

How Does U.S. Multinational Firms' Foreign Corruption Risk Affect Auditor Behavior?

Yangyang Fan

Hong Kong Polytechnic University

yangyang.fan@polyu.edu.hk

Mark (Shuai) Ma

American University

shuaim@american.edu

Jeffrey Pittman

Memorial University of Newfoundland

jpittman@mun.ca

Abstract: This study examines how U.S. multinational firms' foreign corruption risk affects audit behavior. Auditors are required by the Foreign Corrupt Practices Act of 1977, Auditing Standard 2405 and other security laws to assess the risk and probability that a public firm's management bribes a foreign government official. If the auditors follow such rules, we would observe a positive association between foreign corruption risk and audit effort. However, on the other hand, prior literature suggests that a firm may gain significant economic benefits through foreign bribery. Such economic benefits (e.g., permits to open new stores) reduces an auditor's perceived business risk of the firm, leading to audit risk and audit effort. Therefore, the effect of foreign corruption risk on auditor behavior is an empirical research question. Using a sample of U.S. multinational firms from 2000 to 2014, we find that foreign corruption risk is negatively associated with audit fees and the probability of receiving a going concern opinion. Also, higher foreign corruption risk is associated with lower bankruptcy risk. Further, the negative effects of foreign corruption risk on audit fees and going concern opinions are more pronounced for firms with stronger political connections and those with weaker governance. Overall, auditors do not seem to respond to foreign corruption risk as required by the FCPA. Our findings have significant implications for the PCAOB, which is currently considering whether there is a need to provide better guidance to auditors regarding their responsibilities with respect to clients' possible illegal acts.

Keywords: Audit Fees; Foreign Corruption Risk; Foreign Corrupt Practices Act; Going Concern Opinion.

How Do Auditors Respond to U.S. Multinational Firms' Foreign Corruption Risk?

1. Introduction

This study examines how U.S. multinational firms' foreign corruption risk affects audit behavior.¹ We are motivated by the recent standard setting agenda of the Public Company Accounting Oversight Board (PCAOB). Specifically, in the 2017 standard setting update,² the PCAOB suggests that an important topic on its research agenda is to consider whether there is a need to provide better directions to auditors regarding their responsibilities with respect to clients' possible illegal acts. According to the Foreign Corrupt Practices Act of 1977 (FCPA), U.S. firms are subject to criminal and civil penalties for bribing foreign government officials. Auditors are required by the FCPA, Auditing Standard 2405 and other security laws to assess the risk that a public firm's management bribes a foreign government official.³ However, prior literature has not examined whether auditors follow such requirements. Our study fills this void in the literature. Understanding how the risk of such illegal acts affects auditor behavior could provide direct insights into the directions that the PCAOB should provide to auditors.

We predict two countervailing effects of foreign corruption risk on auditor behavior. On the one hand, there are reasons why U.S. firms' foreign corruption risk may increase audit risk and effort. If the FCPA rules and AS 2405 are effectively enforced by an auditor, we expect higher foreign corruption risk to increase the auditor's workload and audit fees. As an interesting

¹ Foreign corruption risk refers to the risk and ex ante probability that a firm bribes foreign government officials.

² See <https://pcaobus.org/Standards/Documents/Q32017-Standard-Setting-Update.pdf>

³ If the auditor finds such evidence on an illegal act, such as the monetary payment as bribes to foreign government officials, the evidence should be reported to the board of directors who would further investigate the bribery. When the board failed to take appropriate action, the illegal act should be reported by auditors to the SEC.

anecdotal evidence, the retailer giant, Walmart was revealed to pay bribery to government officials in Mexico in exchange for permits to open new stores and other economic favors. In May of 2015, a shareholder group of Walmart, CtW Investment Group asked the PCAOB to investigate the possible violation of the FCAP by Ernst and Young for knowingly withholding information on Walmart's bribery activities.⁴ However, both the PCAOB and the U.S. security and exchange commission (SEC) refused to comment on this issue.⁵ To date, auditors have never been prosecuted by the U.S. government in case of client foreign corruption. Therefore, the actual legal threat from the FCPA is very low, and it is not clear whether auditors would exert effort to detect foreign bribery activity.

On the other hand, as in the Walmart case, firms engage in foreign bribery to secure economic benefits and profitable projects. Given the opaque nature and low detection rate of foreign bribery (e.g., OECD 2017), the economic benefits that firms can gain from foreign bribery significantly exceed the expected legal costs. Further, Karpoff, Lee and Martin (2017) find that even if foreign corruption is detected by the SEC or DoJ, the benefits firms gain from foreign bribery is still, on average, much larger than the penalties of FCPA enforcements and other costs (e.g. reputation damage, litigation costs, etc.). Together, these studies suggest that U.S. firms gain significant economic benefits through foreign bribery. Examples of such benefits include access to external capital, government assistance and legal permits to open new factories and stores (e.g., Faccio et al. 2006, Claessens et al. 2008). Such economic benefits (e.g., the opening of new stores) may reduce an auditor's perceived business risk of the firm, leading to lower audit risk

⁴ See <http://ctwinvestmentgroup.com/wp-content/uploads/2015/05/CtW-to-PCAOB-re-EY-5-21-15.pdf>

⁵ See <http://fortune.com/2015/09/16/sec-white-pcaob-audit/>

and lower auditor effort.⁶ Given these competing arguments, the effect of foreign corruption risk on auditor behavior is an empirical research question.

Our empirical analyses use a sample of 28,191 firm-year observations of U.S. multinational firms from 2000 to 2014. We measure foreign corruption risk based on the government corruption index of foreign countries where a US. multinational company has material subsidiaries. The measure of government corruption is the annual Corruption Perceptions Index (CPI) provided by Transparency International since 1996. The index employs expert surveys to rank countries according to the perceived corruption in the country. CPI has been validated and widely used in prior literature (e.g., Wilhelm 2002). Further, to figure out the locations of foreign operations, we rely on the locations of material foreign subsidiaries publicly disclosed by firms in Exhibit 21 of 10 K reports. Thus, our firm-level measure of foreign corruption risk is the weighted average CPI with the number of foreign subsidiaries in each country as the weight.⁷

Our first set of primary analyses tests the effect of foreign corruption risk on audit fees. Higher audit fees can be a result of a higher audit risk premium and/or greater audit efforts (Pratt and Stice 1994, Simunic and Stein 1996, Bell et al. 2001, Hogan and Wilkins 2008) . If auditors make efforts assessing clients' possible foreign corruption behavior as required by the FCPA, clients with higher corruption risk should be charged with higher audit fees. However, if the economic benefits that a firm gains from foreign bribery reduce the auditor's assessed audit risk, we should observe lower audit fees for clients with higher corruption risk. We find that

⁶ We do not suggest that auditors directly use foreign corruption risk as a variable in their models to analyze a firm's business risk. Instead, we argue that foreign corruption risk affects other variables used in those models. For example, in the Walmart case, Walmart obtained permits to open new stores in Mexico through bribing Mexican officials. Auditors may view the opening of new stores as an indicator of low business risk.

⁷ In robustness tests, we use the equally weighted average of the CPI as alternative firm-level measure of corruption risk. Results remain similar. In addition, to mitigate concerns about possible non-linear relations between firm size and auditor behavior, we also use a size-adjusted corruption risk measure.

foreign corruption risk is negatively associated with audit fees, consistent with the economic benefits gained from foreign bribery significantly reducing audit risk. These results are robust to controlling for firm fixed effects and other determinants of audit fees. Compared with firms with corruption risk at the top quartile, firms with corruption risk at the bottom quartile have 7.05 percent lower audit fees. Therefore, our findings are both statistically and economically significant.

Next, we examine how foreign corruption risk affects the probability of an auditor issuing a going concern opinion and bankruptcy risk. Again, we argue that economic benefits gained from foreign bribery reduces an auditor's perceived business risk of a firm and audit risk. Consistent with our expectation, we find that higher foreign corruption risk is associated with a lower probability of an auditor issuing a going concern opinion. Further, we show that the effect of foreign corruption risk on going concern opinions is not due to either Type I or Type II errors in going concern opinions. Also, we find that higher foreign corruption risk is associated with lower bankruptcy risk.

To examine whether auditors actually follow the FCPA rules in a certain subsample, we further split the sample based on the median of corruption risk. It is possible that auditors spends efforts assessing a firm's corruption risk as required by the FCPA only when the real probability of foreign corruption is high. If so, the effect of foreign corruption risk on audit fees and going concern opinions should become less negative or even positive in the subsample with high corruption risk.⁸ However, we still find a significant negative effects of foreign corruption risk on audit fees and going concern opinions in the subsample with high corruption risk. Further, in a

⁸ If an auditor assesses a firm's corruption risk as required by the FCPA, this would have a positive effect on audit fees, mitigating the negative effect of corruption risk on audit fees.

subsample with low corruption risk, we also do not find evidence that auditors respond to foreign corruption risk as required by the FCPA.

We also provide cross-sectional analyses. First, we consider the moderating effect of corporate political connections. A politically connected firm is less likely to be prosecuted by the SEC or DoJ (e.g., Correia 2014). Therefore, the firm may be more likely to engage in foreign bribery, and its auditor will be even less concerned about FCPA and pay more attention to the economic benefits. Consistent with our expectation, the negative effects of foreign corruption risk on audit fees and going concern opinions are more pronounced for firms with stronger political connections. Second, we examine whether governance moderates our findings. Strong corporate governance improves firm performance (through legal ways) and thus reduces the need to further gain economic benefits through illegal methods (e.g., Elyasiani and Jia 2010; Schmidt and Fahlenbrach 2017). Therefore, we expect a well governed firm to be less likely to engage in foreign bribery. Also consistent with our expectation, we find that governance, measured by institutional ownership and management ownership, mitigates the negative effects of foreign corruption risk on audit fees and going concern opinions.

We further provide tests by using the Chinese corruption crackdown in 2012 as a plausibly exogenous event that deters firms from foreign bribery. The crackdown deters U.S. firms from bribing Chinese government officials and mitigate the economic benefits of operating in China (Chow 2017), increasing the affected firms' business risk and audit risk. We expect the event to reduce affected firms' foreign corruption risk and thus increase audit fees and going concern opinions. Consistent with our expectation, we find that U.S. firms with more subsidiaries in China experience greater increases in audit fees and going concern opinions after 2012. These findings mitigate concerns about alternative explanations based on endogeneity or reverse causality.

Finally, we examine the association between foreign corruption risk and audit quality. An alternative explanation for our findings is that firms with high corruption risk self-select to hire lower quality auditors who charge lower fees. We find that higher foreign corruption risk is not associated with earnings management or the probability of subsequent restatements. These findings mitigate concerns over firms self-selecting auditors with different quality. In addition, we provide several robustness tests.

