Hometown favoritism and the quality of government monitoring: Evidence from rotation of Chinese auditors

Jian Chu, Raymond Fisman, Songtao Tan, and Yongxiang Wang*

This version: February 9, 2020

Abstract

Audits are a standard mechanism for reducing corruption in government investments. The quality of audits themselves, however, may be affected by relationships between auditor and target. We study whether provincial chief auditors in China show greater leniency in evaluating prefecture governments in their hometowns. In city-fixed-effect specifications – in which the role of shared background is identified from auditor turnover – we show that hometown auditors find 38 percent less in questionable monies. This hometown effect is similar throughout the auditor's tenure, and is diminished for audits ordered by the provincial Organizations Department as a result of the departure of top city officials. We argue that our findings are most readily explained by favoritism rather than an endogenous response by local officials to concerns of better enforcement by hometown auditors. We complement these city-level findings with firm-level analyses of earnings manipulation by state-owned enterprises via real activity manipulation (a standard measure from the accounting literature), which we show is higher under hometown auditors.

JEL classification: D73, G3, M42, H83

Keywords: Social Ties, Audit quality, State-owned enterprise, Government investment, China

*Chu: School of Business, Nanjing University, Anzhong Building 820, Nanjing, PR. China 210093 (email: chujian@nju.edu.cn); Fisman: Economics Department, Boston University, Room 304A, Boston, MA 02215 (email: rfisman@bu.edu); Tan, School of Finance, Renmin University of China, Mingde Main Building 604, Beijing, PR. China 100872 (email: Tansongtao@126.com); Wang: Finance and Business Economics Department, Marshall School of Business, University of Southern California, HOH 716, Los Angeles, CA 90089; and Shanghai Advanced Institute of Finance, Shanghai Jiaotong University, Shanghai, China, 200030 (email: yongxiaw@ marshall.usc.edu). Rui Dong,Junkai Huang and Yiming Cao provided excellent RA work.

1 Introduction

Government investment provides essential (and potentially very productive) public amenities, such as transport infrastructure and schools. At the same time, public investment may be particularly prone to corruption (e.g., Tanzi and Davoodi (1998)). One common prescription to limit theft from and mismanagement of public projects is the threat of ex post evaluation and audit, which in turn raises the concern that preexisting relationships between the auditor and those under investigation may allow corrupt or inept officials to avoid detection and/or punishment. Thus, there is an emphasis on the role of *independent* auditors to ensure effective enforcement (Dabla-Norris et al. (2012)).

While conflict-of-interest rules restrict the most obvious relationships between monitor and target, such as family ties or business relationships, less visible or more diffuse ties may nonetheless facilitate auditor-target collusion, or otherwise compromise the objectivity of oversight. In this paper, we examine how such ties affect the findings of provincial audits of municipal fund expenditures in China. We focus on the provincial chief auditor's city of birth as a source of potential connection to audit targets.[1] Hometown connections are a natural focus in our setting, as such ties are a well-documented nexus of favor exchange in China (Fisman et al. (2018)), Vietnam (Do et al. (2017)) and countries with weak institutions more generally (Hodler and Raschky (2014)) which, we argue, may lead to greater leniency in evaluations of "hometown" expenditures.

We explore this "hometown favoritism" hypothesis by looking at the outcomes of audits in 277 Chinese prefectures during the years 2006-2016. According to the *Audit Law of the People's Republic of China*, evaluations are carried out – either directly or indirectly – by province-level audit departments.[2] The chief officers of province-level audit departments, like many top officials in China, experience frequent rotation, providing plausible variation for identifying whether lead auditors show greater leniency for audits of their hometown governments. In our preferred specification – which includes city fixed effects so that the hometown auditor effect is identified from auditor turnover – we find that audits turn up 38 percent fewer suspicious expenditures when the lead auditor is investigating his hometown (we do not find that a hometown auditor conducts fewer audits).[3]

[1] We use the terms prefecture and city interchangably throughout, and elaborate on the definition of a prefecture in the next section.

[2] In the case of indirect audits, the prefecture-level audit departments carry out the audits, supervisied by the province-level audit department. Major expenditures must be audited directly by the province-level audit department, according to the Audit Law. Even in cases in which the audit is carried out by the prefecture audit department, the city's chief auditor reports directly to the province's chief auditor.

[3] We cannot distinguish between auditor-target corruption versus an auditor's preference for leniency toward hometown officials. In either case, investigations turn up little suspicious activity. This distinction is analogous to the "active" versus "passive" waste in the corruption literature, which is rarely able to differentiate between the two

A natural alternative interpretation for this finding is based on the idea that a well-connected and well-informed hometown auditor may more effectively deter misbehavior. The net effect of "hometown deterrence" on observed suspicious expenditures is theoretically ambiguous – if hometown auditors deter misbehavior, local government officials will engage in less underlying suspicious activity, but a greater fraction of such activities will be uncovered. We further show that, even if the former effect dominates, deterrence is unlikely to account for our main results, based on a pair of heterogeneity analyses. First, we look at the hometown auditor effect as a function of his tenure. Chief auditor assignments are made in each province by its Organization Department of the Party Standing Committee (one of the province's highest authority). As we explain in the next section, these appointments are governed by a range of considerations, and would be exceedingly difficult for prefecture-level bureaucrats (or indeed the chief auditors themselves) to predict. This uncertainty in the assignment process implies that, in the earlier years of his tenure, a chief auditor oversees evaluations of projects that were planned and implemented before local officials could anticipate the arrival of a hometown auditor. Thus, if anticipation of strict enforcement were responsible for the hometown effect, we would expect the relationship between hometown audits and suspicious expenditure to be muted early in an auditor's tenure. We do not, however, find any evidence of a differential effect in the auditor's first year, or as a function of the auditor's tenure more generally.

We next examine whether the hometown auditor effect differs in years in which one of the city's top two officials (the party secretary and the mayor) leaves office. Central government regulation dictates that, following such departures, audits be directly carried out by the provincial Audit Department and overseen by the provincial CPC committee's Organization Department, among the most powerful departments in the province (whose leader always serves on the the provincial Standing Committee). We argue that Organization Department oversight will constrain the chief auditor, and as a result any hometown favoritism will be attenuated in years of top officials' departures. Consistent with the disciplining role of this higher-level oversight, the hometown auditor effect drops by nearly half in party secretary and mayor turnover years (that is, we observe less hometown favoritism when one of the city's top two officials leaves office).

Finally, we complement our city-year analyses with firm-level analyses on earnings manipulation at state-owned enterprises. Since state-owned enterprises also fall under the purview of provincial auditors, we examine whether questionable accounting practices are more common in the presence of a hometown auditor. We focus on earnings management through real activities manipulation (RAM) which, while not strictly illegal, captures expenditure changes which reside in a legal gray zone that would naturally raise auditors' concerns, a point we discuss in more detail below. In the paper that develops this measure, Roychowdhury (2006) suggests that it captures firms' use of price

without direct observation of bribery. See Bandiera et al. (2009) for an exception.

discounts to temporarily boost sales, overproduction to report lower cost of goods sold, and reduced discretionary expenditures to improve reported margins (Roychowdhury (2006) further shows that firms deploy such techniques to meet analyst earnings expectations).

The SOE findings complement our main results on government audits in several ways. First, our RAM analyses further serve to assess whether the hometown audit effect is the result of favoritism or anticipated enforcement. In contrast to audit outcomes, in which favoritism and deterrence potentially yield the same prediction, for real activities manipulation the two theories generate opposing predictions: In the presence of a lenient auditor, a firm will engage in more questionable accounting practices, whereas anticipation of greater scrutiny will lead firms to avoid accounting red flags. Second, our SOE sample allows for a more disaggregated analysis, so we may better account for attributes of potential audit targets. Third, it allows us to examine whether the hometown audit effect manifests itself in public expenditure audits as well as evaluations of quasi-public state enterprises (which, in our sample, are partially privatized). Our analyses of earnings manipulation in state-owned firms reinforces the view that auditors show greater leniency toward hometown officials: RAM is on average about a quarter of a (within-firm) standard deviation higher in the presence of a hometown auditor. This result survives the inclusion of city as well as firm fixed-effects.

Our work contributes to several related literatures that collectively aim to understand the impediments to effective oversight of both public projects and private firms. In particular, a sizeable literature in accounting and finance focuses on the monitoring role of external auditors, and emphasizes the potential conflicts that result from ties between a firm's leadership and and ostensibly independent auditors. He et al. (2017), for example, show for a sample of Chinese firms that audit quality is poorer when external auditors share school ties with audit committee members, and a large number of earlier papers show that social ties between executives and external auditors similarly impair the quality of external auditors' work (see, e.g., Guan et al. (2016) for China, and Baber et al. (2014) for the U.S.).

These papers focus exclusively on oversight of private firms by outside monitors that are effectively hired on behalf of shareholders to monitor its agents (i.e., the executive), and highlight the potential conflicts that arise when executives and the board play a role in monitor selection. A closely related set of concerns arise with the hiring of so-called third party auditors, to monitor firms' compliance with national laws and regulations. As observed by Duflo et al. (2013), third-party auditors are also often hired by the firm, which creates a similar set of conflicts of interest as for external auditors.

To our knowledge, we are the first to study potential conflicts in monitoring by government auditors. Our setting is quite distinct from the oversight of private firms – whether by external auditors to monitor shareholders' interests or third-party auditors to monitor regulatory compliance

– examined in earlier work. We look at monitors selected by independent bureaucrats who should be less subject to the conflicts of interest that afflict a firm's executive or board. Furthermore, our focus on oversight of public rather than private activities has distinct political economy and welfare implications.

Given our focus on hometown connections, we also contribute to the literature on the role of social ties in the functioning of bureaucracies in general and in China in particular. This literature has generally emphasized favoritism as the dominant force (e.g., Fisman et al. (2018) and others), though Fisman et al. (2019) and Fisman et al. (2017) emphasize that other considerations – whether better information, enforcement or other concerns – may also play an important role in some settings.

Finally, our finding that social ties are associated with greater leniency in oversight has direct policy implications for the design of conflict-of-interest rules. In general, there is a tradeoff in restricting well-connected candidates from monitoring positions: a locally-connected monitor may have better information or ability to enforce compliance than an outsider, an advantage that needs to be weighed against the costs of potential favoritism. Our results suggest that favoritism may be a dominant factor in our setting, which provides a rationale for the existence of rules against assignment to one's home region precisely to reduce the potential for collusion or self-dealing (see Fisman et al. (2017)). Furthermore, our results suggest potential future directions for the growing body of work that uses the *results* of external audits to study accountability and corruption (e.g., Ferraz and Finan (2008),Ferraz and Finan (2011) Gerardino et al. (2017), and Avis et al. (2018)). These studies take audit reports as unbiased, whereas we highlight the fact that audits themselves might be corrupted.

2 Background and Data

2.1 Monitoring and evaluation of Chinese municipal governments

The system of oversight for Chinese governments' revenues and expenditures was delineated in the *Constitution of the People's Republic of China*, adopted in 1982. The Constitution stipulated the creation of a central government body, estabilshed by the State Council, to "supervise through auditing the revenue and expenditure of all departments under the State Council and of the local governments at various levels, and the revenue and expenditure of all financial and monetary organizations, enterprises and institutions of the state" (Article 91 of the Constitution). The Constitution further required that local governments also establish auditing organs. These were required for governments at the county-level (one level below prefecture/city) and higher. Article 109 of the

Constitution specified that, "the local auditing organs...should report to the corresponding local government and also auditing organs at the higher level." That is, the audit department at the county-level was mandated to report to the prefecture-level audit department (in addition to reporting to the county government), the prefecture audit department to the provincial audit department (and also the prefecture government), and so forth. Thus, from the initial establishment of China's governmental audit system, the provincial audit chief's direct authority over the prefectural audit chief has been codified in law.

