0.048
AUDCHG	0.003	0.224
AUDCHG×EARN	-0.006	-0.046
INFLUEN	-0.026	-1.858*
INFLUEN×EARN	-0.095	-0.681
CLI_IMP	-0.011	-0.419
CLI_IMP×EARN	0.422	1.376
_cons	-0.032	-1.923*
Industry FE	Yes	
Year FE	Yes	
Clustering	Firm	
Observations	834	
adj. R^2	0.013	

This table presents the results of regression of annual cumulative abnormal returns (*CAR*) on earnings (*EARN*), *NOINSP* and their interactions, as well as control variables and interactions of control variables and *EARN* for a sample of 417 U.S.-listed Chinese companies and 417 U.S. companies. *NOINSP* is an indicator variable that equals 1 if the issuer's audit firm is not inspected by the PCAOB, and 0 otherwise. See Appendix B for definitions of other variables. ***, **, and * indicate, respectively, statistical significance at the 0.01, 0.05, and 0.10 levels (two-tails).

Table 9: Results of regression of abnormal accruals on PCAOB inspection status using an alternative control group of U.S. companies

	Dependent Variables			
	ABACC (1)		Abs_ABACC (2)	
Variables	**Coef.**	**t-stat**	**Coef.**	**t-stat**
NOINSP	**-0.083**	**-0.758**	**-0.143**	**-1.049**
SIZE	0.000	0.035	-0.032	-1.655*
FGNINCOME	-0.002	-0.067	0.003	0.122
GEOSEG	0.003	0.402	0.029	2.051**
BUSSEG	-0.002	-0.156	0.016	0.979
BTM	0.009	0.306	0.046	1.011
LEVERAGE	0.189	1.649*	0.384	2.676***
LITIGATION	0.838	14.574***	1.345	14.071***
CFO	0.020	0.108	0.155	0.668
Std_CFO	0.268	1.026	2.226	6.386***
SALESGR	-0.123	-1.175	-0.099	-0.861
BIG4	0.010	0.174	0.086	1.051
ICMW	0.048	0.537	0.019	0.209
INSTHOLD	-0.119	-1.808*	-0.231	-2.302**
CLI_IMP	-0.092	-0.680	-0.219	-1.134
cons	0.033	0.359	0.507	3.926***
N	14,273		14,273	
adj. R^2	0.096		0.362	

This table presents the results of a regression of abnormal accruals (*ABACC*) or absolute value of abnormal accruals (*Abs_ABACC*) on *NOINSP* and control variables for a sample of 439 U.S.-listed Chinese companies and 13,834 U.S. companies. See Appendix A for the calculation of abnormal accruals. *NOINSP* is an indicator variable that equals 1 if the issuer's audit firm is not inspected by the PCAOB, and 0 otherwise. See Appendix B for definitions of other variables. ***, **, and * indicate, respectively, statistical significance at the 0.01, 0.05, and 0.10 levels (two-tails).

Table 10: Summary of Results

	Primary Control Group	Alternative Control Groups	
Audit quality measures	**Matched U.S. public companies**	**All U.S. public companies**	**U.S.-listed Chinese companies audited by non-Chinese auditors**
Abnormal accruals	No significant difference	No significant difference	No significant difference
Earnings and cash flows predictability	No significant difference	Treatment companies have higher audit quality	Treatment companies have higher audit quality
Accounting conservatism	No significant difference	Treatment companies have lower audit quality	Treatment companies have higher audit quality
Likelihood of restatements	Treatment companies have *higher* audit quality	Treatment companies have higher audit quality	No significant difference
Meeting or beating earnings benchmarks	No significant difference	No significant difference	No significant difference
FSD score	No significant difference	Treatment companies have higher audit quality	No significant difference
Earnings informativeness	Treatment companies have *higher* audit quality	No significant difference	No significant difference

This table summarizes the results from using three control groups. Treatment companies refer to the U.S.-listed Chinese (including Hong Kong based) companies, whose auditors are not inspected by PCAOB. The first control group refers to the size, industry, and year-matched companies among all U.S. public companies (column1). The second control group refers to all U.S. public companies in *Compustat* with the necessary data to estimate the models (column 2). The third control group refers to the U.S.-listed Chinese companies whose auditors are inspected by the PCAOB (column 3).