In sum, our findings suggest that higher foreign corruption risk reduces audit fees and the probability of issuing a going concern opinions due to economic benefits that firms gained from foreign bribery. Thus, auditors don't seem to assess foreign corruption risk as required by the FCPA in the full sample or a subsample. These findings support the concern by regulators (e.g., the PCAOB) that auditors fail to appropriately react to the risk of clients engaging in illegal acts.

Our study makes several important contributions. First, our study is of interest to the PCAOB and other regulators interested in enforcing the FCPA and understanding the consequences of the FCPA. As discussed earlier, the PCAOB is considering whether there is a need to provide better directions to auditors regarding their responsibilities with respect to clients' possible illegal acts. Again, our study suggests that auditors do not seem to assess foreign corruption risk as required by the FCPA. Our findings support the necessity for the PCAOB to provide more guidance about auditors' responsibilities in assessing and reporting clients' possible foreign bribery activities.

Second, we contribute to the literature on auditor behavior by providing evidence on the audit fees and opinion effects of ex ante foreign corruption for U.S. firms. In a different setting, Lyon and Maher (2005) find that audit fees are higher for a small sample of 82 firms that voluntarily disclosed their bribery behavior was before the passage of the Foreign Corrupt

Practices Act in 1977. Foreign bribery was not deemed as illegal in U.S. before 1977. So, Lyon and Maher argue that the increased audit fees are due to auditors' assessed business risk being increased by the ex post disclosure of foreign bribery that attracts significant negative publicity. Different from Lyon and Maher (2005), we focus on ex ante corruption risk rather than detected bribery activities. Findings on ex post disclosure of detected bribery activities do not establish an effect of ex ante corruption risk on auditor behavior. We find that auditors charge lower audit fees and issue fewer going concerns to firms with higher foreign corruption risk. Therefore, our findings suggest that ex ante foreign corruption risk has a different effect on audit risk and auditor behavior than public disclosure of ex post corruption behavior.

Finally, we contribute to the literature on the impact of operation location on auditor behavior. Prior studies (e.g. Simunic 1980, Beatty 1993) suggest that the existence of foreign operation of U.S. firms is associated with higher audit fees. But, to the best of our knowledge, few prior studies have examined whether the characteristics of foreign operation matter. Our study helps better understand the effect of the foreign operation characteristics on audit fees and audit opinions.

We organize the remainder of the paper as follows. Section 2 provides relevant literature and develops our hypotheses. Section 3 describes the data and regression models. We provide results in Section 4, and Section 5 provides additional analyses. Section 6 concludes.

2. Literature Review

2.1 Foreign Corruption Practice Acts

In the aftermath of the Watergate scandal, more than 400 of U.S. firms were revealed by the SEC to actively bribe foreign officials for foreign business interests. The foreign corruption practice acts (FCPA) were introduced by the U.S. congress in 1977 to combat the potential threat of U.S.

firms' foreign corruption behavior to the U.S. international relations with foreign countries. The FCPA consists of two primary provisions. The anti-bribery provision prohibits firms from making any payments to foreign officials for economic returns. Definitions of bribery activities is broad under this provision. Foreign officials include anyone working for a foreign government or an international organization (e.g., World Bank), even including doctors working at state-owned hospitals and professors at public universities. The threshold for materiality is zero. Thus, any cash or non-cash payments to foreign officials are prohibited. The other provision is related to the accounting record-keeping of foreign business transactions. According to FCPA, U.S. public firms are responsible for maintaining an effective accounting reporting and internal control system that accurately reflects all the foreign business transactions.

Later the FCPA was amended twice in 1997 and 1998. The 1997 amendment clarified the standard for judging a violation of the FCPA. A firm violates the FCPA when it consciously disregards or ignores the FCPA and knowingly makes illegal payments to a foreign official. The 1998 amendment extended the scope of entities covered by the FCPA beyond U.S. borders. Specifically, the accounting related provision covers both domestic and foreign public firms listed in U.S.; the anti-bribery provision covers U.S. corporations, foreign corporations listed in the U.S. and foreign persons who run foreign business while in the US.

2.2 Effect of FCPA Enforcement

The biggest criticism of the FCPA is that it creates a significant competitive disadvantage for U.S. firms to run business in foreign countries where bribery activities are prevalent (e.g., Graham 1984). For example, a survey of U.S. multinational firms' executives by Peat, Marwick, Mitchell & CO. in 1979 show that 71% of respondents in the survey suggest the FCPA significantly increased the cost of running business in a foreign country. However, for a long time after its

introduction, the FCPA was weakly enforced. The U.S. SEC and DoJ are jointly responsible for the enforcement of FCPA.

The first high-profile FCPA case was the prosecution against the German firm Siemens AG in 2007. The SEC alleged that Siemens paid bribery payment to government officials around the world between 2001 and 2007. Siemens settled the case by paying a criminal fine of \$450 million to the DoJ and \$350 million as a civil fine to the SEC.⁹ This is the largest penalty against a firm due to FCPA violation as of 2015. Following this influential case, many other famous multinational firms have been prosecuted, including Total S.A., Avon Inc., DaimlerChrysler AG, Hewlett-Packard Company, ALCOA and Walmart.

This controversial law has attracted researchers' attention in recent years. Prior studies suggest that the FCPA and its enforcements have significant effects on subsequent economic activities. Hine and James (1995) shows that the U.S. firms' investment in foreign countries with high corruption level slows down after the passage of the FCPA in 1977. Zume (2014) studies the anti-bribery act in UK, which is largely the same as the FCPA. His findings are similar to Hine and James (1995). Cuervo-Cazurra (2008) find that the deterrent effect of the FCPA on investment in highly corrupt foreign countries is strengthened after the establishment of the Anti-bribery convention by the organization for economic deployment (OECD). Firms from other OCED countries also reduced their investment in corrupt countries after the establishment of Anti-bribery convention. Wei (2000) finds that U.S. firms' foreign investment is more sensitive to the corruption level in a country than firms from other countries. Karpoff, Lee and Martin (2017) analyze a sample of foreign corruption scandals and find that firms secure profitable projects by bribing in foreign counties. The benefits firms gain from foreign bribery activities is on average

⁹ More details are available at <https://www.sec.gov/litigation/litreleases/2008/lr20829.htm>

larger than the penalties due to FCPA enforcements. These findings are consistent with firms gaining economic benefits gained from foreign corruption behavior and the FCPA reducing such benefits. Graham and Stroup (2016) find that an FCPA enforcement reduces US firms' investments in countries targeted by the enforcement. This is also consistent with firms gaining benefits from foreign corruption behavior and anti-corruption enforcements reducing such benefits.

2.3 Auditing Effect of Firm Political Activities

Our study examines the effect of a firm's ex ante foreign corruption risk on auditor behavior. A line of related prior literature has examined the effect of firm political activities on auditor choice and audit fees. Gul (2006) examines auditors' reaction to Malaysia firms' political connections. Politically connected firms are more likely to manipulate their financial information during the Asian financial crisis, because the government is less likely to prosecute these firms. Therefore, auditors charge Malaysian firms with political connection higher audit fees than non-connected firms during the crisis. But, such findings become insignificant after Malaysia government introduced a capital control police to help political connected firms. Lyon and Maher (2005) analyze the audit fees of a sample of 82 firms that voluntarily disclosed their bribery behavior in the 1970s. Their sample period was before the passage of the Foreign Corrupt Practices Act in 1977. So, foreign bribery was not deemed as illegal in U.S. The authors argue that foreign bribery could attract significant negative publicity and increase the business risk of the client. As a result, audit fees were higher for clients that disclosed paying bribes. Using a sample of firms from 28 countries, Guedhami, Pittman and Saffar (2014) study the auditor choice behavior by firms with political connections. Firms with political connections are more likely to hire a big 4 auditor. Such results are stronger when investors are more concerned over agency problems. These results

suggest that politically connected firms want to improve transparency to mitigate investors' concerns over the agency problems.

Our study is significantly different from these prior studies. Gul (2006) focuses on firms' ties with domestic government. Our study examines the effect of a firm's ex ante corruption risk in foreign countries on auditor behavior regardless of political ties. U.S. firms are not likely to have strong political ties in foreign countries as the ties between Malaysian firms and the government in Gul (2006). Lyon and Maher (2008) examine the effect of ex post identified bribery activities prior to the passage of the FCPA in 1977. Differently, we examine the effect of ex ante corruption risk after 1977. Findings on ex post disclosure of detected bribery activities do not establish an effect of ex ante corruption risk on auditor behavior. After the passage of the FCPA, firms no longer voluntarily disclose foreign bribery activities. Without evidence on identified bribery activities, ex ante corruption risk does not attract negative publicity. Thus, it is not clear whether the ex-ante corruption risk assess auditors' assessed business risk when the client provides no public disclosure on their bribery activities.

2.4 Auditor Liability under FCPA

Auditors' responsibility in foreign corruption prevention is a controversial issue. On the one hand, auditors argue that they do not have the expertise to detect illegal acts (e.g., Cheng and Epstein 2012). On the other hand, U.S. auditors are required by laws to assess the risk that a public firm's management bribes a foreign government. From 1989, AU section 317 of the U.S. Generally Accepted Auditing Standards (GAAS) requires an auditor to detect illegal acts with material effects on the financial statements. The auditor should consider the effect of illegal acts on the accuracy of financial statements and whether the illegal acts' effects are appropriately disclosed in the financial statements (Taylor and Mcneal 2012). In 1996, Section 10A of the Securities

Exchange Act further extended the scope of illegal acts that auditors are responsible for detecting. Specifically, an auditor should detect any violation of any law, rule or regulation.

If an auditor finds evidence on an illegal act, such as the monetary payment as bribes to foreign government officials, the Securities Exchange Act requires the evidence to be reported to the board of directors who would further investigate the bribery. If the firm refuses to take remedial actions, the board should report the illegal act to the SEC. The auditor should also withdraw from the engagement. When the board failed to take appropriate action, the illegal act should be directly reported by the auditor to the SEC.

Though the U.S. SEC and the DoJ significantly increased their effort in enforcing the FCPA, auditors are never penalized for failure to detect and report firms' foreign bribery activities. In a recent influential FCAP lawsuit, a whistleblower revealed that the retailer giant, Walmart paid \$24 million to government officials in Mexico in exchange for favorable decisions by the officials (e.g., the approval of new store permits). A shareholder group of Walmart, CtW Investment Group alleged that Walmart's auditor Ernst and Young violated the FCPA. Specifically, based on internal E-mails, Ernst and Young was informed by Walmart's internal audit team of the firm's investigation of foreign corruption behavior in 2006 and 2007. CtW Investment Group asked the PCAOB to investigate whether Ernst and Young responded appropriately to Walmart's bribery activities in Mexico. However, both the PCAOB and the SEC refused to respond to the request by CtW Investment Group. Therefore, though the revelation of clients' briberies might hurt auditor reputation, auditors are never prosecuted by the U.S. government in case of client foreign corruption. Thus, it is not clear whether auditors would be motivated to enforce the FCPA and detect such bribery activities.