The laws contained in the 1982 Constitution also led to the formal establishment of the National Audit Office of the People's Republic of China in September, 1983, which is a cabinet-level ministry, one of twenty-six such departments that comprise the State Council, China's chief administrative body. Among other responsibilities, the National Audit Office supervises provincial audit offices throughout the country. By the end of 1983, all provinces had established their own Audit Departments, with the exception of Shanghai, Qinghai, Fujian and Guangxi, which established theirs in 1984.

The laws formalizing the roles and responsibilities of audit offices at various levels were not put in place until the passage of the 1994 Audit Law, which went into effect on January 1, 1995. The audit law was substantially revised in February 2006, so as to give expanded responsibilities to each audit office. In particular, the law specified that the local office was required to audit all local government branches and local SOEs, and also that the local chief audit officer would be selected by the local Party Standing Committee. More importantly (and of particular relevance for our setting), Article 16 of the law specified that a local audit office has the authority to directly audit lower-level government sectors and SOEs (that is, the provincial audit office has the authority to audit any prefectural government department and any SOE controlled by the prefecture.)[4]

In general, provincial auditors tend to focus primarily on more significant audits. While there is no formal delineation of investigations of municipal expenditures conducted at the prefecture- versus provincial-level, a review of the practices of several provinces (Hunan, Jiangsu, Sichuan) suggests a few commonalities. Provincial auditors generally audit the implementation of the fiscal budgeting (revenues and expenditures) of prefecture government departments. Furthermore, when an entire sector (e.g., the finance industry or public utilities) faces an audit across the entire province, it is managed by the provincial audit department, as it requires coordination across multiple prefectures. Larger individual investments in fixed assets, such as roads or buildings, may fall under the purview of provincial auditors. SOEs owned by the provincial government are also overseen by the provincial auditor, rather than the prefectural auditor in the city where the SOE is located. Furthermore, the

[4]The full text of China's audit regulations may be found at http://www.gov.cn/zhengce/2019-07/15/content_5409738.htm last accessed January 29, 2020.

provincial Party Standing Committee can order "special audits" at its discretion, which provides wide latitude for the provincial audit office in its oversight of prefectures.

Finally, the departure of top prefecture officials, by law, automatically triggers an audit by the provincial audit office.[5] More specifically, the government responsibilities or sectors under direct supervision of the departing officer are targeted for provincial audit. For the mayor, the prefecture government's office would be audited, as well as any other sectors or departments assigned to him for supervision. For example, if the mayor were mainly in charge of the Education and Finance Departments (not an unusual situation in Chinese cities), while the vice-mayor supervised the Price and Police Departments, then Finance and Education would be audited when the mayor departs, but not Price and Police. This audit cannot be undertaken by the prefecture office, since top prefecture officials outrank the prefecture's chief auditor. Crucially, audits conducted immediately following the departure of one or both of the prefecture's chief officers also take place under the leadership and guidance of the province's Organization Department, one of the highest administrative body in the province. The Organization Department is essentially the human resource manager for the Communist Party of China, which makes promotions and other HR decisions for the CPC bureaucracy. Precisely because of its consequences for future promotion or demotion decisions, the audits conducted as top officials leave office are more scrutinized than the routine fiscal audits that occur in other years.[6] As a result, the provincial chief auditor has less discretion in his oversight of a prefecture in the years of a city chief officer's departure.

We summarize the structure and responsibilities of the CPC bureaucracy as it pertains to the audit department and its various roles in Figure 1. As the diagram emphasizes, there exists a parallel hierarchy within the audit offices, with the audit department at each level of government supervised by the one above it. The figure also highlights the audit responsibilities of the provincial and municipal audit offices. In particular, it illustrates that the provincial audit office is directly responsible for a combination of provincial and municipal audits, and supervises the various municipality audit departments under its jurisdiction, as well as top city leaders (which, as the figure shows, supervise the city audit department and so cannot be audited by them).

[5]This requirement was put in place for county-level leaders in the *Interim Provisions on the Audit of Economic Responsibilities of Party and Government Leading Cadres at the County Level*in May 1999. An expansion of these provisions were implemented in January 1, 2005, that extended the audit requirements to officials with ranks up to that of mayor (*Ting Ju Ji* in Chinese Pinyin). See the *Opinion on Expanding the Scope of the Economic Responsibility Audit of Party and Government Leading Cadres to the Level of the* Ting Ju Ji, released Nov 24, 2004.

[6]The departure year oversight is further bolstered by the involvement of the provincial Discipline Inspection Commission (DIC), the provincial division of the CPC Central Commission for Discipline Inspection. While departure year audits are initiated by the OD, if suspicions are raised around the leader's behavior as a result of the audit, the case may be referred to the DIC for disciplinary action.

2.2 Selection of the provincial audit chief

In each provincial audit department, the chief auditor is assisted by, on average, six vice-chief audit officers. It is possible for any government officials with the same rank as, or one level below, the provincial audit chief to be selected as a chief auditor. We obtained the name of each provincial chief auditor from the *China Audit Yearbooks* (see Section 2.3), and hand-collected information on the last job title/position for each individual. Many chief auditors held lower-level positions as auditors or finance/tax officials within the same province: 38 percent of provincial chief auditors were provincial vice-chief auditors immediately before their appointments (which is defined as *PastAuditor*); 15 percent came from the provincial Finance Department or Tax Bureau, either as vice-chief officer (thus the appointment was a promotion) or chief officer (so that the appointment to chief auditor was a lateral move), which is defined as *PastFinance*. However, many also come from less closely aligned branches of the bureaucracy: 30 percent served as the vice-chief or chief officer[7] of a prefecture within the province, which is defined as *PastCityLeader*; 5 percent came from the provincial Commission for Discipline Inspection or provincial Supervision Department, as vice-chief officer (*PastDiscipline*).[8] The remaining 12 percent came from different departments within the provincial government (e.g., the Education Department, Price Department) or the central government.

The chief auditor is appointed by the provincial Standing Committee (subject to the rubber stamp approval of the provincial People's Congress), based on the Organization Department's recommendation. The timing of the appointment is itself uncertain, as it depends on the career opportunities of the incumbent chief auditor, who may be promoted by the provincial Standing Committee to higher office. Furthermore, as the distribution of successors makes clear, there is a wide range of candidates for the position – even for the 38 percent that are provincial vice-chief auditors, the provincial Standing Committee has 6 candidates to choose among. Overall, both the timing of turnover and the identity of the successor for the chief auditor position would be difficult for prefectural officials to anticipate, a point we return to below.

2.3 Data

The main outcome variables throughout come from public records of prefecture-level audits, recorded in *China Audit Yearbooks*. Since 2003, these annual publications have included the number of audit assignments undertaken and the amount of questionable monies uncovered, aggregated to the city-level. We utilize the years 2006 to 2016 as the investigations covered by the yearbooks expanded

[7] That is, vice-mayor, mayor, party secretary, or vice-party-secretary.

[8] For all but the largest prefectures, the provincial chief auditor has the same rank as the prefecture mayor or party secretary, so that the appointment of a prefectural chief officer as provincial chief auditor would be seen as a lateral move, whereas for vice-chief officers it would be a promotion.

substantially in 2006.[9]

Our sample consists of all Chinese prefectures, with the exception of Beijing, Chongqing, Shanghai and Tianjin, which are directly under the administration of the central government. Note that while we use the terms prefecture and city interchangeably, Chinese prefectures are administrative subdivisions of provinces that encompass a combination of urban and rural areas, with populations as high as 15 million.

Our hand-collected audit data are complemented by hand-collected information on the background of each provincial chief audit officer, using a range of sources, including the *China Audit Yearbooks*, official websites of each provincial Audit Office, and as needed the website *Baidu* (China's Google). Using these sources, we were able to identify the birth city of the full set of 66 provincial chief auditors in our data. We use these background characteristics to generate the following officer-level controls: years as chief auditor (*Tenure*), age, gender, dummy variables to denote the department of the official's previous position (*PastAuditor*, *PastFinance*, *PastCityLeader*, *PastDiscipline*), and education category variables to capture highest degree (*Education:* 4 for doctorate, 3 for master's, 2 for undergraduate degree, 1 for some college or less) and whether he has a finance background (*EduFinance*).

To identify dates of turnover of top city officials (which, recall, triggers an audit overseen by the Organization Department), we use the *Chinese Local Leader Database*, accessed via CSMAR, the most widely used data vendor in China.

We also include (time-varying) city-level variables, which all come from the *Chinese City Statistical Yearbooks*. City-level covariates include basic political and economic variables, in particular: the logarithm of GDP per capita, the logarithm of city population, the ratio of industrial output to GDP, the logarithm of total government revenues, the fiscal balance (government expenditures divided by revenues), foreign direct investment as a fraction of GDP, and average years of education.[10] Finally, we include in our summary statistics below the ratio of suspicious expenditures to total expenditures, as well as government expenditures to municipal GDP.

We note that the city-year panel is unbalanced because of missing data, as well as changes in administrative units. For example, in 2011 Chaohu prefecture was split into three parts and absorbed by surrounding cities, and thus disappears from our dataset. Tongren, by contrast, only became a prefecture-level administrative unit in 2011, and so only appears in our data from that year. Overall, 249 cities have data for all 11 years of our data, comprising 93.2 percent of our city-year data.

Finally, for our analysis of SOE earnings management, we use firm-year level data, also taken

[9] In the earlier years that prefecture-level audits were reported, the scale and outcome variables differed across years – it was only in 2006 that the National Audit Office put in place consistent reporting criteria.

[10] Years of education is a provincial-level variable, as city-level figures are not available.

from CSMAR, for the period of 2006 to 2018. Our main outcome variable is real activity manipulation (RAM), using the standard definition from Roychowdhury (2006). Intuitively, the RAM measure aims to capture the extent to which a firm's activities are adjusted in order to improve reported margins. It includes manipulation along three dimensions: cash flow from operations (cash discounts to boost short-term sales), production costs (overproduction to reduce per-unit costs), and discretionary expenditures (e.g., cutbacks to R&D). In practice, each component of RAM is calculated by generating deviations from predicted values. For example, "abnormal" cash flow from operations (CFO) is generated as the residuals from a regression in which cash flow is a function of the level and growth in sales:

$$\frac{CFO_{it}}{Assets_{it-1}} = \alpha_0 + \alpha_1 \frac{1}{Assets_{it-1}} + \beta_1 \frac{Sales_{it}}{Assets_{it-1}} + \beta_2 \frac{\Delta Sales_{it}}{Assets_{it-1}} + \epsilon_{it}$$

Following Cohen et al. (2008), we sum the (normalized) values of the three measures of activities manipulation, to generate our overall RAM measure. As an alternative measure of questionable accounting practices, we use accrual manipulation (AM), as pioneered by Dechow et al. (1995), calculated as the difference between total accruals (revenues and expenses booked but not realized in a given year) and non-discretionary accruals, which are in turn estimated from a model based on the gap between revenue and receivables growth.

