The influence of qualified foreign institutional investors on internal control quality: evidence from China

The Influence of Qualified Foreign Institutional Investors on Internal Control Quality: Evidence from China

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Abstract

This study aims to investigate whether qualified foreign institutional investors (QFIIs) improve companies' internal control quality to mitigate information asymmetry. By analysing a sample of 22,310 firm-year observations from Chinese listed companies between 2005 and 2017, we found that companies with QFIIs exhibit higher internal control quality and fewer internal control deficiencies. In particular, higher QFII ownership is associated with higher quality of internal control. Interestingly, QFIIs from high-governance-quality countries are more likely to improve the internal control system of their investee companies. Finally, the improvement in internal control quality attributed to QFIIs leads to better operating performance. Our results are robust to alternative measures of QFIIs, alternative proxies for internal control quality, and various controls for endogeneity issues.

Keywords: Qualified foreign institutional investors; internal control quality; Chinese equity markets; information asymmetry

JEL classification: G23, G30, L25

1. Introduction

Foreign institutional investors play an increasingly important role in the integration of international capital markets (Jin et al., 2016). They are one of the leading players in the globalisation of emerging markets. Nevertheless, as minority and "outside" investors, foreign institutional investors usually suffer from severe information asymmetry that is caused by multiple agency issues (principal-principal and principal-agent) and/or an inferior information environment within investee companies (Kang and Kim, 2010; Huang and Zhu, 2015; Zhang et al., 2017; Kim et al., 2020). Therefore, overcoming the information disadvantage is crucial for foreign institutional investors (Kim et al., 2020). However, we still lack knowledge on how foreign institutional investors mitigate information asymmetry. Further, investigating the influence of foreign institutional investors on specific governance practices and corporate events in emerging markets is also an important but unexplored area (Aggarwal et al., 2011; Huang and Zhu, 2015). Relevant studies mainly focus on auditor choices (He et al., 2014; Kim et al., 2019), global convergence of accounting reports (Fang et al., 2015), split-share structure reform (Huang and Zhu, 2015), and earnings management (Lel, 2019). Our study seeks to address this gap by investigating the influence of foreign institutional investors on the effectiveness (high-quality) of internal control, which is a vital governance practice to address agency problems and information asymmetry.

Internal control refers to a process designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations, reliability of financial statements, and compliance with applicable laws and regulations (Changchit et al., 2001; Doyle et al., 2007). An effective internal control system has long been considered as a crucial corporate governance mechanism to prevent the recurrence of unethical conduct (e.g. earnings management and fraud) and reporting improprieties (Ji et al., 2017). In particular, a high-quality internal control system ensures high-

quality financial and non-financial information reporting and a transparent information environment (Ashbaugh-Skaife et al., 2007; Feng et al., 2009; Ji et al., 2017), and hence, this mitigates information asymmetry. This is particularly critical for minority investors, such as foreign institutional investors, because their direct influence on business strategies is limited. A well-established internal control system can complement weak monitoring roles and reduce potential investment risks (Chen et al., 2017).

The Chinese setting provides an ideal laboratory to study whether foreign institutional investors will improve investee companies' internal control quality for the following two reasons. First, since the Qualified Foreign Institutional Investor (QFII) scheme was officially launched by the China Securities Regulatory Commission (CSRC) in 2002, we have observed an increasingly large number of foreign institutional investors entering Chinese markets, especially those from well-governed jurisdictions. However, because of the quota system, QFIIs can only take small ownership and face agency problems from management and large domestic investors, such as state entities. Hence, QFIIs are more likely to protect their benefits by improving corporate governance practices to reduce agency issues (Huang and Zhu, 2015; Cao et al., 2017). This, in turn, enhances their local reputation in China and leads to more investment quotas. Meanwhile, these qualified offshore investors are experienced and sophisticated large international investors who have advanced knowledge and skills to monitor and advise business and governance practices (Kim et al., 2020; Li et al., 2021). The QFII scheme expects them to not only facilitate the Chinese market's financial globalisation but also advise better and internationally accepted governance practices (Huang and Zhu, 2015). Although China has achieved significant economic progress and has become the largest emerging economy in the world, its inferior governance, weak institutions, and poor law enforcement still raise severe concerns (Bai et al., 2004; Yuan et al., 2009).

Based on a panel dataset of 2,773 unique Chinese listed companies with 22,310 firm-year observations between 2005 and 2017, we find that companies with QFIIs experience an increase in future internal control quality and exhibit fewer internal control deficiencies. Similarly, QFII ownership is positively associated with future internal control quality. We then explore why QFIIs push investee companies to improve the quality of internal control. First, the incentive to facilitate the effectiveness of internal control may be attributable to QFIIs' high awareness of corporate governance because the overwhelming majority of these investors in Chinese listed companies are from well-governed regimes or advanced economies, such as countries in North America and Western and Northern Europe. As a result, they are more accustomed to higher-standard codes of conduct and better governance practices in their home countries (Gong et al., 2013).[1] Hence, when investing in foreign markets, these offshore investors are highly likely to transplant their strong governance awareness and high standards of conduct to the investees, more likely to comply with rules and laws, and pay particular attention to internal control issues. Second, investing in a foreign market is accompanied by additional risk and investment uncertainty due to a lack of transparent and sufficient information for the fair evaluation of their prospective investees; when compared to local investors, overseas investors are naturally characterised by information disadvantages (Oh et al., 2011; Li et al., 2021). Because efficient internal control is generally viewed as an essential signalling mechanism that helps reduce information asymmetry and enhance transparency (Feng et al., 2009; Ji et al., 2017), foreign investors are motivated to promote better internal control practices and help maintain the effectiveness of the control system to address concerns that arise from geographical distances. Our evidence reveals that this positive impact is more salient in companies with QFIIs from countries with high institutional quality than in