2.5 Hypotheses

We are interested in examining how auditors respond to a firm's foreign corruption risk. As discussed above, foreign corruption risk may have two countervailing effects on audit risk and audit efforts. We rely on audit fees and going concern opinions to infer audit risk and audit efforts. Higher audit fees can be a result of a higher audit risk premium and/or greater audit efforts. Going concern opinions are also used to infer audit risk and more specifically the perceived business risk of clients. Higher perceived business risk increases the probability of going concern opinions. On the one hand, auditors are required by the FCPA, Auditing Standard 2405 and other security laws to assess the risk that a public firm's management bribes a foreign government. If the FCPA and other rules are effectively enforced by an auditor, we expect higher foreign corruption risk to increase the auditor's workload and audit effort. This would result in higher audit fees. Also, auditors may increase the probability of issuing going concern opinions to firms with higher foreign corruption risk, if there are significant legal costs of foreign bribery to the clients.

However, on the other hand, firms may gain significant economic benefits from foreign bribery. This argument is supported by recent FCPA enforcement cases. For example, Walmart secured permits to open new stores in Mexico through bribery. Similarly, Ralph Lauren bribed foreign government officials to sell its products to Argentina without the necessary paperwork and inspections.¹⁰ JP Morgan's subsidiary in Asia hired more than 100 interns and employees at the request of foreign governments officials and obtained more than \$100 million in revenue.¹¹ Given the extreme difficulty to detect foreign bribery (e.g., OECD 2017), the expected legal costs of foreign bribery are likely much smaller than the economic benefits. Further, Karpoff, Lee and

¹⁰ <https://www.sec.gov/news/press-release/2013-2013-65htm>

¹¹ <https://www.sec.gov/news/pressrelease/2016-241.html>

Martin (2017) find that even if the foreign bribery is detected, the benefits firms gain from foreign bribery activities is on average larger than the penalties of FCPA enforcements and other costs. Therefore, the economic benefits that a firm can gain from foreign bribery (e.g., the opening of new stores) may lower auditors' perceived business risk of a firm and lower audit risk. The reduced business risk and audit risk would further reduce audit fees and going concern opinions.

Given these competing arguments discussed above, the effects of foreign corruption risk on auditor pricing and going concern opinions are not clear. Therefore, we state our hypotheses in the following null form.

H₁: Audit fees are not associated with a U.S. multinational firm's ex ante foreign corruption risk.

H₂: Going concern opinions are not associated with a U.S. multinational firm's ex ante foreign corruption risk.

3. Research design

3.1 Sample Selection

Our initial sample includes all U.S. firm-year observations (178,215) with available audit fee information from the *Audit Analytics* database for the period 2000–2014. The sample period starts from 2000, the first year in which audit fee information is available in *Audit Analytics*. We then merge the audit fee data with foreign subsidiary data from Scott Dyreng's website. This data captures the number of a firm's material subsidiaries in each country disclosed in Exhibit 21 as required by the SEC (e.g., Dyreng and Lindsey 2009). Our sample is thus restricted to companies with foreign subsidiaries. We require financial data to be available in *Compustat* to compute control variables used in the multiple regression specified in model (1) below. We further exclude financial firms (with SIC code 6011 to 6799) from our sample. Thus, our final sample for audit fees tests consists of 28,191 firm-year observations of U.S. multinational firms. For going concern

opinions tests, we use the subsample of financial distressed firms with negative cash flows or negative earnings (e.g., Francis and Yu 2009). Further, because going concern opinions are sticky (Myers et al. 2014), we focus on firm-time going concern opinion. We remove firms with repeated going concern opinions from our sample. Therefore, our final sample for going concern tests includes 8,193 firm-year observations of U.S. multinational firms.

3.2 Regression Model

Our first hypothesis is about the effect of U.S. firms' foreign corruption risk on audit fees. We test the hypothesis by estimating the following ordinary-least-squared (OLS) regression model (1):

$$\begin{aligned}
 \text{Audit Fees}_{i,t} = & \alpha_0 + \alpha_1 \text{Corruption Risk}_{i,t} + \alpha_2 \text{Size}_{i,t} + \alpha_3 \text{Loss}_{i,t} + \alpha_4 \text{Leverage}_{i,t} + \alpha_5 \text{BM}_{i,t} \\
 & + \alpha_6 \text{Tenure}_{i,t} + \alpha_7 \text{Big N}_{i,t} + \alpha_8 \text{\#Countries}_{i,t} + \alpha_9 \text{\#Segment}_{i,t} + \alpha_{10} \text{CiviLaw}_{i,t} \\
 & + \alpha_{11} \text{RuleofLaw}_{i,t} + \alpha_{12} \text{Repudiation}_{i,t} + \alpha_{13} \text{Expropriation}_{i,t} + \text{Year Indicators} \\
 & + \text{Firm Indicators} + \text{Error}_{i,t}
 \end{aligned}
 \tag{1}$$

The dependent variable, *Audit Fees*, is the natural log of total audit fees for client firm *i* in year *t*, as reported by Audit Analytics. The independent variable of interest is *Corruption Risk*, a firm-level of foreign corruption risk of U.S. multinational firms. Specifically, *Corruption Risk* is the negative of the natural log of the weighted average of Corruption Perception Index (CPI) of all the foreign countries in which the firm has subsidiaries, where the weight is the number of subsidiaries in the country. We obtain the CPI data from Transparency International. CPI ranges from 0 to 100, where 0 means the highest level of perceived corruption and 100 means the lowest level of perceived corruption. Thus, to make sure that *Corruption Risk* is a positive measure of foreign corruption risk, we multiply the natural log of the weighted average of CPI by negative one.

As discussed in the last section, foreign corruption risk may have two competing effects on audit fees. If auditors make efforts assessing clients' possible foreign corruption behavior as

required by the FCPA, audit fees should be higher for clients with higher corruption risk. The coefficient on *Corruption Risk* should be positive. However, if the economic benefits that a firm gains from foreign bribery reduce the auditor's assessed audit risk, audit fees should be lower for clients with higher corruption risk. Then, the coefficient on *Corruption Risk* is expected to be negative.

Model (1) includes separate indicator variables for each unique firm in the sample.¹² These firm fixed effects control for any time-invariant characteristics by transforming the model into a “within-company” model. This approach significantly limits the number of unobserved correlated omitted variables that might threaten our inferences (Armstrong et al. 2012). However, there are four additional points to consider that we explicitly account for in model (1). First, the period that we study, 2000-2014, was a time of significant changes in the audit market that is correlated with audit fees. For this reason, we also include year fixed effects in model (1) to account for any time-varying trends in audit fees.

We also include several additional control variables based on prior research (e.g. Simunic 1980, Beatty 1993). Audit fees are expected to be higher when clients are larger (*Size*), have higher leverage (*Leverage*), and lower book-to-market ratios (*BM*), are less profitable (*Loss*), are audited by big 4 auditors (*Big4*), have more segments (*#Segments*). Audit fees are also expected to be affected by audit firm tenure (*Tenure*). We also control for the number of foreign countries in which a company has subsidiaries (*#Countries*). In addition, following prior studies (e.g., La Porta et al. 1998), we control for several other potentially correlated characteristics of the foreign countries where the firm has subsidiaries. *CivilLaw* is an indicator variable that equals 1 if any of the foreign countries in which the firm has subsidiaries has a civil law system. Countries with

¹² Our primary test results remain similar if we use industry effects instead of firm fixed effects.

civil law systems are expected to have weaker investor protection. *RuleofLaw* measures how the rule of law is experienced and perceived by the general public in those foreign countries. *Repudiation* and *Expropriation* measure the risk of contract repudiation and expropriation by management in foreign countries where the firm has subsidiaries. Stronger rule of law, lower risk of contract repudiation and lower management expropriation risks are associated with better investor protection and stronger corporate governance (Bertowitz et al. 2003, Klapper and Love 2004). Data used for *CivilLaw*, *RuleofLaw*, *Repudiation* and *Expropriation* are from Rafael La Porta's website. Appendix A provides additional details on the definitions of these variables.

Our second hypothesis is concerned about the effect of U.S. firms' foreign corruption risk on going concern opinions. We test our hypothesis by estimating the following Probit regression model (2):

$$\begin{aligned}
 & \text{Probit}(\text{Going Concern}_{i,t} = 1) \\
 & = \alpha_0 + \alpha_1 \text{Corruption Risk}_{i,t} + \alpha_2 \text{Size}_{i,t} + \alpha_3 \text{Loss}_{i,t} + \alpha_4 \text{Leverage}_{i,t} + \alpha_5 \text{BM}_{i,t} \\
 & + \alpha_6 \text{Tenure}_{i,t} + \alpha_7 \text{Big N}_{i,t} + \alpha_8 \# \text{Countries}_{i,t} + \alpha_9 \# \text{Segment}_{i,t} + \alpha_{10} \text{RepLag}_{i,t} \\
 & + \alpha_{11} \text{CiviLaw}_{i,t} + \alpha_{12} \text{RuleofLaw}_{i,t} + \alpha_{13} \text{Repudiation}_{i,t} + \alpha_{14} \text{Expropriation}_{i,t} \\
 & + \text{Year Indicators} + \text{Industry Indicators} + \text{Error}_{i,t}
 \end{aligned}
 \tag{2}$$

The dependent variable *Going Concern* is an indicator for a firm *i* that received a going concern opinion for the first time in year *t*. We include industry effects instead of firm effects in this table, because many firms never receive a going concern opinion in our sample. In addition, we include all the controls from Model (1) and audit report lag (*RepLag*). Longer audit report lags are associated with a higher probability of issuing going concern opinions. The key variable of interest is *Corruption Risk*. If the economic benefits that a firm gains from foreign bribery reduce the auditor's assessed business risk of the firm, we expect the coefficient on *Corruption Risk* to be negative.

4. Empirical Analyses

4.1 Descriptive Statistics

Table 1 Panel A provides the distribution of foreign subsidiaries in our sample by country. Specifically, we report the average CPI of each country during our sample period and the number of firm-years and subsidiary-years in each country. As shown in Table 1 Panel A, the three countries with most observations of U.S. firms are U.K., Canada and Germany. The five most corrupt countries in our sample are South Georgia, Gambia, Gaza Strip, Mauritania, and Chad. There are 24, 6, 52, 6 and 55 observations in these countries, respectively. The five least corrupt countries in our sample are Tonga, Christmas Island, Canada, Nauru and United Kingdom. There are 1, 12, 15,328, 2 and 15,371 observations in these countries, respectively.