In our SOE analyses we include the same set of chief auditor controls as for our city-level analyses, as well as the following firm-level covariates: the logarithm of total assets, leverage (total liabilities divided by total assets), ROA (return on assets), MB Ratio (the ratio of market cap to book value of total equities), log(BoardSize), ownership share of the largest shareholder, whether the chairperson is also the CEO, the ratio of independent directors to total number of directors, ownership share of top (vice-CEO and above) managers, and a dummy indicating whether the aduitor is one of the Big 4 Audit firms (PwC, Deloitte, Ernst & Young, and KPMG).

2.4 Data overview

We begin by presenting an overview of the patterns in the data, which will help to motivate some features of our empirical specifications in the next section.

In Figure 2, we show a series of figures depicting some of the time series patterns in the data. We begin in Figure 2a by showing the average of the logarithm of suspicious expenditures per audit across the years in our sample. There is a distinct increase in 2013, a natural result of the well-publicized anti-corruption crackdown initiated by China's central government in November 2012. In Figure 2b, we show that there is an associated shift in auditor background – there is a

drop in appointments of former city leaders as chief auditors, and a corresponding increase in chief auditors who are hired directly from the ranks of provincial or prefecture auditors. This is also a natural consequence of the anticorruption crackdown, with a shift away from political/patronage appointments toward those based more on expertise (although this shift comes with the perhaps unintended consequences we documented in this paper: professional auditors' conflicts-of-interest or hometown favoritism, which may have undermined anticorruption efforts).

Our main takeaway from these initial graphs is that it will be essential to control throughout for the anti-corruption period, both directly via year fixed effects, and also potentially via interactions with our main control variables.

In Figure 2c, we show the log of suspicious expenditures uncovered per audit over time, splitting the sample based on whether the chief auditor was born in the prefecture. Across the full sample, suspicious expenditures uncovered are lower in cities when overseen by hometown provincial chief auditors, a pattern that persists when we add auditor and city-year controls (Appendix Figure A1). In the next section, we will explore how this pattern is affected when we also include city fixed effects, and thus identifies the relationship from (within-city) auditor turnover.

Before proceeding to our regression analyses, we provide summary statistics on the main variables we use, both for the city-year and firm-year analyses, in Tables 1a and 1b respectively. Several figures warrant elaboration. The mean ratio of suspicious to annual expenditures is 0.183 (median 0.08). There are two reasons why the ratio may be relatively high. First, audited projects may have expenditures that extend back a number of years, so that total audited expenditures may be somewhat higher than current expenditures. Second, improper revenue generation may also contribute to the total value of suspicious expenditures.[11] We also observe that the municipal expenditure to GDP ratio is very high in our sample with a mean of 0.162 (median 0.146). This is consistent with the central role of municipal governments in the economy, particularly in China.[12]

In Table 2, we compare the city-year attributes of observations with $Hometown = 0$ versus $Hometown = 1$. While we emphasize that we will be identifying the role of hometown ties in city fixed effect specifications, which exploit auditor turnover to identify the hometown effect, we also note that the two groups of cities are statistically indistinguishable from one another in their basic attributes such as income and government expenditure.

[11] Revenues that are flagged as suspicious or improper include, for example, the shifting forward of revenues in order to improve the city's fiscal balance, or giving questionable tax breaks to local firms.

[12] China's local governments play an outsized role even when compared to other emerging market economies. For example, based on IMF data, the ratio of local government revenue to GDP was 0.24 in China in 2010, as compared to 0.075, 0.076, and 0.082 for Russia, South Africa, and Brazil respectively (International Monetary Fund (2018)).

3 Results

The main specification for our analyses of audit outcomes is as follows:

$$log(SuspiciousExpenditures_{cy}) = \beta Hometown_{a(c)y} + \boldsymbol{\beta_a X_{a(c)y}} + \boldsymbol{\beta_c X_{cy}} + \gamma_c + \upsilon_y + \epsilon_{cy} \quad (1)$$

β is the coefficient of interest, relating the hometown status of the chief auditor $a(c)$ in city c to the suspicious expenditures turned up by his audit. The vectors $\boldsymbol{X_{a(c)y}}$ and $\boldsymbol{X_{cy}}$ reflect (time-varying) auditor and city attributes, while γ_c and υ_y are fixed effects for each of the 277 cities and 11 years in our data. We cluster standard errors at the city-level throughout.

In columns (1) – (4) of Table 3, we present specifications that include progressively more controls, adding in city fixed effects (column (2)), auditor controls (column (3)), city-year controls (column (4)), and finally auditor fixed effects (column (5)).[13] We suppress the coefficients on control variables to conserve space, but include the full set of results in Appendix Table A1.

Across all specifications the coefficient on *Hometown* is significant at least at the 5 percent level. In our favored specification, which includes controls for auditor and city characteristics, $\hat{\beta}$ =0.471, indicating that suspicious expenditures uncovered by a hometown auditor were 38 percent (i.e., $1 - e^{-0.471}$) lower than those found by non-hometown auditors . In column (6) we limit our sample to prefectures for which there is within-city variation in *Hometown* and obtain a similar (though marginally smaller) coefficient on *Hometown*. We also find very strong correlations between suspicious expenditures and several other auditor attributes, most notably the two variables which capture whether the official has a background in finance, either based on education or past employment. While this correlation is interesting in its own right, there are many reasons that might account for the relationship: auditors with finance training tend to be technocrats who may have a different standard for suspicious behavior; they may have less access to networks that allow them to detect suspicious behavior; or their finance expertise may act as a deterrent. We leave exploration of these possibilities for fuuture work.

In the final two columns of Table 3, we examine whether the link between hometown auditor and suspicious expenditures is driven by the number of audits undertaken, versus the value of suspicious expenditures per audit. In theory both are possible, given the provincial audit office's discretion in whether to conduct audits in particular areas. We find that the hometown-expenditure relation is driven entirely by the per audit rate of suspicious expenditures (column (7)) rather than the number of audits (column (8)). While ex ante we have no strong prior expectations of whether hometown ties affect the number or intensity of audits, the fact that we find evidence only for the

[13] A single observation drops out with the addition of city fixed effects, because for Wuzhong prefecture we have only a single year of data.

latter is most plausibly the result of fixed government rules dictating the audits that take place in each city, which may limit auditor discretion on this margin.

Given the extremely large increase in suspicious expenditures found under the anti-corruption crackdown, in Table 4 we allow for the effect of a hometown auditor as well as other covariates to differ post-2103. We define the variable $Post2013$ to denote years 2013 and later, and include the interaction term $Hometown * Post2013$ our basic specification in equation (1). We include city and auditor controls, as well as city and year fixed effects (column (1), and also a full set of interactions with control variables (i.e., $Post2013 * \boldsymbol{X_{a(c)y}}$ and $Post2013 * \boldsymbol{X_{cy}}$) in column (2). In both cases, the direct effect of $Hometown$ is marginally more negative than in the preceding column, and the coefficient on $Hometown * Post2013$ is positive, though smaller in magnitude and does not approach statistical significance. Overall, we cannot reject the existence of a comparable effect of $Hometown$ before versus during the anticorruption campaign.[14] In columns (3) and (4) we present analogous results allowing for a differential effect in 2011 and 2013, the years in which the National Audit Office conducted its audits of local government debt. Ex ante, one might expect a moderating effect in those years because of the additional scrutiny resulting from central government oversight (though the NAO audits focused primarily on assessing whether local debt was excessive overall). The interaction of *NAO* and *Hometown* is positive in both specifications (indicating a lesser impact of *Hometown* in NAO audit years) but in neither case can we reject that it is equal to zero. Overall, the results in Table 4 suggest that the hometown effect is reasonably stable across years – while we find suggestive between-year differences in the coefficient on *Hometown*, we are plausibly underpowered to detect systematic differences.

There are two primary explanations for the low rate of suspicious expenditures uncovered in chief auditors' hometowns, which have very different implications for the role of hometown ties. The two accounts build on the classic tradeoff implicated by social connections more broadly – favoritism versus reduced information frictions, each of which may result from stronger social ties. Under the alternative information frictions interpretation (which we refer to as the "deterrence" interpretation), hometown auditors may have insider knowledge or networks that facilitate more rigorous enforcement. Anticipating more stringent oversight, city officials may engage in less suspicious activity. (A related possibility – with overlapping predictions – is that auditors may be particularly

[14] In this exercise, our aim is to assess whether the 2013 anti-corruption campaign acts as a confounder for the relationship between hometown auditors and suspicious expenditures, rather than speculating about whether this relationship should change as a result of the crackdown. We note that corruption – while possibly related to hometown ties – is a distinct phenomenon, so that a decline in corruption does not necessarily affect hometown favoritism. The lack of any change in the homeotwn audit effect after 2013 has many candidate explanations: it may reflect that the campaign was politically-driven, as many have speculated, or that its priorities lay in domains other than auditing. For the purposes of our paper, the main takeaway is that the hometown effect is statistically indistinguishable in the pre- versus post-2013 periods.

concerned for hometown welfare, and thus be particularly tenacious in their oversight of officials in their hometowns.) As we note in the introduction, hometown deterrence has an ambiguous effect on reported suspicious activity overall – while it reduces underlying suspicious expenditures, it should increase the rate at which they are uncovered. Thus, exploring the possibility of deterrence as an underlying explanation implicitly assumes that the former effect dominates.

One natural approach to testing for the deterrence interpretation is to consider whether the hometown auditor effect varies across his tenure. As we discuss in Section 2.1, there are many candidates for the provincial chief auditor position, and also uncertainty over the timing of an incumbent auditor's departure. As a result, it would be very difficult for city officials to forecast the timing of the incumbent's departure or the identity of his successor. Hence, first-year auditors conduct audits of prefecture officials who likely did not anticipate the chief auditor's changed hometown status.

In Table 5 we provide three specifications that assess the extent to which the deterrence story is likely to play a first-order role. In column (1) we add the interaction term $FirstYear * Hometown$ (as well as the direct effect, $FirstYear$) to capture whether there is a differential effect of hometown auditors in their first year in the position. The coefficient on the interaction term is positive, though small in magnitude. It is relatively imprecisely measured, but still implies that one may reject that the coefficients on $FirstYear * Hometown$ and $Hometown$ sum to zero (i.e., that the hometown effect when $FirstYear = 1$ is equal to zero) at the 1 percent level. In column (2), instead of focusing only on the first year, we allow the hometown effect to vary linearly as a function of the chief auditor's tenure ($Tenure * Hometown$), and in column (3) we also introduce a quadratic interaction ($Tenure^2 * Hometown$). In neither of these cases is there any evidence that the hometown effect is stronger in the earlier years of an auditor's tenure.

We may exploit a second dimension of heterogeneity both to assess the plausibility of the deterrence view, as well as to further bolster the view that the auditor's hometown ties – rather than some other correlated attribute – accounts for our main results. Specifically, we take advantage of the differential timing of turnover for prefectures' chief officers which, as noted in Section 2.1, automatically triggers an audit jointly overseen by the provincial chief auditor and the provincial Organization Department. We argue that the additional layer of oversight provided by the Organization Department – the province's most powerful administrative body – limits the provincial auditor's scope for leniency, while not limiting his ability to use inside knowledge to evaluate prefecture expenditures. Thus, if leniency accounts for the our main hometown effect, we expect it will be reduced in turnover years; we do not expect this to be the case if deterrence is behind the lower rate of suspicious expenditures. We define the indicator variable $CityTurnover_{cy}$ to denote any year y that the mayor or party secretary of prefecture c leaves his position.