Table 1 Panel B shows the average corruption risk in each year. We find the average corruption risk decreases throughout our sample period. Table 1 Panel C shows the average corruption risk in each industry. There are significant variations in average corruption risk across different industries. The three industries with highest corruption risk are Agricultural Production – Livestock, Hotels and other lodging places and Local and Interurban Passenger Transit.

Table 2 Panel A provides summary statistics for the variables used in our regressions for the full sample. We winsorize all the continuous variables at the 1st and 99th percentiles. The average *Audit Fees* in our sample is approximately \$1,014,595 (based on the mean value of 13.83). The average corruption risk is -4.21, indicating an average CPI of approximately 67.04. In terms of subsample comparisons, as shown in table 2 Panel B, companies in the higher foreign corruption group are larger, less profitable, have higher book-to-market ratio, have long auditor tenure, have operations in more foreign countries and have more segments. In addition, the frequency of hiring Big 4 auditors is equivalent between subsamples with low and high

corruption risk. Therefore, there is not likely a significant association between audit quality and foreign corruption risk.

Table 2 Panel C provides Pearson correlations among variables used in our primary analysis. Foreign corruption risk is negatively associated with audit fees (-0.095), suggesting lower auditor effort and lower audit risk. But, the correlation between foreign corruption risk and going concern opinions is insignificant. These findings do not control for correlated variables. So, we base our conclusions on the multiple regressions next. Other correlations are also consistent with expectations. For example, audit fees are positively correlated with *Size*, *Leverage* and *Big4*. The highest correlation is between *Audit Fees* and *#Countries*. But we do not observe any correlation large enough to cause concerns over multi-collinearity.¹³

4.2 The Effect of Foreign Corruption Risk On Audit Fees

Our first hypothesis examines the association between foreign corruption risk and audit fees. If auditors spend efforts on detecting foreign corruption behavior as required by the FCPA and other business laws, we expect a positive association between foreign corruption risk and audit fees. However, if firms gain economic benefits from foreign corruption activities, we expect firms with high foreign corruption risk to have lower audit risk and lower audit fees. Table 3 reports regression results of Model (1). The dependent variable is *Audit Fees*, the natural log of total audit fees. The standard errors reported are clustered by firm.¹⁴ We first estimate the effect of foreign corruption risk in the full sample. The results in Column 1 show that the coefficient on *Corruption Risk* is significantly negative (coefficient= -0.141, $p < 0.01$), indicating that higher

¹³ We also estimate the variance inflated factors (VIFs) for all the independent variables in Models (1) and (2). We do not find any VIF greater than 10.

¹⁴ All the regressions later also use firm-clustered standard errors.

corruption risk is associated with lower audit fees. This is consistent with the argument that firms gain economic benefits from foreign bribery and reduce auditors' perceived business risk. Because both *Audit Fees* and *Corruption Risk* are logged variables, the coefficient in this log-log regression shows the elasticity of *Audit Fees* to *Corruption Risk*. Therefore, when *Corruption Risk* increases by 1 percent, *Audit Fees* decrease by 0.141 percent. Further, compared with firms with *Corruption Risk* at the top quartile, firms with *Corruption Risk* at the bottom quartile have 7.05 percent lower audit fees. Therefore, our findings are economically significant.

With regards to control variables, consistent with prior literature (Simunic 1980, Beatty 1993), audit fees are significantly higher for companies that are larger (*Size*), less profitable (*Loss*), have less leverage (*Leverage*), have big 4 auditors (*Big4*) and have more operational and geographic segments (*#Segments*). Moreover, audit fees are also significantly higher for companies that have subsidiaries in more foreign countries (*#Countries*). In addition, the adjusted R-square of the regression is 0.930, suggesting that the model fits very well overall.

Even though the findings above suggest that foreign corruption risk reduces audit fees, it does not necessarily mean that auditors never spend any effort on detecting foreign corruption behavior. It is possible that auditors pay attention to foreign corruption risk only when the likelihood of foreign corruption is high. Thus, in the full sample, the negative effect of economic benefits on audit fees may outweigh the positive effect of legal liabilities required by the FCPA and other laws in the full sample. To exclude this possibility, we further split the sample based on the median of corruption risk. When foreign corruption risk is high, firms are more likely to actually bribe in foreign countries, possibly attracting more attention from auditors. Therefore, if the positive effect on audit fees exists, we should be able to observe it in the subsample with high corruption risk. As shown in Column 2, the coefficient on *Corruption Risk* is significantly negative for the sub sample with high corruption risk (coefficient=-0.203, $p < 0.01$). In Column 3, the

coefficient on corruption risk is still negative though statistically insignificant for the sub sample with low corruption risk. This is possibly because economic benefits that firms gain through foreign bribery are limited when foreign corruption risk is low. Thus, in both subsamples, we do not find evidence of auditors making efforts detecting corruption activities required by the FCPA. These findings instead suggest that firms with higher corruption risk gain more economic benefits from foreign bribery. Overall, our findings are consistent with the argument that firms operating in high-corruption foreign countries benefit from bribery, leading to lower audit risk, and thus are charged lower audit fees.

4.3 The Effects of Foreign Corruption Risk on Going Concern Opinions and Bankruptcy Risk

Our primary test suggests that firms operating in high-corruption foreign countries is associated with lower audit fees. We interpret the lower audit fees as results of lower audit risk and lower auditor effort. In this subsection, we directly examine the effect of foreign corruption risk on auditors' assessed bankruptcy risk. When a firm engages in foreign corruption activities, economic benefits gained from bribery may reduce the auditor's assessed bankruptcy risk of the firm, reducing the probability of the auditor issuing a going concern opinion. Table 4 Panel A reports a Probit model analyses of the effect of foreign corruption risk on going concern opinions. The dependent variable *Going Concern* is an indicator for a firm that received a going concern opinion for the first time. The coefficient on Corruption Risk is negative and significant, indicating that foreign corruption risk is associated with a lower probability of audit issuing going concern opinions. Similar to Table 3, Table 4 also runs the regression in the full sample and two subsamples with corruption risk below and above the median. We still find a significant negative coefficient on Corruption Risk in the subsample with high corruption risk. These are consistent with our expectations.

We next examine the determinants of Type I (false positive) and Type II (false negative) auditor reporting errors. An auditor commits a Type I error by rendering a going concern opinion to the clients that do not go bankrupt in the next year, while Type II error occurs when the client declares bankruptcy within one year of receiving a clean audit opinion. Column 1 of Table 4 Panel B uses an indicator for Type I errors as the dependent variable; Column 2 of Table 4 Panel B uses an indicator for Type II errors as the dependent variable. The sample for type I error consists all the observations that do not bankrupt in the following fiscal year. The sample for type II error consists all the observations that do not receive going concern opinion in the fiscal year. The results in Table 4 Panel B show that the foreign corruption risk does not affect auditor reporting errors. In other words, the effect of foreign corruption risk on going concern opinions are not due to Type I or Type II errors.

We further directly examined the effect of foreign corruption risk on a measure of bankruptcy risk. In Table 4 Panel C, the dependent variable is *Z-Score*, which is a bankruptcy risk measure from the Zmijewski (1984) bankruptcy prediction model. Higher *Z-Score* indicated greater bankruptcy risk. We include most control variables from Model (1). The result shows that foreign corruption risk is associated with significantly lower bankruptcy risk the full sample and in the subsample with high corruption risk. These findings lend further support to our argument that foreign corruption risk lowers a firm's audit risk by reducing business risk. With regards to the control variables, bankruptcy risk is higher for companies with higher leverage.

5. Additional tests

5.1 The Moderating Effect of Political Connections

We consider the moderating effect of corporate political connections. Prior studies (e.g., Correria 2014) suggest that political connections weaken SEC 's and other government agencies' legal

enforcements against financial frauds and other illegal behavior. Therefore, a politically connected firm may be less likely to be prosecuted of foreign bribery by the SEC or DoJ. Such weak enforcement may encourage the firm to engage in more foreign bribery, and its auditor will be even less concerned about FCPA and pay more attention to the economic benefits. Following Correria (2014), we use two alternative measures of political connections: 1) a firm' contributions to political action committees in the prior three years (*PAC*) and 2) lobbying expenditures made in the prior three years (*Lobby*). Data of *PAC* are manually collected from the Federal Election Commission's (FEC) website (www.fec.gov); data of *Lobby* are collected from OpenSecrets (www.opensecrets.org). Political action committees collect donations from individuals, corporations and organizations to campaign for or against political candidates. Firms could also directly spend capital on lobbying to build political connections.

To test the moderating effects of political connections, we interact political connections with *Corruption Risk* in the regression models.¹⁵ We drop observations with missing data of political connections. For the going concern tests, we use linear probability models rather than Probit models because interaction effects in Probit models are hard to interpret (e.g., Ai and Norton 2003). Results are reported in Table 5. Consistent with our expectation, we find significant negative interaction effects of political connections and *Corruption Risk* in both regressions at the 10 percent level or better. Therefore, the negative effects of foreign corruption risk on audit fees and going concern opinions are more pronounced for firms with stronger political connections.

¹⁵ We demean *Corruption Risk*, *PAC* and *Lobby* for all the regressions in Table 5. To make the coefficients on the main effects easier to interpret, Jaccard, Turrisi, and Wan (1990) suggest centering when examining an interaction effect between continuous variables. For example, after centering, the coefficient on *Corruption Risk* shows the effect of corruption risk on audit fee or going concern opinion when political connection is at sample mean. The coefficients on the interactions terms are not affected by centering.

5.2 *The Moderating Effect of Corporate Governance*

Next, we examine the moderating effects of corporate governance. We use two measures of governance: institutional ownership (*InstitOwn*) and management ownership (*MgmtOwn*). Prior studies suggest that both institutional and managerial ownership has positive impacts on firm's governance and performance (e.g., Core and Larcker 2002; Elyasiani and Jia, 2010; Schmidt and Fahlenbrach, 2017). The strong performance of a well governed firm naturally reduces the need to further gain economic benefits through illegal foreign bribery. Therefore, we expect stronger governance to mitigate the negative effects of foreign corruption risk on audit fees and going concern opinions. To test the moderating effect of governance, we interact *InstitOwn* and *MgmtOwn* with *Corruption Risk*. Again, going concern tests are based on linear probability models. Also consistent with our expectation, Table 6 suggests find that higher institutional ownership and higher management ownership mitigates the negative effects of foreign corruption risk on audit fees and going concern opinions.