In column (1) of Table 6 we provide estimates of Equation (1), adding $CityTurnover$ and $CityTurnover*Hometown$ as covariates. The direct effect of $CityTurnover$ is quantitatively small, and statistically insignificant. Of greater interest, the coefficient on $CityTurnover * Hometown$ (0.38) is more than half the size of the coefficient on $Hometown$, but of opposite sign, and significant at the 5 percent level. Thus, turnover-induced audits overseen by the Organization Department turn up relatively more suspicious expenditures when targeting the hometown of the province's chief auditor. Paralleling our presentation of results in Table 3, we show the decomposition of this effect into suspicious expenditures per audit versus number of audits. As before, we find that the effect comes entirely from the expenditures-per-audit margin.

Before turning to our firm-level analyses on earnings manipulation, we conclude with a set of further robustness tests and heterogeneity analyses, which we collect in Table 7. We first consider whether some other attribute of provincial leaders that is plausibly correlated with *Hometown* might account for our main findings, and then explore heterogeneity by prefecture characteristics. We begin in column (1) by including $Homeprovince_{a(c)y}$, an indicator variable which captures whether the auditor was born in the province that contains city c. This variable is uncorrelated with suspicious expenditures, highlighting the distinct role played by hometown ties, which has been emphasized in the literature (see Fisman et al. (2018) among many others). In column (2) we include the variable $SameHometown_Leaders_{a(c)y}$which captures whether the auditor of city c in year y shares his hometown with either the city mayor or party secretary (i.e., the two highest-ranking city officials). The coefficient on this shared background variable is close to zero, and does not affect the point estimate on *Hometown* coefficient. In columns (3) and (4) we take two approaches to assessing whether connections to other top provincial leaders might account for our results. First, we simply exclude the set of cities that is the hometown of the province's governor or party secretary in at least one year during our sample period. Because this is a relatively rare event, it reduces the sample by less than 10 percent, and does not impact our main result. We further show in column (4) that having a hometown provincial leader is uncorrelated with suspicious expenditures.

We now turn to examine heterogeneity by city attributes. In column (5), we control for whether the chief auditor's hometown is adjacent to city c (*NearbyHometown*) to capture potential geographic spillovers; its coefficient is close to zero and does not affect the *Hometown* coefficient, again emphasizing the particular role of hometown ties. Column (6) excludes capital cities and again our main results are unchanged.

Finally, columns (7) and (8) look at the interactions of *Hometown* with two basic city features, $log(GDPpercapita)$ and $log(Population)$. Both interactions are negative, indicating less of a hometown effect for larger, more developed prefectures, and the GDP interaction is significant at the 10

percent level. Given that the result is only marginally significant (and furthermore one of several heterogeneity tests) we would not ascribe too strong an interpretation to this finding.

Taking stock of the results presented thus far, we argue that they are most easily reconciled with the view that that chief auditors show greater leniency when assessing their hometown governments.

Firm-level results on SOE earnings manipulation

We next present a set of analyses at the firm-level of locally-owned state-owned enterprises. These results complement our city-level findings in two ways. First, they allow us to assess the association between hometown auditors and audit outcomes for a distinct set of organizations – it may give greater confidence in our interpretation if we find consistent results across the two sets of analyses. Second, we may build on the vast literature in accounting on earnings manipulation to relate the presence of a hometown auditor to suspicious *behaviors* of audited entities, rather than findings of suspicious behaviors *uncovered by* the auditor. The latter case, which is what we measure in our city-level analyses, potentially conflates suspicious actions with the auditor's ability or willingness to uncover suspicious actions.

As outlined in Section 2.3, we measure earnings management by SOEs primarily based on Real Activities Manipulation (RAM). Recall that this measure aims to capture three types of manipulation: cash flow via cash discounts to generate short-term sales, overproduction to generate higher margins, and the postponement of discretionary expenditures (e.g., R&D) to boost short-term earnings.

Before proceeding to our results, we clarify why ex ante one might expect real activities manipulation to result from relatively lax monitoring. Conceptually, RAM is in a legal gray area in China – not explicitly illicit, though not clearly legal either – indeed, it may constitute exactly the type of suspicious (though not illegal) expenditure that auditors are meant to uncover.This line of reasoning has also motivated a substantial literature in accounting, which links audit quality and quantity to various measures of earnings management (e.g., Caramanis and Lennox (2008)). At the same time, RAM constitutes only a rough proxy for suspicious activity at SOEs, rather than the direct measure available for city government spending. As such, the results in this section should be treated with appropriate caution.

Our main specification is similar to Equation 1, except that the level of observation is at the firm-year (fy):

$$RAM_{fy} = \beta Hometown_{a(c(f))y} + \boldsymbol{\beta_a X_{a(c(f))y}} + \boldsymbol{\beta_c X_{c(f)y}} + + \boldsymbol{\beta_c X_{fy}} + \omega_f + \upsilon_y + \epsilon_{fy} \qquad (2)$$

As implied by the specification in (2), we maintain our full set of time-varying auditor and city controls, and add in a set of firm-level control variables. In our preferred specification, we include firm fixed effects (ω_f), which absorb the city fixed effects we employed in the preceding analyses. Standard errors are clustered at the city level, to account for the level of identifying variation.

We present results based on equation 2 in Table 8. In column (1) we show results including only year and firm fixed effects as controls, so that we may identify the hometown-RAM relationship from auditor turnover. We observe a positive relationship, with a coefficient of 0.027 on $Hometown$. We add progressively more controls in the next set of columns, including auditor characteristics (column (2)), firm characteristics (column (3)), and city characteristics (column (4)). The addition of auditor controls leads to a coefficient on $Hometown$ of 0.030 (significant at the 5 percent level), so that the presence of a hometown auditor is associated with an increase of about a quarter of the within-firm standard deviation in RAM of 0.121 (assuming that real activities do not change with the presence of a hometown auditor for reasons other than earnings manipulation). The further addition of firm and city controls has little effect on the estimated relationship. In Appendix Table A2, we use accruals manipulation (Dechow et al. (1995)) as the outcome. While we observe a positive correlation between the presence of a hometown auditor and earnings manipulation, the correlation is quite weak.[15]

Finally, in Appendix Tables A3 and A4 we repeat our analyses of RAM for two sets of firms *not* overseen by the provincial auditor: centrally-owned SOEs, which are audited by the central government, and non-SOE firms. We may view these as placebo tests for the association between hometown auditors and earnings manipulation. In both cases, the coefficients on $Hometown$ are uniformly small and statistically indistinguishable from zero.

4 Conclusion

In this paper we show robust statistical evidence that provincial chief auditors turn up fewer suspicious expenditures in audits of government activities in their hometowns. Consistent with these results reflecting leniency toward hometown governments, this effect is reduced in years that audits are overseen by the province Organization Department, which limits the provincial chief auditor's discretion. We find supporting evidence in our analyses of earnings manipulation by locally-owned SOEs, also overseen by the provincial chief auditor.

To our knowledge, we are the first to document the consequences of shared backgrounds on the quality of government audits. Our findings have implications for the optimal design of government

[15] As suggested by Cohen et al. (2008), accruals versus real activity manipulation may be substitutes. If so, one may not necessarily expect both measures to be positively correlated with opportunities for manipulation.

monitoring institutions – we highlight the importance of accounting for a wider range of potential conflicts-of-interest in the assignment of monitors – and also for researchers in political economy, in modeling the role of social ties in bureaucracies.

References

Avis, E., C. Ferraz, and F. Finan (2018). Do government audits reduce corruption? estimating the impacts of exposing corrupt politicians. *Journal of Political Economy 126*(5), 1912–1964.

Baber, W. R., J. Krishnan, and Y. Zhang (2014). Investor perceptions of the earnings quality consequences of hiring an affiliated auditor. *Review of Accounting Studies 19*(1), 69–102.

Bandiera, O., A. Prat, and T. Valletti (2009). Active and passive waste in government spending: evidence from a policy experiment. *American Economic Review 99*(4), 1278–1308.

Caramanis, C. and C. Lennox (2008). Audit effort and earnings management. *Journal of accounting and economics 45*(1), 116–138.

Cohen, D. A., A. Dey, and T. Z. Lys (2008). Real and accrual-based earnings management in the pre-and post-sarbanes-oxley periods. *The accounting review 83*(3), 757–787.

Dabla-Norris, E., J. Brumby, A. Kyobe, Z. Mills, and C. Papageorgiou (2012). Investing in public investment: an index of public investment efficiency. *Journal of Economic Growth 17*(3), 235–266.

Dechow, P. M., R. G. Sloan, and A. P. Sweeney (1995). Detecting earnings management. *Accounting review*, 193–225.

Do, Q.-A., K.-T. Nguyen, and A. N. Tran (2017). One mandarin benefits the whole clan: hometown favoritism in an authoritarian regime. *American Economic Journal: Applied Economics 9*(4), 1–29.

Duflo, E., M. Greenstone, R. Pande, and N. Ryan (2013). Truth-telling by third-party auditors and the response of polluting firms: Experimental evidence from india. *The Quarterly Journal of Economics 128*(4), 1499–1545.

Ferraz, C. and F. Finan (2008). Exposing corrupt politicians: the effects of brazil's publicly released audits on electoral outcomes. *The Quarterly journal of economics 123*(2), 703–745.

Ferraz, C. and F. Finan (2011). Electoral accountability and corruption: Evidence from the audits of local governments. *American Economic Review 101*(4), 1274–1311.

Fisman, R., D. Paravisini, and V. Vig (2017). Cultural proximity and loan outcomes. *American Economic Review 107*(2), 457–92.

Fisman, R., J. Shi, Y. Wang, and W. Wu (2019). Social ties and the selection of china's political elite. Technical report.

Fisman, R., J. Shi, Y. Wang, and R. Xu (2018). Social ties and favoritism in chinese science. *Journal of Political Economy 126*(3), 1134–1171.

Gerardino, M. P., S. Litschig, and D. Pomeranz (2017). Can audits backfire? evidence from public procurement in chile. Technical report, National Bureau of Economic Research.

Guan, Y., L. N. Su, D. Wu, and Z. Yang (2016). Do school ties between auditors and client executives influence audit outcomes? *Journal of accounting and economics 61*(2-3), 506–525.

He, X., J. A. Pittman, O. M. Rui, and D. Wu (2017). Do social ties between external auditors and audit committee members affect audit quality? *The Accounting Review 92*(5), 61–87.

Hodler, R. and P. A. Raschky (2014). Regional favoritism. *The Quarterly Journal of Economics 129*(2), 995–1033.

International Monetary Fund (2018). *Government Finance Statistics*, Volume 32. International Monetary Fund.

Roychowdhury, S. (2006). Earnings management through real activities manipulation. *Journal of accounting and economics 42*(3), 335–370.

Tanzi, V. and H. Davoodi (1998). Corruption, public investment, and growth. In *The welfare state, public investment, and growth*, pp. 41–60. Springer.

Figure 1: The Organization of Chinese Audits

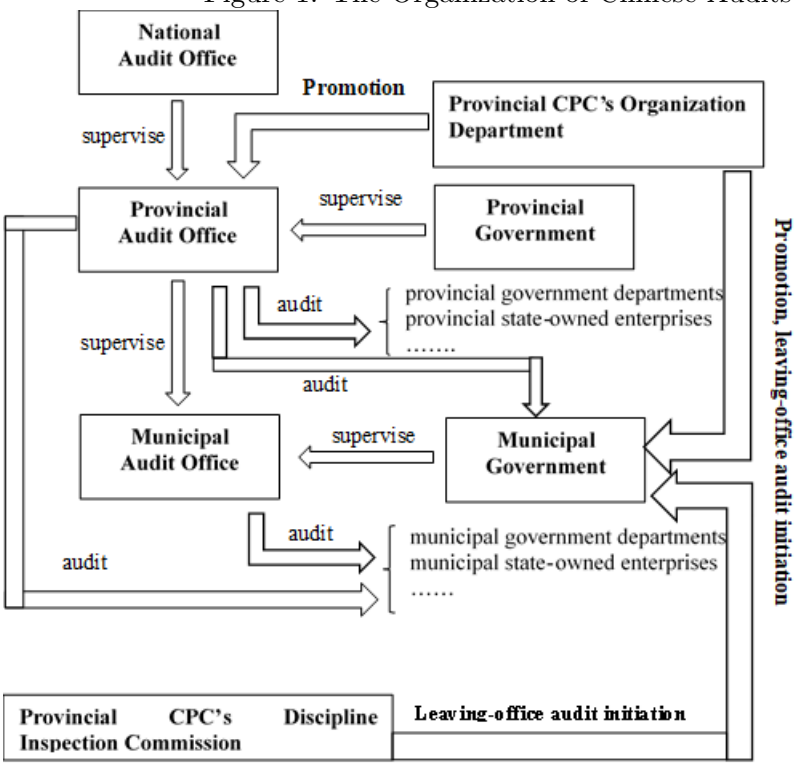
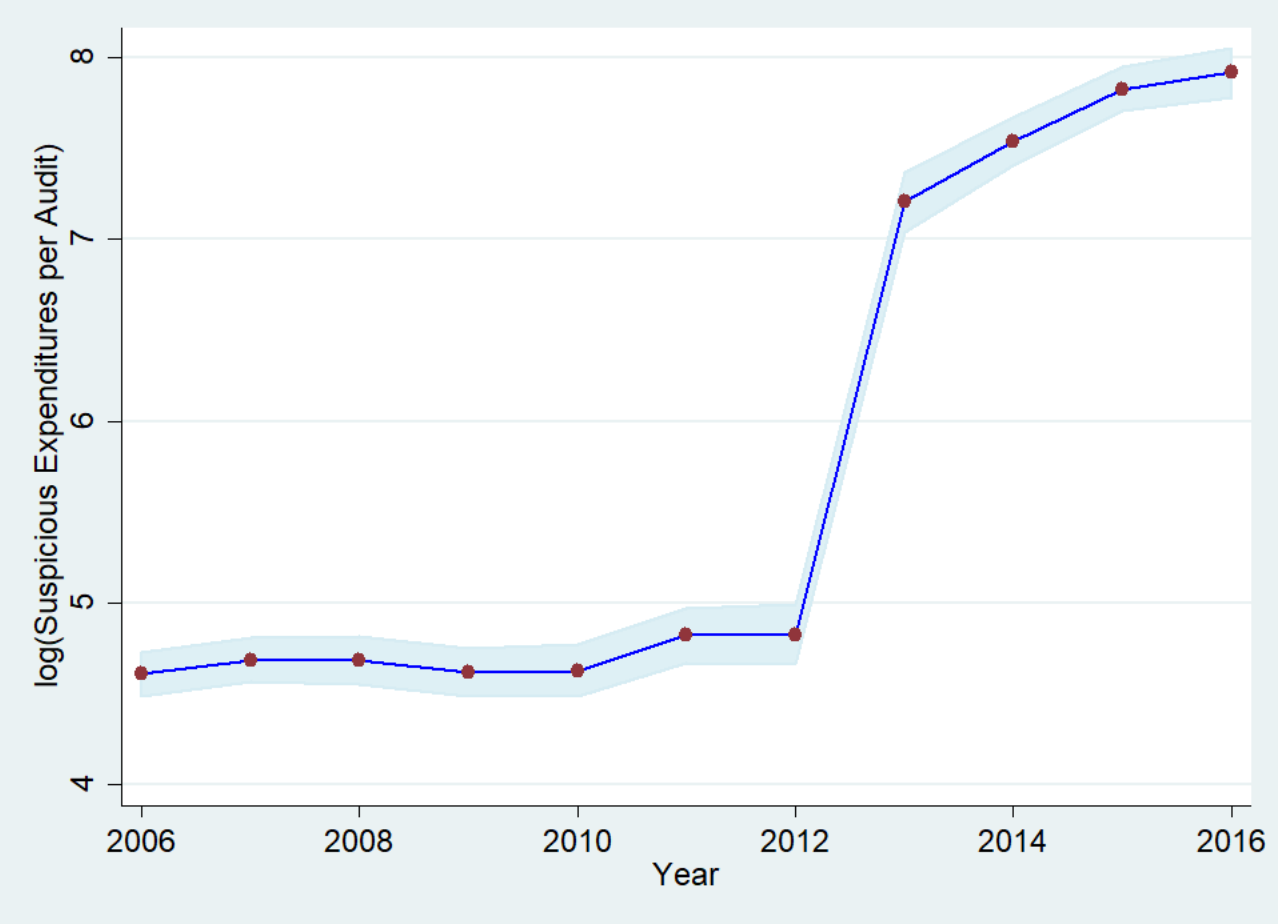
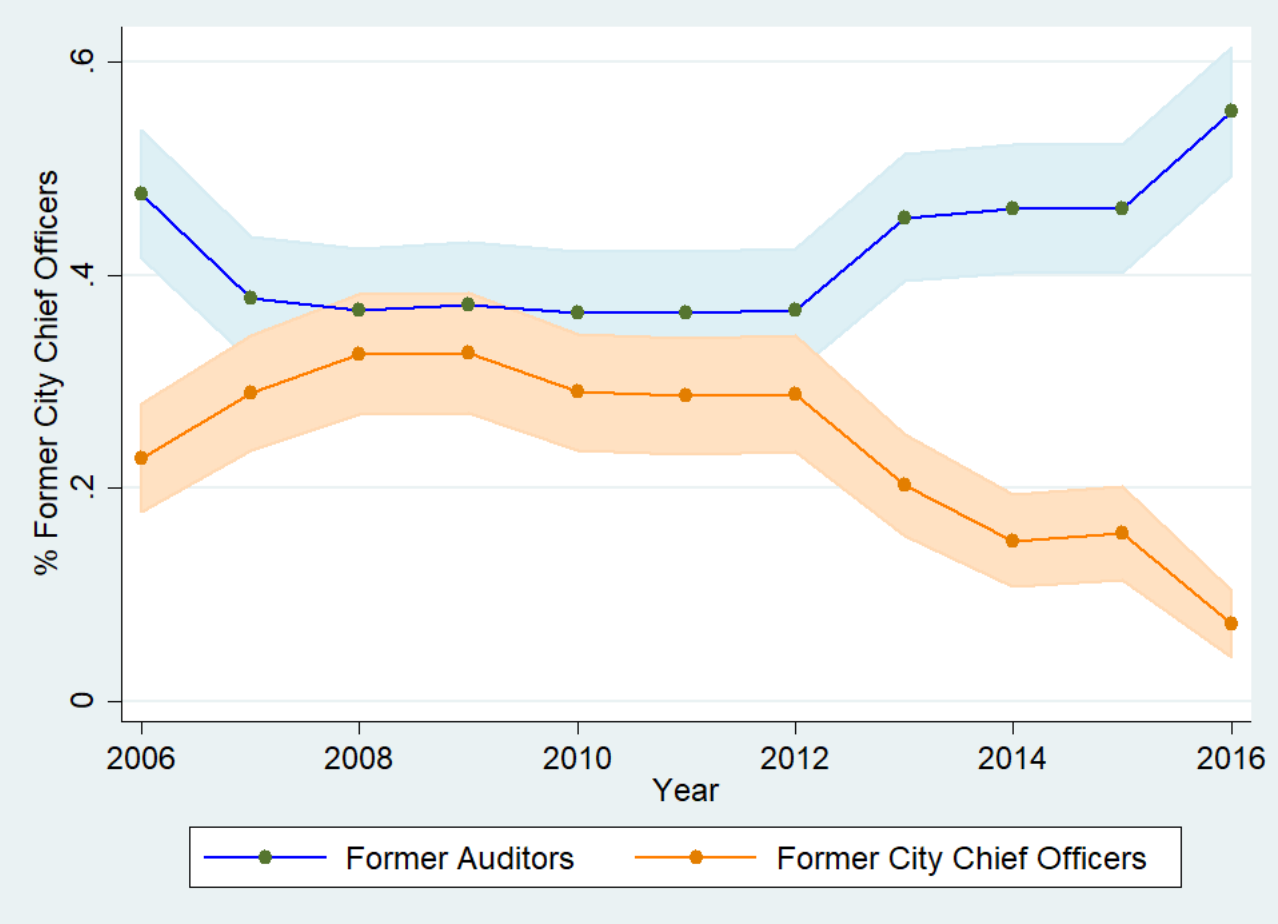


Figure 2a: The Distribution of log(SuspiciousExpenditures per Audit) across Years



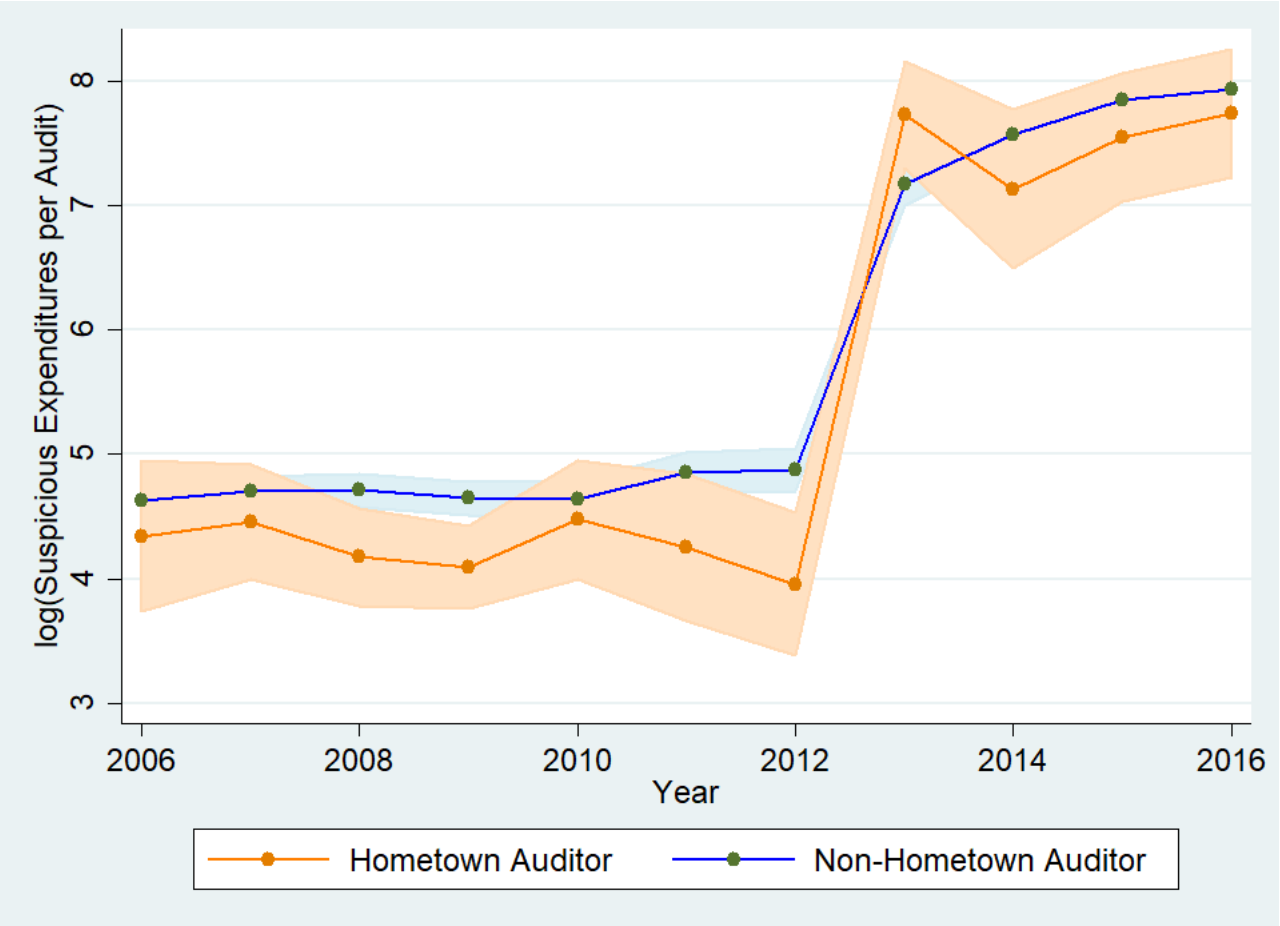
Notes: This figure shows the distribution of $log(SuspiciousExpenditures\ per\ Audit)$ across the years in our sample. Each dot indicates the average of $log(SuspiciousExpenditures\ per\ Audit)$. The shaded area shows the 95 percent confidence interval.