5.3 *The Effects of An Exogenous Event That Deters Foreign Corruption*

To provide stronger evidence on the causal effects of foreign corruption risk on audit fees, we provide several additional tests in Table 7 based on plausibly exogenous events that deter firms from foreign bribery. Following recent literature (e.g. Ke et al. 2017, Liu et al. 2017), we use the Chinese corruption crackdown in 2012 as another plausible exogenous shock to the corruption risk. A nationwide campaign against corruption that has instilled fear in China's bureaucrats (Chow 2017) and therefore reduce the chance for the companies to gain economic benefits through bribery. As a result, we expect to see a weaker association between foreign corruption risk and audit fees for companies with subsidiaries in China in the post 2012 period. Specifically,

we calculate the percentage of foreign subsidiaries that are operated in China for each firm-year (*%China*), and then interact it with *Post12* which is an indicator variable that equals 1 if a firm-year observation is in the post 2012 period.¹⁶

Regression result are reported in Table 7. To mitigate concerns about firms' self-selection to have presence in China, we require all the observations in the sample to have at least one material subsidiary in China. As shown in Table 7 Column 1, the coefficient on the interaction term is significantly positive, suggesting that audit fees increase for U.S. firms with more subsidiaries in China after the 2012 corruption crackdown. In Table 7 Column 2, we employ a linear probability model for the going concern test. The coefficient on the interaction term is significantly positive, indicating that the probability of auditor issuing a going concern opinion also increases for U.S. firms with more subsidiaries in China after the 2012 corruption crackdown.

All the findings above suggest that audit fees and going concern opinions are increased by a plausibly exogenous event that deters firms from foreign bribery. These are consistent with the findings that corruption risk is negatively associated with audit fees and going concern opinions. These findings also make it harder to evasion alternative explanations based on endogeneity or reverse causality.

5.4 The Association Between Foreign Corruption Risk and Audit Quality

An alternative explanation to the negative association between foreign corruption risk and audit fees is that firms with higher foreign corruption risk self-select auditors with lower quality who also charge lower audit fees. If so, the audit fee effect we find in Table 3 may not be due to

¹⁶ We do not have expectations for the coefficient on *%China*. In column 1, the coefficient on *%China* is negative and significant, possibly because Chinese market has high economic growth. Thus, operating in China may reduce the business risk.

differences in auditor efforts or audit risk but attributable to difference in audit quality. To rule out this alternative explanation, we examine the association between foreign corruption risk and audit quality.

Following prior research (e.g. Francis and Yu 2009, Lennox and Caramanis 2008, Lennox and Li 2014, DeFond and Zhang 2014), we use three measures of audit quality: the absolute value of abnormal accruals from Modified Jones Model,¹⁷ the upward income increasing abnormal accruals and the incidence of restatements in subsequent years. We control for several common control variables that affect audit quality including company size (*Size*), profitability (*Loss*), leverage (*Leverage*), book to market ratio (*BM*), auditor tenure (*Tenure*) and whether the company has a big 4 auditor (*Big4*). We also include the number of countries in which the company has subsidiaries (*#Countries*) and the number of segments (*#Segments*). We control for year fixed effects in all the tests. In addition, firm-fixed effects are included in the abnormal accruals tests. Industry fixed effects are used instead of firm-fixed effects in the restatement test because many firms in our sample never have restatements.

As shown in Table 8 Panels A, B and C, the coefficients on *Corruption Risk* are insignificant, indicating that firms with higher foreign corruption risk do not have lower audit quality. These results mitigate the alternative argument that the difference in audit fees is due to difference in audit quality rather than auditor efforts. Coefficients on the control variables are also generally consistent with our expectations. For example, audit quality is lower for companies that are less profitable and have higher leverage, while audit quality is higher for companies with big auditors.

¹⁷ We require each industry year to have at least 10 observations for the estimation of the Modified Jones model.

5.5 Other Additional Tests

We provide several untabulated additional tests. First, we calculate two additional measures of foreign corruption risk. To mitigate concerns about using the number of subsidiaries as the weight, we use the equally weighted average CPI of all the foreign countries in which a company has subsidiaries. We further use a size-adjusted corruption risk measure to further mitigate other possible concerns related to firm size, such as non-linear relations between firm size and audit behavior. Specifically, we classify all the observations of each 2-digit SIC industry into 10 groups based on firm size. Then, size-adjusted corruption risk is measured as a firm's corruption risk (*Corruption Risk*) minus the average corruption risk of the group that the firm belongs to. Using these two alternative measures, the results are qualitatively similar to our main findings. Second, to eliminate the concern that a very high portion of our observation all have subsidiaries in three foreign countries (i.e., United Kingdom, Canada, Germany), we exclude subsidiaries in these three countries when calculating the weighted average CPI and re-run the regression models. The results remain robust. Third, to further show the robustness of our conclusions, we split the full sample into subsamples by big 4 audit firms or not, the median of firm size and other firm characteristics that are included in the regression models. We do not find evidence that auditors follow the requirements by the FCPA in any subsample.

6. Conclusion

The PCAOB is currently considering whether there is a need to provide better guidance to auditors regarding their responsibilities with respect to clients' possible illegal acts. This study responds to the regulator's concerns by examining how auditors respond to U.S. firms' foreign corruption risk. According to the Foreign Corrupt Practices Act of 1977 (FCPA), U.S. firms are subject to criminal and civil penalties for bribing foreign government officials. Auditors are

required by the FCPA, Auditing Standard 2405 and other security laws to assess the risk that a public firm's management bribes a foreign government official. However, to date, auditors have never been prosecuted by the U.S. government in case of client foreign corruption. So, it is not clear whether auditors would exert effort to detect such bribery activity. Further, on the other hand, prior studies (e.g., Graham and Stroup 2016, Karpoff, Lee and Martin 2017) suggest that firms may gain significant economic benefits from engaging in foreign corruption behavior. Such economic benefits (e.g. permits to open new stores) may lower auditors' perceived business risk of the firms, reducing audit risk and effort. Given these competing arguments, the effect of foreign corruption risk on auditor behavior is an empirical research question.

Following prior studies (e.g., Wilhelm, 2002), we infer a foreign country's corruption level based on the annual Corruption Perceptions Index (CPI) provided by Transparency International since 1996. We construct our firm-level measure of foreign corruption risk as the weighted average CPI with the number of foreign subsidiaries in each country as the weight. Using a sample of 28,191 firm-year observations of U.S. multinational firms from 2000 to 2014, we find that foreign corruption risk is negatively associated with audit fees and going concern opinions, consistent with economic benefits gained from foreign bribery significantly reducing audit fees and auditors' perceived business risk of clients. We further split the sample based on the median of corruption risk. In neither subsample, we find evidence that auditors respond to foreign corruption risk as required by the FCPA.

We provide several additional tests. First, we find that higher foreign corruption risk is associated with lower bankruptcy risk and not associated with type I or type II errors in going concern opinions. Second, the effects of foreign corruption risk are more pronounced for firms with stronger political connections and firms with weaker governance. Third, we provide tests using a plausibly exogenous event that deters firms from foreign bribery. Consistent with our

primary findings, we find that such an event significantly increases audit fees and going concern opinions. Finally, foreign corruption risk does not seem to be associated with audit quality. Thus, the difference in audit fee is not due to firms with higher corruption risk self-selecting auditors with different quality.

In conclusion, all these findings suggest that auditors don't seem to assess foreign corruption risk as required by the FCPA. We believe these findings have significant implications for the PCAOB and other regulators interested in enforcing the FCPA.

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Table 1. Sample Descriptions*Panel A Sample Distribution by Country*

Countries with the most firm-year observations			Most corrupt countries			Least corrupt countries		
Country	Average CPI	N	Country	Average CPI	N	Country	Average CPI	N
United Kingdom	68.66	15,371	South Georgia	38.93	24	Tonga	89.50	1
Canada	68.76	15,328	Gambia	39.20	6	Christmas Island	75.43	12
Germany	66.75	10,345	Gaza Strip	39.36	52	Canada	68.76	15,328
France	65.92	9,921	Mauritania	42.32	6	Nauru	68.67	2
Netherlands	63.65	9,848	Chad	46.92	55	United Kingdom	68.66	15,371

Panel B Average Corruption risk by Year

Year	Average Corruption Risk
2000	71.23
2001	70.28
2002	67.02
2003	66.18
2004	65.76
2005	65.71
2006	65.86
2007	65.83
2008	65.24
2009	64.91
2010	64.56
2011	64.93
2012	65.18
2013	64.49
2014	64.79

Panel C Average Corruption risk by Industry

Industry	Average Corruption Risk
Agricultural Services	84.44
Legal Services	75.93
Security and Commodity Brokers	75.82
Apparel and Accessory Stores	73.19
Coal Mining	73.07
General Building Contractors	53.32
Automotive Dealers and Service Stations	51.49
Local and Interurban Passenger Transit	50.65
Hotels and Other Lodging Places	49.89
Agricultural Production - Livestock	44.30

Note:

This table shows the sample descriptions. Panel A shows the distribution of firm-year observations by country. For each country we calculate the average CPI during the sample period. Panel B shows the distribution of firm-years and average *Corruption Risk* by year. *Corruption Risk* is the negative of the natural

log of the weighted average of corruption index of all the foreign countries in which the firm has subsidiaries. Panel C shows the distribution of firm-years and average corruption risk by industry.

Table 2. Descriptive Statistics*Panel A Summary Statistics*

Variable	N	Mean	S.D.	Q1	Median	Q3
<i>Audit Fees</i>	28,191	13.83	1.35	12.92	13.87	14.72
<i>Going Concern</i>	28,191	0.02	0.15	0	0	0
<i>Corruption Risk</i>	28,191	-4.21	0.23	-4.37	-4.25	-4.11
<i>Size</i>	28,191	6.53	2.15	5.15	6.59	7.97
<i>Loss</i>	28,191	0.33	0.47	0	0	1
<i>Leverage</i>	28,191	0.30	4.10	0.02	0.17	0.34
<i>BM</i>	28,191	0.53	0.69	0.25	0.46	0.75
<i>Tenure</i>	28,191	10.16	8.58	4	8	13
<i>Big4</i>	28,191	0.83	0.38	1	1	1
<i>#Countries</i>	28,191	10.20	12.93	2	5	13
<i>#Segments</i>	28,191	2.07	1.21	1.61	2.48	2.94
<i>CivilLaw</i>	28,191	0.43	0.33	0	0.48	0.67
<i>RuleofLaw</i>	28,191	8.39	1.25	7.80	8.57	9.23
<i>Repudiation</i>	28,191	8.65	0.81	8.33	8.89	9.17
<i>Expropriation</i>	28,191	9.10	0.71	8.75	9.27	9.67

Panel B Comparative Statistics

Variable	High corruption risk	Low corruption risk	Difference in mean
<i>Size</i>	6.90	6.21	0.69***
<i>Loss</i>	0.29	0.36	-0.07***
<i>Leverage</i>	0.24	0.35	-0.11**
<i>BM</i>	0.54	0.53	0.01
<i>Tenure</i>	11.33	9.15	2.18***
<i>Big4</i>	0.85	0.81	0.04***
<i>#Countries</i>	14.51	6.52	7.99***
<i>#Segments</i>	2.17	1.97	0.20***
<i>CivilLaw</i>	0.54	0.33	0.22***
<i>RuleofLaw</i>	7.55	9.10	-1.55***
<i>Repudiation</i>	8.13	9.10	-0.97***
<i>Expropriation</i>	8.63	9.51	-0.89***