Figure 2b: The Distribution of Auditor Background across Years



Notes: This figure shows the distribution of auditor background across years. Each dot indicates the fraction of auditors from different backgrounds. The shaded area shows the 95 percent confidence interval.

Figure 2c: The Average of log(SuspiciousExpenditures per Audit) across Years for Hometown versus non-Hometown Auditors



Notes: This figure shows the distribution of *log*(*SuspiciousExpenditures per Audit*) across years, splitting the sample based on whether the chief auditor was born in the prefecture. Each dot indicates the average of the *log*(*SuspiciousExpenditures per Audit*) uncovered by auditors from different backgrounds. The shaded area shows the 95 percent confidence interval.

Table 1a: Summary Statistics, City-Year Aggregates

Variable Name	Mean	StdDev	Obs
$log(SuspiciousExpenditures)$	11.661	1.889	2940
$log(SuspiciousExpenditures\ per\ Audit)$	5.754	1.830	2940
$SuspiciousExp/GovExp$	0.183	0.265	2940
$log(Projects\ Audited)$	5.908	0.682	2940
$Hometown$	0.056	0.230	2940
$Gender$	0.163	0.075	2940
Age	0.883	0.321	2940
$Tenure$	54.571	3.232	2940
$Tenure^2$	4.589	2.729	2940
$Education$	28.502	30.016	2940
$EduFinance$	2.405	0.782	2940
$PastAuditor$	0.375	0.484	2940
$PastFinance$	0.420	0.494	2940
$PastDiscipline$	0.168	0.374	2940
$PastCityLeader$	0.080	0.271	2940
$Log(GDPpc)$	0.238	0.426	2940
$IndustrialRatio$	10.271	0.762	2940
$Log(Population)$	0.494	0.099	2940
$Log(GovRev)$	5.893	0.623	2940
$GovBalance$	13.421	1.091	2940
FDI/GDP	2.626	1.457	2940
$AvgEdu$	0.020	0.019	2940

Table 1b: Summary Statistics, Firm-Year Aggregates for Locally-Owned SOEs

Variable Name	Mean	StdDev	Obs
RAM	0.008	0.193	5996
AM	-0.004	0.112	5266
$log(Assets)$	22.305	1.238	5996
$Leverage$	0.521	0.195	5996
ROA	0.030	0.055	5996
$MBRatio$	3.220	3.394	5996
$TopOwnership$	0.370	0.152	5996
$log(BoardSize)$	2.318	0.179	5996
$Dual$	0.120	0.325	5996
Ind_Dir_Ratio	0.367	0.051	5996
$Mgtshare$	0.004	0.021	5996
$Big4Audit$	0.048	0.213	5996

Notes: $log(SuspiciousExpenditures)$ is the logarithm of total questionable expenditures found during the audit. $log(SuspiciousExpenditures\ per\ Audit)$ is the logarithm of total questionable expenditures per audited project. $log(Projects\ Audited)$ is the logarithm of number of audited projects. $Hometown$ is an indicator variable denoting that the provincial chief auditor was born in city c. $Gender$ is an indicator variable denoting that the chief auditor is male. Age is the age of the chief auditor. $Tenure$ is the tenure of the chief auditor. $Education$ is the education of the chief auditor: 4 for doctor, 3 for master, 2 for bachelor, 1 for college or lower level. $EduFinance$ is an indicator variable denoting whether the chief auditor has a business finance background. $PastAuditor$ is an indicator variable denoting whether the chief auditor previously worked in the auditing department. $PastFinance$ is an indicator variable denoting if the chief auditor previously worked in the finance/taxation department. $PastDiscipline$ is an indicator variable denoting if the chief auditor worked previously in the disciplining department. $PastCityLeader$ is an indicator variable denoting if the chief auditor worked previously as a city official with rank vice-mayor or higher. $Log(GDPpc)$ is the logarithm of city GDP per capita. $IndustrialRatio$ is the ratio of industrial output to total GDP. $Log(GovRev)$ is the logarithm of fiscal revenue of the city. FDI/GDP is foreign direct investment scaled by GDP. $GovBalance$ the ratio of municipal government expenditures to revenues. RAM is real activity manipulation. AM is accrual manipulation. $Leverage$ is total liabilities divided by total assets. $log(Assets)$ is the logarithm of total assets. ROA is return on assets. $MBRatio$ is the ratio of market capitalization to book value of total equity. $TopOwnership$ is the ownership share of the largest shareholder. $log(BoardSize)$ is the log of the number of board members. $Dual$ is an indicator variable denoting that the chairperson is also the CEO. $Indep\_Ratio$ is the ratio of independent directors to total number of directors. $Mgtshare$ denotes the fraction of shares held by management at the level of vice-CEO and higher. $Big4Audit$ is an indicator variable denoting whether the firm's auditor is one of the Big 4 global audit firms.

Table 2: Comparison of City Attributes, by Hometown Status

	$Hometown = 1$		$Hometown = 0$		Difference	
Varible Name	Mean	StdDev	Mean	StdDev	Difference	t-statistic
$Log(GDPpc)$	10.316	0.627	10.268	0.769	0.048	0.472
$IndustrialRatio$	0.491	0.092	0.494	0.099	-0.004	-0.227
$Log(Population)$	5.942	0.556	5.890	0.627	0.052	0.470
$Log(GovRev)$	13.507	0.950	13.416	1.098	0.091	0.570
$GovBalance$	2.681	1.266	2.622	1.468	0.058	0.265
$GovExp/GDP$	0.167	0.076	0.162	0.075	0.005	0.361
FDI/GDP	0.020	0.023	0.020	0.019	0.000	0.054
$AvgEdu$	8.526	0.661	8.646	0.616	-0.120	-1.053
$CityLeaderHometown$	0.122	0.328	0.097	0.296	0.025	0.522

Notes: $Hometown$ is an indicator variable denoting if the provincial chief auditor was born a given city. See the notes to Table 1 for detailed definitions of the variables.

Table 3: The Relationship Between Auditor Hometown and Government Audit Outcomes

Dependent Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	$log(SuspiciousExpenditures)$						$log(SuspExp/Audit)$	$log(Projects\ Audited)$
Hometown	-0.331**	-0.520***	-0.473***	-0.471***	-0.413***	-0.426***	-0.445***	-0.020
	(0.158)	(0.176)	(0.148)	(0.143)	(0.111)	(0.130)	(0.136)	(0.050)
Year FEs	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
City FEs		Yes	Yes	Yes	Yes	Yes	Yes	Yes
Auditor Controls			Yes	Yes		Yes	Yes	Yes
Auditor FE					Yes			
City Controls				Yes	Yes	Yes	Yes	Yes
Sample	Full	Full	Full	Full	Full	Within-City Variation	Full	Full
Observations	2940	2939	2939	2939	2939	339	2939	2939
R-Squared	.553	.81	.826	.827	.839	.822	.807	.787
Mean of Dep. Var.	11.7	11.7	11.7	11.7	11.7	11.7	5.75	5.91

Notes: Standard errors clustered by city in parentheses. The sample covers the period from 2006 to 2016. The dependent variable in columns (1)-(6) is $log(SuspiciousExpenditures)$, which denotes the logarithm of total questionable expenditures found during the audit. The dependent variable in columns (7) is $log(SuspiciousExpenditures\ per\ Audit)$, which denotes the logarithm of total questionable expenditures per audited project. The dependent variable in columns (8) is $log(Projects\ Audited)$, which denotes the logarithm of number of projects audited. The sample in column (6) is limited to cities that have variation in $Hometown$ during the sample period. $Hometown$ is an indicator variable denoting that the provincial chief auditor was born in city c. Auditor Controls include $Gender$, Age, $Tenure$, $Tenure^2$, $Education$, $EduFinance$, $PastAuditor$, $PastFinance$, $PastDiscipline$, and $PastCityLeader$. City controls include $Log(GDPpc)$, $IndustrialRatio$, $Log(Population)$, $Log(GovRev)$, $GovBalance$, FDI/GDP, and $AvgEdu$. The coefficients and standard errors of the control variables are suppressed to conserve space. See the notes to Table 1 for detailed definitions of the control variables.
Significance: * significant at 10%; ** significant at 5%; *** significant at 1%.

Table 4: Differences in hometown auditor effect across time periods

	(1)	(2)	(3)	(4)
Dependent Variable	$log(SuspiciousExpenditures)$			
$Hometown$	-0.516***	-0.507***	-0.517***	-0.511***
	(0.135)	(0.103)	(0.150)	(0.152)
$Hometown * Post2013$	0.106	0.199		
	(0.267)	(0.222)		
$Hometown * NAO$			0.247	0.201
			(0.174)	(0.176)
Year FEs	Yes	Yes	Yes	Yes
City FEs	Yes	Yes	Yes	Yes
Auditor Controls	Yes	Yes	Yes	Yes
City Controls	Yes	Yes	Yes	Yes
City*Post2013 Controls		Yes		
City*NAO Controls				Yes
Observations	2939	2939	2939	2939
R-Squared	.827	.84	.827	.829
Mean of Dep. Var.	11.7	11.7	11.7	11.7

Notes: Standard errors clustered by city in parentheses. The sample covers the period from 2006 to 2016. The dependent variable in all columns is $log(SuspiciousExpenditures)$, which denotes the logarithm of total questionable expenditures found during the audit. $Hometown$ is an indicator variable denoting that the provincial chief auditor was born in city c. $Post2013$ denotes years 2013 and later, and NAO is an indicator variable denoting the years 2011 and 2013 when the National Audit Office audited local government debt. Auditor Controls include $Gender$, Age, $Tenure$, $Tenure^2$, $Education$, $EduFinance$, $PastAuditor$, $PastFinance$, $PastDiscipline$, and $PastCityLeader$. City controls include $Log(GDPpc)$, $IndustrialRatio$, $Log(Population)$, $Log(GovRev)$, $GovBalance$, FDI/GDP, and $AvgEdu$. The coefficients and standard errors of the control variables are suppressed to conserve space. See the notes to Table 1 for detailed definitions of the control variables.
Significance: * significant at 10%; ** significant at 5%; *** significant at 1%.

Table 5: The Role of Auditor Tenure

	(1)	(2)	(3)
Dependent Variable	$log(SuspiciousExpenditures)$		
$Hometown$	-0.504***	-0.313	-0.259
	(0.148)	(0.209)	(0.248)
$FirstYear$	0.054		
	(0.079)		
$FirstYear * Hometown$	0.215		
	(0.170)		
$Tenure$	-0.057	-0.075**	-0.073**
	(0.041)	(0.031)	(0.032)
$Tenure * Hometown$		-0.040	-0.070
		(0.032)	(0.097)
$Tenure^2$	0.006*	0.008***	0.007**
	(0.004)	(0.003)	(0.003)
$Tenure^2 * Hometown$			0.003
			(0.009)
Year FEs	Yes	Yes	Yes
City FEs	Yes	Yes	Yes
Auditor Controls	Yes	Yes	Yes
City Controls	Yes	Yes	Yes
Observations	2939	2939	2939
R-Squared	.827	.827	.827
Mean of Dep. Var.	11.7	11.7	11.7

Notes: Standard errors clustered by city in parentheses. The sample covers the period from 2006 to 2016. The dependent variable in all columns is $log(SuspiciousExpenditures)$, which denotes the logarithm of total questionable expenditures found during the audit. $Hometown$ is an indicator variable denoting that the provincial chief auditor was born in city c. Auditor Controls include $Gender$, Age, $Tenure$, $Tenure^2$, $Education$, $EduFinance$, $PastAuditor$, $PastFinance$, $PastDiscipline$, and $PastCityLeader$. City controls include $Log(GDPpc)$, $IndustrialRatio$, $Log(Population)$, $Log(GovRev)$, $GovBalance$, FDI/GDP, and $AvgEdu$. The coefficients and standard errors of the control variables are suppressed to conserve space. See the notes to Table 1 for detailed definitions of the control variables.
Significance: * significant at 10%; ** significant at 5%; *** significant at 1%.

Table 6: City Turnover, Administrative Oversight, and Audit Outcomes

Dependent Variable	(1) $log(Suspicious\ Expenditures)$	(2) $log(SuspExp/Project)$	(3) $log(Projects\ Audited)$
$Hometown$	-0.670***	-0.638***	-0.024
	(0.168)	(0.159)	(0.056)
$CityTurnover$	-0.012	0.001	-0.015
	(0.029)	(0.031)	(0.012)
$CityTurnover * Hometown$	0.378**	0.367**	0.007
	(0.178)	(0.175)	(0.044)
Year FEs	Yes	Yes	Yes
City FEs	Yes	Yes	Yes
Auditor Controls	Yes	Yes	Yes
City Controls	Yes	Yes	Yes
Observations	2939	2939	2939
R-Squared	.828	.808	.787
Mean of Dep. Var	11.7	5.75	5.91

Notes: Standard errors clustered by city in parentheses. The sample covers the period from 2006 to 2016. The dependent variable in columns (1) is $log(SuspiciousExpenditures)$, which denotes the logarithm of total questionable expenditures found during the audit. The dependent variable in columns (2) is $log(SuspiciousExpenditures\ per\ Audit)$, which denotes the logarithm of total questionable expenditures per audited project. The dependent variable in columns (3) is $log(Projects\ Audited)$, which denotes the logarithm of number of projects audited. $Hometown$ is an indicator variable denoting that the provincial chief auditor was born in city c. $Turnover$ denotes years in which the prefecture mayor or party secretary departs, which triggers audit oversight by the province-level Organization Department. Auditor Controls include $Gender$, Age, $Tenure$, $Tenure^2$, $Education$, $EduFinance$, $PastAuditor$, $PastFinance$, $PastDiscipline$, and $PastCityLeader$. City controls include $Log(GDPpc)$, $IndustrialRatio$, $Log(Population)$, $Log(GovRev)$, $GovBalance$, FDI/GDP, and $AvgEdu$. The coefficients and standard errors of the control variables are suppressed to conserve space. See the notes to Table 1 for detailed definitions of the control variables.
Significance: * significant at 10%; ** significant at 5%; *** significant at 1%.

Table 7: Robustness and heterogeneity

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Dependent Variable	$log(SuspiciousExpenditures)$							
$Hometown$	-0.471***	-0.473***	-0.436***	-0.472***	-0.470***	-0.367**	-0.452***	-0.461***
	(0.143)	(0.143)	(0.156)	(0.143)	(0.147)	(0.163)	(0.144)	(0.139)
$Homeprovince$	-0.006							
	(0.103)							
$SameHometownLeaders$		-0.025						
		(0.080)						
$ProvLeaderHometown$				-0.063				
				(0.138)				
NearbyCity					0.004			
					(0.079)			
$Hometown * log(Population)$							-0.190	
							(0.227)	
$Hometown * log(GDPpercapita)$								-0.226*
								(0.122)
Excluding Mayor/PS hometowns?			Yes					
Excluding Prov capitals?						Yes		
Observations	2939	2939	2698	2939	2939	2654	2939	2939
R-Squared	.827	.827	.827	.827	.827	.824	.827	.827
Mean of Dep. Var.	11.7	11.7	11.6	11.7	11.7	11.6	11.7	11.7

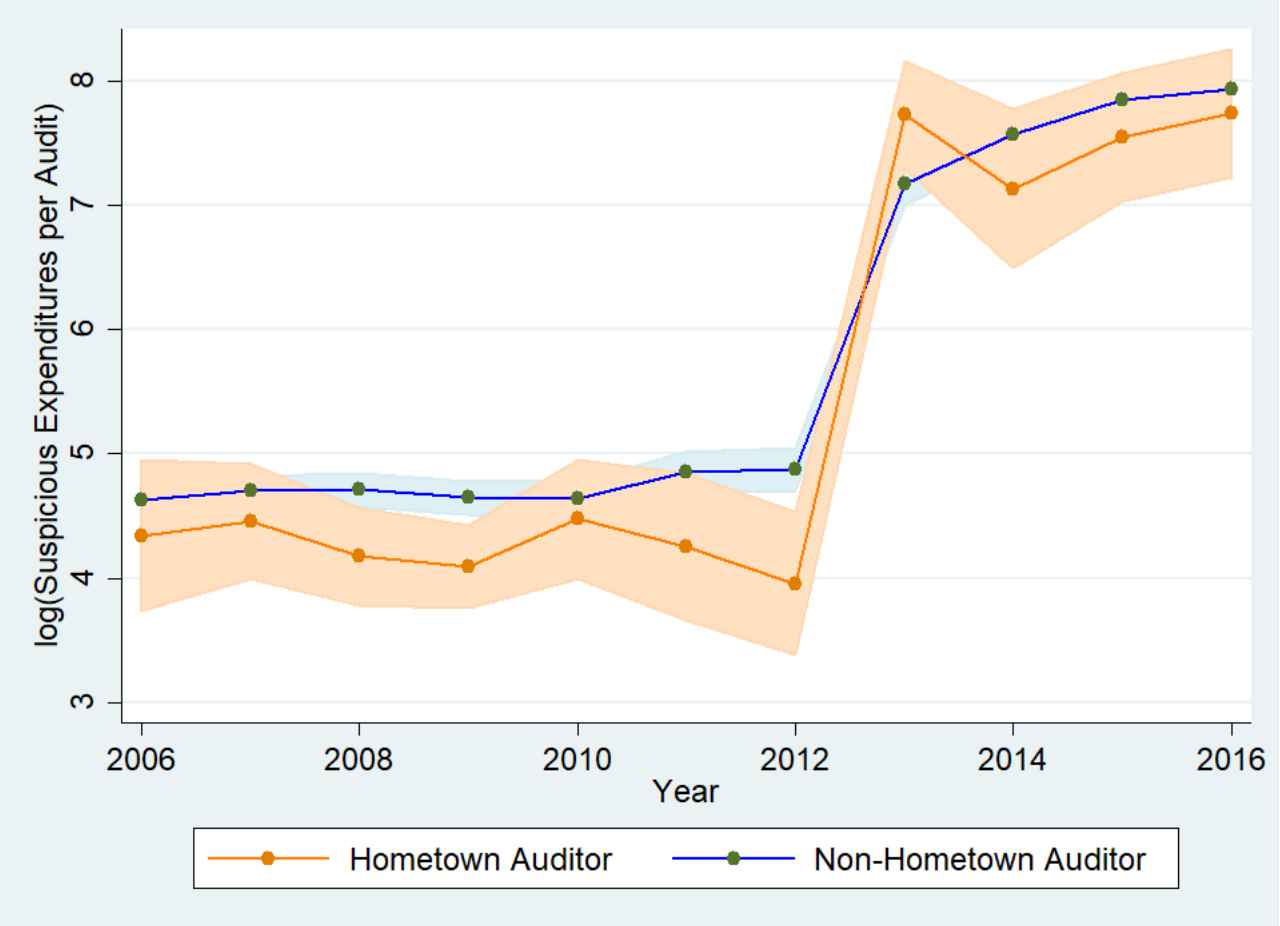
Notes: Standard errors clustered by city in parentheses. The sample covers the period from 2006 to 2016. Column (2) excludes cities that, at some point during this period, was the hometown of the provincial governor or party secretary for the province where c is located. Column (5) excludes provincial capital cities. The dependent variable in all columns is $log(SuspiciousExpenditures)$, which denotes the logarithm of total questionable expenditures found during the audit. $Hometown$ is an indicator variable denoting that the provincial chief auditor was born in city c. $Homeprovince$ is an indicator variable denoting that the provincial chief auditor was born in province of city c. $SameHometownLeader$ is an indicator variable denoting that the provincial chief auditor had the same hometown as the city mayor or party secretary. $ProvLeaderHometown$ is an indicator variable denoting that the provincial governor or party secretary was born in city c. All regressions include the following auditor controls: $Gender$, Age, $Tenure$, $Tenure^2$, $Education$, $EduFinance$, $PastAuditor$, $PastFinance$, $PastDiscipline$, and $PastCityLeader$. All regressions include the following city controls: $Log(GDPpc)$, $IndustrialRatio$, $Log(Population)$, $Log(GovRev)$, $GovBalance$, FDI/GDP, and $AvgEdu$. The coefficients and standard errors of the control variables are suppressed to conserve space. See the notes to Table 1 for detailed definitions of the remaining control variables.
Significance: * significant at 10%; ** significant at 5%; *** significant at 1%.