Panel C Pearson Correlation Matrix

	<i>AuditFees</i>	<i>Going_Concern</i>	<i>CorruptionRisk</i>	<i>Size</i>	<i>Loss</i>	<i>Leverage</i>	<i>BM</i>	<i>Tenure</i>	<i>Big4</i>	<i>#Countries</i>	<i>#Segments</i>	<i>CivilLaw</i>	<i>RuleofLaw</i>	<i>Repudiation</i>
<i>AuditFees</i>	-0.190***													
<i>CorruptionRisk</i>	-0.095***	0.007	1											
<i>Size</i>	0.767***	-0.238***	0.073***	1										
<i>Loss</i>	-0.280***	0.201***	-0.054***	-0.435***	1									
<i>Leverage</i>	-0.047***	0.034***	-0.011*	-0.030***	0.032***	1								
<i>BM</i>	-0.016***	-0.099***	0.023***	-0.123***	0.040***	-0.039***	1							
<i>Tenure</i>	0.321***	-0.078***	0.049***	0.316***	-0.179***	-0.00600	-0.017***	1						
<i>Big4</i>	0.430***	-0.164***	-0.019***	0.473***	-0.190***	-0.040***	-0.005	0.263***	1					
<i>#Countries</i>	0.544***	-0.076***	0.138***	0.471***	-0.167***	-0.012**	-0.060***	0.242***	0.221***	1				
<i>#Segments</i>	0.143***	-0.099***	0.024***	0.093***	-0.073***	-0.034***	0.00900	0.079***	0.095***	0.161***	1			
<i>CivilLaw</i>	0.116***	-0.025***	0.373***	0.095***	-0.019***	0.00400	-0.034***	0.070***	0.088***	0.254***	0.148***	1		
<i>RuleofLaw</i>	-0.105***	0.005	-0.767***	-0.083***	0.021***	0.014**	-0.006	-0.051***	-0.001	-0.185***	-0.043***	-0.312***	1	
<i>Repudiation</i>	-0.095***	-0.002	-0.772***	-0.090***	0.052***	0.009	-0.010*	-0.060***	0.012**	-0.158***	0.001	-0.249***	0.830***	1
<i>Expropriation</i>	-0.104***	0.005	-0.774***	-0.094***	0.050***	0.010*	-0.018***	-0.065***	0.007	-0.195***	-0.025***	-0.314***	0.891***	0.929***

Note:

This table shows the descriptive statistics and correlations. Panel A shows the descriptive statistics, including the number of observations, mean, standard deviation, the bottom quarter, median and top quarter. Panel B shows the comparative statistics between two subsamples with corruption risk above and below median. Panel C shows the Pearson correlations. ***, ** and * refer to two-tailed significance at the 0.01, 0.05 and 0.10 level, respectively.

Table 3. The effect of foreign corruption risk on audit fees

Dep. Var. =	(1) Full sample	(2) High Corruption Risk	(3) Low Corruption Risk
	<i>Audit Fees</i>		
<i>Corruption Risk</i>	-0.141*** (-2.61)	-0.203*** (-2.72)	-0.001 (-0.00)
<i>Size</i>	0.100*** (12.41)	0.100*** (7.84)	0.090*** (8.15)
<i>Loss</i>	0.096*** (9.99)	0.101*** (7.39)	0.070*** (5.38)
<i>Leverage</i>	-0.000 (-0.19)	0.076* (1.95)	-0.000 (-0.52)
<i>BM</i>	0.058*** (6.54)	0.060*** (4.71)	0.067*** (5.43)
<i>Tenure</i>	0.002 (1.53)	0.001 (0.64)	0.005*** (2.89)
<i>Big4</i>	0.354*** (11.97)	0.298*** (6.04)	0.362*** (8.97)
<i>#Countries</i>	0.014*** (10.26)	0.011*** (7.50)	0.022*** (6.81)
<i>#Segments</i>	0.036*** (4.91)	0.027** (2.55)	0.052*** (4.99)
<i>CivilLaw</i>	0.024 (0.77)	0.054 (1.12)	-0.018 (-0.40)
<i>RuleofLaw</i>	-0.009 (-0.49)	0.015 (0.52)	-0.022 (-0.74)
<i>Repudiation</i>	-0.042 (-1.29)	-0.036 (-0.72)	-0.046 (-0.83)
<i>Expropriation</i>	0.021 (0.48)	0.004 (0.06)	0.065 (0.88)
Intercept	12.664*** (50.99)	12.546*** (39.88)	12.858*** (20.29)
Year Fixed Effects	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes
Observations	28,191	12,996	15,195
Adjusted R-squared	0.930	0.939	0.927

Note:

This table examines the effect of foreign corruption on the audit fees. *Audit Fees* is the natural log of audit fees in the fiscal year. *Corruption Risk* is the negative of the natural log of the weighted average of corruption index of all the foreign countries in which the firm has subsidiaries. The OLS regressions all control for year and firm fixed effects. We clustered standard errors by firms in all the regressions. Variable definitions are provided in Appendix 1. *t*-statistics are reported in parentheses. ***, ** and * refer to two-tailed significance at the 0.01, 0.05 and 0.10 level, respectively.

Table 4. The effect of foreign corruption risk on going concern opinions*Panel A the probability of going concern opinions*

Dep. Var. =	(1)	(2)	(3)
	Full sample	High Corruption Risk	Low Corruption Risk
		Probit (<i>Going_Concern</i> =1)	
<i>Corruption Risk</i>	-0.766** (-1.99)	-1.103* (-1.85)	-1.009 (-0.97)
<i>Size</i>	-0.735*** (-18.82)	-0.876*** (-11.53)	-0.677*** (-14.09)
<i>Loss</i>	1.296*** (4.52)	2.380*** (3.27)	1.005*** (3.11)
<i>Leverage</i>	1.113*** (7.46)	1.117*** (3.83)	1.060*** (5.76)
<i>BM</i>	-0.287*** (-7.05)	-0.210*** (-3.11)	-0.379*** (-6.61)
<i>Tenure</i>	-0.010 (-1.07)	-0.020 (-1.27)	-0.007 (-0.58)
<i>Big4</i>	-0.221* (-1.78)	-0.216 (-0.90)	-0.261* (-1.70)
<i>#Countries</i>	0.027*** (2.89)	0.056*** (4.42)	-0.004 (-0.18)
<i>#Segments</i>	-0.031*** (-3.92)	-0.041*** (-3.06)	-0.025** (-2.43)
<i>RepLag</i>	1.146*** (9.10)	1.038*** (4.62)	1.324*** (8.00)
<i>CivilLaw</i>	0.168 (1.12)	0.394 (1.32)	-0.040 (-0.19)
<i>RuleofLaw</i>	0.098 (1.27)	-0.141 (-1.05)	0.225* (1.72)
<i>Repudiation</i>	0.010 (0.06)	0.628** (2.18)	0.224 (0.82)
<i>Expropriation</i>	-0.382* (-1.82)	-0.913** (-2.55)	-0.236 (-0.76)
Intercept	-8.158 (-1.03)	-14.959 (-0.04)	-25.452 (-0.01)
Year Fixed Effects	Yes	Yes	Yes
Industry Fixed Effects	Yes	Yes	Yes
Observations	8,193	3,356	4,837
Pseudo R-squared	0.340	0.340	0.360

Table 4.*Panel B The effect of foreign corruption risk on going concern opinion type I and II errors*

Dep. Var. =	(1) Probit (Type I error=1)	(2) Probit (Type II error=1)
<i>Corruption Risk</i>	-0.589 (-1.19)	2.244 (0.64)
<i>Size</i>	-0.761*** (-14.43)	-0.524 (-1.27)
<i>Loss</i>	0.560 (1.47)	-0.919 (-0.69)
<i>Leverage</i>	1.075*** (5.58)	-1.317 (-0.68)
<i>BM</i>	-0.251*** (-4.53)	-0.614 (-1.64)
<i>Tenure</i>	-0.003 (-0.25)	0.015 (0.29)
<i>Big4</i>	-0.316* (-1.93)	1.980 (1.32)
<i>#Countries</i>	0.002 (0.13)	0.086* (1.82)
<i>#Segments</i>	-0.016 (-1.52)	-0.028 (-0.49)
<i>RepLag</i>	-0.009 (-0.04)	1.167 (0.77)
<i>CivilLaw</i>	0.180* (1.82)	0.184 (0.20)
<i>RuleofLaw</i>	-0.010 (-0.05)	-2.291 (-1.11)
<i>Repudiation</i>	-0.373 (-1.39)	2.914 (1.04)
<i>Expropriation</i>	1.233*** (6.72)	2.520** (2.12)
Intercept	-15.965 (-0.03)	-37.310 (-0.00)
Year fixed effect	Yes	Yes
Industry fixed effect	Yes	Yes
Pseudo R-squared	0.357	0.507
Observations	4,324	3,936

Table 4.*Panel C The effect of foreign corruption risk on bankruptcy risk*

Dep. Var. =	(1)	(2)	(3)
	Full sample	High Corruption Risk <i>Bankruptcy Risk</i>	Low Corruption Risk
<i>Corruption Risk</i>	-0.267** (-2.25)	-0.325*** (-3.16)	-0.019 (-0.03)
<i>Size</i>	-0.149*** (-8.16)	-0.099*** (-7.39)	-0.179*** (-7.32)
<i>Loss</i>	1.391*** (24.90)	1.081*** (21.12)	1.538*** (24.12)
<i>Leverage</i>	3.140*** (4.27)	5.148*** (11.60)	2.580*** (3.59)
<i>BM</i>	-0.439*** (-4.14)	-0.098*** (-3.36)	-0.605*** (-4.82)
<i>Tenure</i>	0.002 (1.25)	-0.001 (-0.58)	0.008** (2.50)
<i>Big4</i>	-0.055 (-0.90)	0.066 (1.13)	-0.212** (-2.22)
<i>#Countries</i>	0.008*** (4.76)	0.003*** (2.89)	0.016*** (4.40)
<i>#Segments</i>	-0.003** (-2.22)	-0.001 (-1.23)	-0.004* (-1.74)
<i>RepLag</i>	0.016 (0.23)	-0.008 (-0.15)	-0.092 (-0.71)
<i>CivilLaw</i>	-0.011 (-0.30)	-0.084** (-2.19)	0.048 (0.67)
<i>RuleofLaw</i>	-0.172** (-2.50)	-0.067 (-1.23)	-0.057 (-0.49)
<i>Repudiation</i>	0.188** (2.27)	0.156** (2.52)	0.134 (0.92)
Intercept	-4.240*** (-7.54)	-5.348*** (-14.08)	-4.018* (-1.75)
Industry Fixed Effects	Yes	Yes	Yes
Year Fixed Effects	Yes	Yes	Yes
Observations	20,753	9,834	10,919
Adjusted R-squared	0.553	0.723	0.512

Note:

This table examines the effect of foreign corruption on audit opinions and bankruptcy risk. In Panel A, we examine the effect of foreign corruption on the going concern opinions. *Going_Concern* is an indicator variable if a company receives a first time going concern opinion in the fiscal year. *Corruption Risk* is the negative of the natural log of the weighted average of corruption index of all the foreign countries in which the firm has subsidiaries. In Panel B, we further examine the going concern opinion errors. Type I error is an indicator for observations that have going concern opinion but do not bankrupt in the next year. Type II error is an indicator for observations that do not have going concern opinion but bankrupt in the next year. The sample for type I error consists all the observations that do not bankrupt in the following fiscal year. The sample for type II error consists all the observations that do not receive going concern opinion in the fiscal year. In Panel C, we further use the bankruptcy risk as the dependent variable in OLS regressions. The Probit regressions all control for year and industry fixed effects. We clustered standard errors by firms. Variable definitions are provided in Appendix 1. *t*-statistics are reported in parentheses. ***, ** and * refer to two-tailed significance at the 0.01, 0.05 and 0.10 level, respectively.