Table 8: Firm Level Regressions on Locally-Owned SOE Real Activity Manipulation

	(1)	(2)	(3)	(4)
Dependent Variable	*Real Activity Manipulation*			
Hometown	0.027**	0.030**	0.034***	0.038**
	(0.014)	(0.013)	(0.013)	(0.016)
Year FEs	Yes	Yes	Yes	Yes
Firm FEs	Yes	Yes	Yes	Yes
Auditor Controls		Yes	Yes	Yes
Firm Controls			Yes	Yes
City Controls				Yes
Observations	5950	5950	5950	5331
R-Squared	.561	.563	.596	.607
Mean of Dep. Var.	.0072	.0072	.0072	.0054

Notes: Standard errors clustered by city in parentheses. The sample covers the period from 2006 to 2018. The sample includes all locally-controlled state-owned enterprises The dependent variable in all columns is real activity manipulation (RAM). $Hometown$ is an indicator variable denoting that the provincial chief auditor was born in city c. Auditor Controls include $Gender$, Age, $Tenure$, $Tenure^2$, $Education$, $EduFinance$, $PastAuditor$, $PastFinance$, $PastDiscipline$, and $PastCityLeader$. Firm controls include $log(Assets)$, $Leverage$, ROA, $MBRatio$, $TopOwnership$, $log(BoardSize)$, $Dual$, $Indep\_Ratio$, $Mgtshare$, and $Big4Audit$. City controls include $Log(GDPpc)$, $IndustrialRatio$, $Log(Population)$, $Log(GovRev)$, $GovBalance$, FDI/GDP, and $AvgEdu$. See the notes to Table 1 for detailed definitions of the control variables, and the text for further description of real activity manipulation.
Significance: * significant at 10%; ** significant at 5%; *** significant at 1%.

Figure A1: The Average of log(SuspiciousExpenditures per Audit) across Years for Hometown versus non-Hometown Auditors, Controlling for Auditor and City Attributes



Notes: This figure shows the (residual) distribution of $log(SuspiciousExpenditures\ per\ Audit)$ across years, splitting the sample based on whether the chief auditor was born in the prefecture. In generating the graph, we control for the auditor and city controls included in Table 3. Each dot indicates the average of the $log(SuspiciousExpenditures\ per\ Audit)$ uncovered by auditors from different backgrounds. The shaded area shows the 95 percent confidence interval.

Table A1: The Relationship Between Auditor Hometown and Government Audit Outcomes, All Covariates Listed

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Dependent Variable			$log(SuspiciousExpenditures)$				$log(SuspExp/Audit)$	$log(Projects\ Audited)$
$Hometown$	-0.331**	-0.520***	-0.473***	-0.471***	-0.413***	-0.426***	-0.445***	-0.020
	(0.158)	(0.176)	(0.148)	(0.143)	(0.111)	(0.130)	(0.136)	(0.050)
$Gender$			0.023	0.055		0.520*	0.004	0.076*
			(0.096)	(0.099)		(0.265)	(0.105)	(0.045)
Age			0.013	0.011		-0.006	0.022**	-0.010*
			(0.009)	(0.009)		(0.025)	(0.011)	(0.005)
$Tenure$			-0.079**	-0.077**		-0.041	-0.102***	0.026**
			(0.032)	(0.031)		(0.085)	(0.031)	(0.013)
$Tenure^2$			0.008***	0.008***		0.005	0.009***	-0.002*
			(0.003)	(0.003)		(0.008)	(0.003)	(0.001)
$Education$			0.037	0.037		-0.251	0.073	-0.039
			(0.063)	(0.064)		(0.191)	(0.064)	(0.027)
$EduFinance$			-0.307***	-0.306***		-0.047	-0.285***	-0.012
			(0.072)	(0.072)		(0.239)	(0.073)	(0.032)
$PastAuditor$			0.147**	0.125		0.001	0.079	0.035
			(0.074)	(0.076)		(0.218)	(0.079)	(0.036)
$PastFinance$			-0.425***	-0.418***		-1.029***	-0.332***	-0.097*
			(0.109)	(0.109)		(0.324)	(0.112)	(0.050)
$PastDiscipline$			0.022	-0.010		0.004	0.055	-0.045
			(0.130)	(0.138)		(0.464)	(0.137)	(0.055)
$PastCityLeader$			0.235**	0.239**		0.482*	0.239**	-0.007
			(0.105)	(0.104)		(0.242)	(0.107)	(0.051)
$Log(GDPpc)$				0.274	0.480	0.356	0.437	-0.089
				(0.293)	(0.334)	(1.266)	(0.312)	(0.162)
$IndustrialRatio$				-0.977	-1.891**	-2.543	-1.537*	0.546
				(0.822)	(0.904)	(2.878)	(0.846)	(0.399)
$Log(Population)$				1.522**	0.631	0.219	1.333*	0.176
				(0.679)	(0.660)	(2.062)	(0.696)	(0.306)
$Log(GovRev)$				0.206	0.004	0.778	-0.019	0.229***
				(0.190)	(0.188)	(0.616)	(0.200)	(0.087)
$GovBalance$				0.064	0.022	0.264	0.037	0.032
				(0.047)	(0.048)	(0.160)	(0.053)	(0.030)
FDI/GDP				-1.569	1.317	-6.903	-2.052	0.398
				(2.292)	(2.539)	(6.371)	(2.296)	(0.992)
$AvgEdu$				-0.112	-0.234	-0.157	-0.170	0.040
				(0.156)	(0.178)	(0.403)	(0.166)	(0.071)
Year FEs	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
City FEs		Yes	Yes	Yes	Yes	Yes	Yes	Yes
Auditor FE					Yes			
Sample	Full	Full	Full	Full	Full	Within-City Variation	Full	Full
Observations	2940	2939	2939	2939	2939	339	2939	2939
R-Squared	.553	.81	.826	.827	.839	.822	.807	.787
Mean of Dep. Var.	11.7	11.7	11.7	11.7	11.7	11.7	5.75	5.91

Notes: Standard errors clustered by city in parentheses. The sample covers the period from 2006 to 2016. The dependent variable in columns (1)-(6) is $log(SuspiciousExpenditures)$, which denotes the logarithm of total questionable expenditures found during the audit. The dependent variable in columns (7) is $log(SuspiciousExpenditures\ per\ Audit)$, which denotes the logarithm of total questionable expenditures per audited project. The dependent variable in columns (8) is $log(Projects\ Audited)$, which denotes the logarithm of number of projects audited. The sample in column (5) is limited to cities that have variation in $Hometown$ during the sample period. $Hometown$ is an indicator variable denoting that the provincial chief auditor was born in city c. Auditor Controls include $Gender$, Age, $Tenure$, $Tenure^2$, $Education$, $EduFinance$, $PastAuditor$, $PastFinance$, $PastDiscipline$, and $PastCityLeader$. City controls include $Log(GDPpc)$, $IndustrialRatio$, $Log(Population)$, $Log(GovRev)$, $GovBalance$, FDI/GDP, and $AvgEdu$. See the notes to Table 1 for detailed definitions of the control variables.
Significance: * significant at 10%; ** significant at 5%; *** significant at 1%.

Table A2: Firm Level Regressions on Locally-Owned SOE Accrual Manipulation

	(1)	(2)	(3)	(4)
Dependent Variable	$AccrualManipulation$			
$Hometown$	0.009	0.010	0.008	0.009
	(0.011)	(0.011)	(0.011)	(0.010)
Year FEs	Yes	Yes	Yes	Yes
Firm FEs	Yes	Yes	Yes	Yes
Auditor Controls		Yes	Yes	Yes
Firm Controls			Yes	Yes
City Controls				Yes
Observations	5222	5222	5222	5081
R-Squared	.113	.115	.179	.179
Mean of Dep. Var.	-.0041	-.0041	-.0041	-.00418

Notes: Standard errors clustered by city in parentheses. The sample covers the period from 2006 to 2018. The sample includes all locally-controlled state-owned enterprises The dependent variable in all columns is accrual manipulation (AM). $Hometown$ is an indicator variable denoting that the provincial chief auditor was born in city c. Auditor Controls include $Gender$, Age, $Tenure$, $Tenure^2$, $Education$, $EduFinance$, $PastAuditor$, $PastFinance$, $PastDiscipline$, and $PastCityLeader$. Firm controls include $log(Assets)$, $Leverage$, ROA, $MBRatio$, $TopOwnership$, $log(BoardSize)$, $Dual$, $Indep\_Ratio$, $Mgtshare$, and $Big4Audit$. City controls include $Log(GDPpc)$, $IndustrialRatio$, $Log(Population)$, $Log(GovRev)$, $GovBalance$, FDI/GDP, and $AvgEdu$. See the notes to Table 1 for detailed definitions of the control variables, and the text for further description of real activity manipulation.
Significance: * significant at 10%; ** significant at 5%; *** significant at 1%.

Table A3: Firm Level Regressions on Centrally-owned SOE Real Activity Manipulation

	(1)	(2)	(3)	(4)
Dependent Variable	*Real Activity Manipulation*			
Hometown	-0.014	0.004	0.009	0.002
	(0.014)	(0.016)	(0.014)	(0.019)
Year FEs	Yes	Yes	Yes	Yes
Firm FEs	Yes	Yes	Yes	Yes
Auditor Controls		Yes	Yes	Yes
Firm Controls			Yes	Yes
City Controls				Yes
Observations	2353	2353	2353	2072
R-Squared	.508	.513	.544	.558
Mean of Dep. Var	.0234	.0234	.0234	.0243

Notes: Standard errors clustered by city in parentheses. The sample covers the period from 2006 to 2018. The sample includes all centrally-controlled state-owned enterprises The dependent variable in all columns is real activity manipulation (RAM). $Hometown$ is an indicator variable denoting that the provincial chief auditor was born in city c. Auditor Controls include $Gender$, Age, $Tenure$, $Tenure^2$, $Education$, $EduFinance$, $PastAuditor$, $PastFinance$, $PastDiscipline$, and $PastCityLeader$. Firm controls include $log(Assets)$, $Leverage$, ROA, $MBRatio$, $TopOwnership$, $log(BoardSize)$, $Dual$, $Indep\_Ratio$, $Mgtshare$, and $Big4Audit$. City controls include $Log(GDPpc)$, $IndustrialRatio$, $Log(Population)$, $Log(GovRev)$, $GovBalance$, FDI/GDP, and $AvgEdu$. See the notes to Table 1 for detailed definitions of the control variables, and the text for further description of real activity manipulation.
Significance: * significant at 10%; ** significant at 5%; *** significant at 1%.

Table A4: Firm Level Regressions on non-SOE Real Activity Manipulation

	(1)	(2)	(3)	(4)
Dependent Variable	*Real Activity Manipulation*			
Hometown	-0.006	-0.005	-0.005	-0.007
	(0.010)	(0.010)	(0.009)	(0.011)
Year FEs	Yes	Yes	Yes	Yes
Firm FEs	Yes	Yes	Yes	Yes
Auditor Controls		Yes	Yes	Yes
Firm Controls			Yes	Yes
City Controls				Yes
Observations	10504	10504	10504	8883
R-Squared	.594	.596	.625	.636
Mean of Dep. Var	-.00396	-.00396	-.00396	-.0054

Notes: Standard errors clustered by city in parentheses. The sample covers the period from 2006 to 2018. The sample includes all non-state-owned (fully private) enterprises The dependent variable in all columns is real activity manipulation (RAM). $Hometown$ is an indicator variable denoting that the provincial chief auditor was born in city c. Auditor Controls include $Gender$, Age, $Tenure$, $Tenure^2$, $Education$, $EduFinance$, $PastAuditor$, $PastFinance$, $PastDiscipline$, and $PastCityLeader$. Firm controls include $log(Assets)$, $Leverage$, ROA, $MBRatio$, $TopOwnership$, $log(BoardSize)$, $Dual$, $Indep\_Ratio$, $Mgtshare$, and $Big4Audit$. City controls include $Log(GDPpc)$, $IndustrialRatio$, $Log(Population)$, $Log(GovRev)$, $GovBalance$, FDI/GDP, and $AvgEdu$. See the notes to Table 1 for detailed definitions of the control variables, and the text for further description of real activity manipulation.
Significance: * significant at 10%; ** significant at 5%; *** significant at 1%.