Table 5. The moderating effect of political connection

Dep. Var. =	(1) <i>Audit Fees</i>	(2) <i>Audit Fees</i>	(3) <i>Going concern</i>	(4) <i>Going concern</i>
<i>Corruption Risk* PAC</i>	-0.088** (2.09)		-0.027* (1.68)	
<i>Corruption Risk* LOBBY</i>		-0.074*** (2.73)		-0.032* (1.70)
<i>Corruption Risk</i>	-0.173 (1.21)	-0.329** (2.04)	-0.082 (1.48)	0.001 (-0.01)
<i>PAC</i>	0.028 (1.48)		0.008 (1.55)	
<i>LOBBY</i>		0.029*** (3.08)		-0.001 (-0.41)
<i>Size</i>	0.102*** (4.13)	0.090*** (2.88)	-0.032*** (-3.25)	-0.015 (-1.22)
<i>Loss</i>	0.104*** (4.56)	0.076** (2.19)	0.029* (1.70)	0.005 (0.31)
<i>Leverage</i>	0.305** (2.53)	0.420** (2.22)	0.041 (0.95)	-0.009 (-0.20)
<i>BM</i>	0.080*** (3.77)	0.033 (0.75)	-0.037* (-1.86)	-0.056** (-2.16)
<i>Tenure</i>	-0.002 (-0.62)	-0.000 (-0.15)	0.001 (1.25)	0.001 (1.20)
<i>Big4</i>	0.299*** (3.11)	0.126 (0.45)	0.022 (0.70)	-0.110* (-1.92)
<i>#Countries</i>	0.010*** (4.10)	0.007*** (3.47)	0.002*** (2.65)	0.001 (1.43)
<i>#Segments</i>	0.012 (0.77)	0.043** (2.39)	-0.001 (-1.16)	-0.001 (-1.21)
<i>CivilLaw</i>	0.029 (0.41)	0.038 (0.38)	-0.048 (-1.37)	-0.103* (-1.92)
<i>RuleofLaw</i>	-0.085* (-1.81)	-0.139** (-2.01)	0.020 (0.82)	-0.034 (-0.86)
<i>Repudiation</i>	-0.074 (-0.95)	-0.295*** (-2.89)	0.069 (1.51)	0.047 (1.04)
<i>Expropriation</i>	0.169 (1.37)	0.528*** (3.17)	-0.131* (-1.70)	0.018 (0.19)
<i>Replag</i>			0.075** (2.57)	-0.020 (-0.47)
<i>Intercept</i>	13.749*** (28.04)	13.436*** (19.36)	0.302 (1.29)	0.062 (0.28)
Firm Fixed Effects	Yes	Yes		
Industry Fixed Effects			Yes	Yes
Year Fixed Effects	Yes	Yes	Yes	Yes
Observations	5,000	2,219	739	266
Adjusted R-squared	0.946	0.945	0.241	0.302

Note:

This table examines the moderating effect of political connection on the associations between foreign corruption and audit fees and opinions. *PAC* is measured as the natural logarithm of the firm's PAC disbursements in the past three years. *LOBBY* is measured as the natural logarithm of the firm's lobby expenses the past three years. Audit fee regressions control for year and firm

fixed effects. Linear probability model regressions of going concern opinions control for year and industry fixed effects. We clustered standard errors by firms. Variable definitions are provided in Appendix 1. *t*-statistics are reported in parentheses. ***, ** and * refer to two-tailed significance at the 0.01, 0.05 and 0.10 level, respectively.

Table 6. The moderating effect of Institutional Ownership and Management Ownership

	(1)	(2)	(3)	(4)
<i>Dep. Var. =</i>	<i>Audit Fees</i>	<i>Audit Fees</i>	<i>Going concern</i>	<i>Going concern</i>
<i>Corruption Risk</i>	-0.159*** (-2.96)	-0.191*** (-2.82)	-0.106*** (-2.63)	-0.078** (-2.09)
<i>InstOwn</i>	0.367* (1.88)		0.292* (1.95)	
<i>Corruption Risk * InstOwn</i>	0.084* (1.82)		0.082** (2.30)	
<i>MgmtOwn</i>		0.046*** (3.56)		0.039* (1.86)
<i>CorruptionRisk*MgmtOwn</i>		0.011*** (3.57)		0.009* (1.87)
<i>Size</i>	0.109*** (13.69)	0.112*** (9.17)	-0.041*** (-12.93)	-0.027*** (-5.47)
<i>Loss</i>	0.080*** (8.69)	0.090*** (7.39)	0.040*** (5.57)	0.010 (1.31)
<i>Leverage</i>	0.292*** (7.33)	0.361*** (6.04)	0.119*** (5.20)	0.019 (0.91)
<i>BM</i>	0.069*** (8.10)	0.090*** (6.06)	-0.046*** (-7.29)	-0.036*** (-3.92)
<i>Tenure</i>	0.002 (1.41)	0.000 (0.12)	0.001 (1.09)	-0.000 (-0.02)
<i>Big N</i>	0.329*** (11.75)	0.205*** (3.60)	-0.037*** (-3.10)	-0.014 (-0.88)
<i>#countries</i>	0.013*** (11.42)	0.011*** (7.50)	0.002*** (4.79)	0.002*** (3.81)
<i>#segment</i>	0.031*** (4.25)	0.028*** (3.15)	-0.002*** (-3.52)	-0.000 (-0.88)
<i>CivilLaw</i>	-0.026 (-0.63)	-0.008 (-0.14)	0.005 (0.33)	-0.023 (-1.63)
<i>RuleofLaw</i>	0.025 (0.84)	0.038 (1.01)	0.003 (0.42)	-0.007 (-1.00)
<i>Repudiation</i>	-0.005 (-0.31)	0.001 (0.05)	-0.003 (-0.19)	-0.008 (-0.50)
<i>Expropriation</i>	-0.012 (-0.41)	-0.033 (-0.82)	-0.016 (-0.66)	-0.003 (-0.19)
<i>Replag</i>			0.063*** (6.46)	0.038** (2.46)
<i>Intercept</i>	12.623*** (51.14)	12.949*** (41.23)	-0.290* (-1.84)	-0.123 (-0.87)
<i>Firm Fixed Effects</i>	Yes	Yes		
<i>Industry Fixed Effects</i>			Yes	Yes
<i>Year Fixed Effects</i>	Yes	Yes	Yes	Yes
<i>Observations</i>	28,191	15,827	8,193	2,994
<i>Adjusted R-squared</i>	0.922	0.921	0.217	0.124

Note:

This table examines the moderating effect of institutional ownership and management ownership. Institutional ownership (*InstOwn*) is measured as the percentage of shares owned

by institutional investors and management ownership (*MgmtOwn*) is measured as total percentage of shares owned by the named executive officers covered in ExecuComp. Audit fee regressions control for year and firm fixed effects. Linear probability model regressions of going concern opinions control for year and industry fixed effects. We clustered standard errors by firms. Variable definitions are provided in Appendix 1. *t*-statistics are reported in parentheses. ***, ** and * refer to two-tailed significance at the 0.01, 0.05 and 0.10 level, respectively.

Table 7. Effects of China Anti-Corruption Crackdown

Dep. Var. =	(1) <i>Audit Fees</i>	(2) <i>Going concern</i>
<i>%China *Post12</i>	0.336*** (2.61)	0.224** (2.06)
<i>%China</i>	-0.476*** (-3.23)	0.016 (0.37)
<i>Size</i>	0.113*** (6.97)	-0.036*** (-6.39)
<i>Loss</i>	0.073*** (4.44)	0.049*** (5.12)
<i>Leverage</i>	0.481*** (5.75)	-0.007 (-0.21)
<i>BM</i>	0.102*** (4.88)	-0.050*** (-4.47)
<i>Tenure</i>	0.015 (1.05)	0.002 (0.45)
<i>Big4</i>	0.210*** (3.24)	0.001 (0.08)
<i>#Countries</i>	0.010*** (7.24)	0.002*** (3.90)
<i>#Segments</i>	0.026** (2.33)	-0.001 (-1.16)
<i>RepLag</i>		0.038*** (3.38)
<i>CivilLaw</i>	-0.107 (-1.54)	0.009 (0.35)
<i>RuleofLaw</i>	0.062 (1.44)	0.018 (1.39)
<i>Repudiation</i>	-0.177*** (-2.65)	-0.020 (-0.81)
<i>Expropriation</i>	0.053 (0.60)	-0.011 (-0.30)
Intercept	13.945*** (33.25)	0.095 (0.65)
Year Fixed Effects	Yes	Yes
Firm Fixed Effects	Yes	Yes
Observations	8,444	1,968
Adjusted R-squared	0.937	0.165

Note:

This table examines the effect of anti-corruption crackdown in China on the audit fees and audit opinions. The sample include all the observations with operations in China. *Audit Fees* is the natural log of audit fees in the fiscal year. *Going_Concern* is an indicator variable that equals one if a company receives a first time going concern opinion in the fiscal year. *Corruption Risk* is the natural log of the weighted average of corruption index of all the foreign countries in which the firm has subsidiaries. *%China* is the proportion of foreign subsidiaries located in China. *Post12* is an indicator variable which equals 1 if the firm-year observation falls in 2012 or after. Audit fee regressions control for year and firm fixed effects. Linear probability model regressions of going concern opinions control for year and industry fixed effects. We clustered standard errors by firms in all the regressions. Variable definitions are provided in Appendix 1. *t*-statistics are reported in parentheses. ***, ** and * refer to two-tailed significance at the 0.01, 0.05 and 0.10 level, respectively.

Table 8. The association between foreign corruption risk and audit quality*Panel A Abnormal Accruals*

Dep. Var. =	(1)	(2)	(3)
	Full sample	High Corruption Risk	Low Corruption Risk
		<i>Abnormal Accruals</i>	
<i>Corruption Risk</i>	-0.004 (-0.41)	-0.001 (-0.06)	-0.007 (-0.20)
<i>Size</i>	0.001 (0.66)	0.001 (0.22)	0.005 (1.43)
<i>Loss</i>	-0.032*** (-11.25)	-0.025*** (-6.90)	-0.034*** (-7.70)
<i>Leverage</i>	0.015 (1.16)	0.020 (1.34)	0.018 (0.80)
<i>BM</i>	0.002 (0.60)	0.003 (0.78)	0.002 (0.45)
<i>Tenure</i>	0.000 (0.04)	-0.000 (-1.63)	0.000 (1.37)
<i>Big4</i>	-0.005 (-0.99)	0.008 (0.93)	-0.015** (-1.97)
<i>#Countries</i>	-0.000 (-0.91)	0.000 (0.48)	-0.000 (-0.36)
<i>#Segments</i>	-0.001 (-0.95)	0.000 (0.29)	-0.002 (-1.00)
<i>CivilLaw</i>	-0.001 (-0.19)	0.015 (1.26)	-0.007 (-0.68)
<i>RuleofLaw</i>	-0.000 (-0.03)	-0.001 (-0.18)	0.001 (0.22)
<i>Repudiation</i>	-0.001 (-0.19)	-0.002 (-0.18)	0.003 (0.20)
<i>Expropriation</i>	-0.002 (-0.24)	0.000 (0.04)	-0.007 (-0.44)
Intercept	-0.001 (-0.03)	-0.021 (-0.31)	-0.032 (-0.21)
Year Fixed Effects	Yes	Yes	Yes
Firm Fixed Effects	Yes	Yes	Yes
Observations	25,386	11,965	13,421
Adjusted R-squared	0.221	0.235	0.215

Panel B Positive Abnormal Accruals

Dep. Var. =	(1)	(2)	(3)
	Full sample	High Corruption Risk	Low Corruption Risk
		<i>Positive Abnormal Accruals</i>	
<i>Corruption Risk</i>	-0.002 (-0.14)	0.012 (0.71)	-0.008 (-0.16)
<i>Size</i>	0.004 (1.57)	0.004 (1.29)	0.006 (1.19)
<i>Loss</i>	-0.010*** (-2.90)	-0.007* (-1.68)	-0.014** (-2.21)
<i>Leverage</i>	0.041** (2.43)	0.027 (1.41)	0.057* (1.85)
<i>BM</i>	-0.008** (-2.53)	-0.008* (-1.91)	-0.007 (-1.18)
<i>Tenure</i>	0.000 (0.37)	-0.000 (-0.70)	0.001 (1.09)
<i>Big4</i>	-0.009 (-1.34)	0.000 (0.03)	-0.019 (-1.57)
<i>#Countries</i>	-0.000** (-2.23)	-0.000 (-0.09)	-0.001 (-1.31)
<i>#Segments</i>	-0.002 (-1.04)	-0.002 (-0.82)	-0.001 (-0.45)
<i>CivilLaw</i>	-0.008 (-1.12)	0.016 (1.20)	-0.012 (-0.97)
<i>RuleofLaw</i>	0.004 (0.94)	-0.002 (-0.33)	0.000 (0.03)
<i>Repudiation</i>	-0.002 (-0.21)	0.018 (0.86)	-0.016 (-1.09)
<i>Expropriation</i>	-0.010 (-0.73)	-0.019 (-0.71)	0.002 (0.10)
<i>Intercept</i>	0.094* (1.67)	0.098 (1.07)	0.102 (0.53)
<i>Year Fixed Effects</i>	Yes	Yes	Yes
<i>Firm Fixed Effects</i>	Yes	Yes	Yes
<i>Observations</i>	11,270	5,489	5,781
<i>Adjusted R-squared</i>	0.485	0.428	0.516

Panel C Restatement

Dep. Var. =	(1) Full sample	(2) High Corruption Risk Restatement	(3) Low Corruption Risk
<i>Corruption Risk</i>	-0.215 (-0.94)	-0.310 (-1.07)	-0.481 (-0.78)
<i>Size</i>	0.011 (0.60)	-0.026 (-0.97)	0.036 (1.55)
<i>Loss</i>	0.164*** (2.95)	0.216*** (2.64)	0.107 (1.48)
<i>Leverage</i>	-0.002 (-0.90)	0.284*** (2.87)	-0.005 (-1.30)
<i>BM</i>	0.083** (2.40)	0.191*** (4.14)	0.013 (0.27)
<i>Tenure</i>	-0.005 (-1.53)	-0.007 (-1.62)	-0.002 (-0.48)
<i>Big4</i>	0.280*** (3.18)	0.554*** (4.17)	0.071 (0.64)
<i>#Countries</i>	0.004 (1.43)	0.002 (0.46)	0.010* (1.77)
<i>#Segments</i>	0.001 (0.04)	-0.018 (-0.51)	-0.003 (-0.08)
<i>CivilLaw</i>	0.054 (0.59)	0.031 (0.22)	0.146 (1.10)
<i>RuleofLaw</i>	-0.049 (-0.95)	-0.077 (-1.07)	-0.066 (-0.82)
<i>Repudiation</i>	0.073 (0.74)	0.058 (0.43)	-0.124 (-0.79)
<i>Expropriation</i>	-0.091 (-0.67)	0.055 (0.34)	-0.227 (-1.13)
<i>Intercept</i>	-3.276*** (-4.19)	-4.492*** (-4.37)	-1.368 (-0.53)
Year Fixed Effects	Yes	Yes	Yes
Industry Fixed Effects	Yes	Yes	Yes
Observations	28,191	12,996	15,195
Pseudo R-squared	0.022	0.022	0.030

Note:

This table examines the effect of foreign corruption risk on audit quality. *Abnormal Accruals* are the absolute values of discretionary accruals estimated based on Modified Jones model. *Positive Abnormal Accruals* are the positive values discretionary accruals estimated based on Modified Jones model, and is set to 0 if negative. *Restatement* is an indicator variable that equals 1 if a company's financial statements are subsequently restated. *Corruption Risk* is the negative of the natural log of the weighted average of corruption index of all the foreign countries in which the firm has subsidiaries. Regressions in Panels A and B all control for year fixed effects and firm fixed effects, and Panel C controls for industry fixed effects and year fixed effects. We clustered standard errors by firms in all the regressions. Variable definitions are provided in Appendix 1. t-statistics are reported in parentheses. ***, ** and * refer to two-tailed significance at the 0.01, 0.05 and 0.10 level, respectively.

Appendix Variable definitions

<i>Audit Fees</i>	=	Natural log of audit fees in the fiscal year. Source: Audit Analytics
<i>Corruption Risk</i>	=	The negative of the natural log of the weighted average of the corruption index of all the foreign countries in which a firm has subsidiaries. The weight is the number of subsidiaries that the firm in that country. Source: Transparency International; Dyreng website
<i>Size</i>	=	Natural log of the market value of equity. Source: Compustat
<i>Loss</i>	=	Indicator variable that is equal to 1 if the firm has negative net income, and 0 otherwise. Source: Compustat
<i>Leverage</i>	=	Total long-term debt divided by total assets at the end of the fiscal year Source: Compustat
<i>BM</i>	=	Book to market ratio, the ratio of book value of equity to the market value of equity. Source: Compustat
<i>Tenure</i>	=	Natural log of audit firm tenure. Source: Audit Analytics
<i>Big4</i>	=	Indicator variable that is equal to 1 if the firm is audited by a Big 4 audit firm during the fiscal year. Source: Compustat
<i>#Countries</i>	=	Number of foreign countries in which the firm has subsidiaries. Source: Dyreng website
<i>Replag</i>	=	Natural log of the number of days between the audit report date and the fiscal year end date. Source: Audit Analytics
<i>#Segments</i>	=	Natural log of the number of the sum of operating segments and geographic segments. Source: Compustat
<i>CivilLaw</i>	=	Indicator variable that equals 1 if any of the foreign countries in which the firm has subsidiaries has a civil law system (La Porta et al. 1998). Source: La Porta website; Dyreng website
<i>RuleofLaw</i>	=	Weighted average of the rule of law index (La Porta et al. 1998) of all the foreign countries in which a firm has subsidiaries. The weight is the number of subsidiaries that the firm in that country. Source: La Porta website; Dyreng website
<i>Repudiation</i>	=	Weighted average of the risk of contract repudiation index (La Porta et al. 1998) of all the foreign countries in which a firm has subsidiaries. The weight is the number of subsidiaries that the firm in that country. Source: La Porta website; Dyreng website
<i>Expropriation</i>	=	Weighted average of the risk of management expropriation index (La Porta et al. 1998) of all the foreign countries in which a firm has subsidiaries. The weight is the number of subsidiaries that the firm in that country. Source: La Porta website; Dyreng website

<i>Going_Concern</i>	=	An indicator for a firm that received a going concern opinion for the first time. Source: Audit Analytics
<i>Z-Score</i>	=	The bankruptcy probability score (Zmijewski 1984), calculated as $-4.3 - 4.5 \times (\text{net income}/\text{total assets}) + 5.7 \times (\text{total debt}/\text{total assets}) - 0.004 \times (\text{current assets}/\text{current liabilities})$. Source: Compustat
<i>PAC</i>	=	The natural logarithm of the firm's PAC disbursements in the past three years. Source: www.fec.gov
<i>LOBBY</i>	=	The natural logarithm of the firm's lobby expense in the past three years. Source: OpenSecrets.org
<i>InstOwn</i>	=	The percentage of shares owned by institutional holders. Source: SEC 13-F filings in the Thomson Reuters Institutional Holdings database
<i>MgmtOwn</i>	=	The total percentage of shares owned by the named executives in ExecuComp. Source: ExecuComp in Compustat
<i>%China</i>	=	The proportion of foreign subsidiaries located in China. Source: Dyreng website
<i>Post12</i>	=	An indicator variable which equals 1 if the firm-year observation falls in 2012 or after. Source: Compustat
<i>Abnormal Accruals</i>	=	Absolute value of abnormal accruals based on Modified Jones model. Source: Compustat
<i>Positive Abnormal Accruals</i>	=	The positive values discretionary accruals estimated based on Modified Jones model, and is set to 0 if negative. Source: Compustat
<i>Restatement</i>	=	An indicator variable that is equal to 1 if the firm restates the current year's accounting information in a subsequent year. Source: Audit Analytics