[1] Similarly, Jia et al. (2020) report that 95.83% of QFIIs in Chinese companies come from advanced economies deemed by the IMF.

companies with QFIIs from countries with low institutional quality. Our findings are robust to a series of additional tests, including alternative measures of key variables, controlling for the characteristics of the audit committee and the effects of domestic institutional investors, as well as a subsample excluding manufacturing entities. Our results are consistent after conducting the dynamic panel generalised method of moments (GMM) and propensity score matching (PSM) approach.

We further uncovered the mechanism for the positive influence of QFII-licensed investors. Existing literature has documented that key shareholders can influence corporate policies by proposing and voting on the board (Lee and Lounsbury, 2011; Oh et al., 2011; Li et al., 2021). Thus, we identify whether QFII is ranked among the top ten shareholders of the company to capture the strength of the influence of QFIIs. Our results demonstrate that foreign investors, when they are among the top ten largest shareholders, have a greater influence on decision making and offer a key mechanism that promotes toward effective internal control. Finally, our further analysis reveals that the enhanced internal control quality attributed to QFIIs leads to higher financial performance.

This study contributes significantly to the literature in three ways. First, we provide new evidence for the ever-growing number of studies exploring the motives and roles of foreign institutional investors. Existing literature on foreign investors' impact mainly focuses on the integration of technological, human, and financial resources (Huang and Shiu, 2009), knowledge spillovers and innovation (Luong et al., 2017), financial stability (Schuppli and Bohl, 2010), stock price crash risk (Kim et al., 2020), social responsibility (Dyck et al., 2019), and firm performance (Douma et al., 2006). This study underscores the effect of QFIIs on improving the quality of firm-level internal control and reducing internal control deficiencies in China.

Second, we echo the call for investigating the influence of foreign institutional investors on specific corporate governance practices (Ferreira and Matos, 2008; Aggarwal et al., 2011; Huang and Zhu, 2015). The current literature mainly focuses on the influence on governance index, which leads to less guidance on practices and regulations. Importantly, we empirically demonstrate that this impact is driven by QFIIs from countries with high institutional quality.

Third, our research provides new insights into current literature on the determinants of internal control quality. Existing literature has documented that the quality of internal control is influenced by firm-specific characteristics (Chen and Keung, 2018), board heterogeneity (Hu et al., 2017), ownership structure (e.g., ownership concentration, managerial, and family ownership) (Deumes and Knechel, 2008; Bardhan et al., 2015), characteristics of the audit committee (Zhang et al., 2007), senior executives' functional backgrounds (Yu et al., 2019; Oradi et al., 2020), national culture, and market regulations.[2] Our study highlights the importance of foreign investors, especially their higher awareness of governance and strict standards of conduct, as a critical channel to facilitate the effectiveness of the internal control system for companies in countries with inferior corporate governance and weak institutional environments.

The remainder of this paper is organised as follows. Section 2 reviews the current literature and develops our hypotheses. The research design is presented in Section 3. Section 4 presents the main findings, robustness checks, and endogeneity analyses. Section 5 explores the mechanism by which QFIIs may be used to promote for changes in the internal control quality of a company. Section 6 extends the study, and Section 7 concludes the paper.

[2] See Chalmers et al. (2019) for a detailed review.

2. Literature review and hypotheses development

2.1 Institutional background

In November 2002, China partially opened its domestic financial market to foreign institutional investors by launching a scheme assigning investment quotas to QFIIs, which was officially approved by the CSRC. This scheme aims to develop domestic capital markets gradually and allows QFII-licensed entities to buy and sell Chinese Yuan (CNY)-denominated A-shares[3] listed on the Shenzhen Stock Exchange (SZSE) and Shanghai Stock Exchange (SSE). Since then, international investors in the domestic A-share market have dramatically increased with respect to foreign investment quotas and the number of QFIIs. The motivation for implementing the QFII scheme is as follows: First, because of the strict selection criteria of the scheme, QFIIs are large and internationally famous institutions (Huang and Zhu, 2015) with in-depth investment knowledge and a strong sense of governance awareness (Gul et al., 2010; Huang and Zhu, 2015; Jin et al., 2016). Therefore, the Chinese market, as a relative latecomer to international markets, attempts to rely on QFIIs to effectively integrate human capital and facilitate asset allocation, in addition to introducing superior managerial skills and corporate governance practices. Second, the QFII scheme aims to help enhance the monetary system, gradually internationalise, and stabilise the Chinese capital market (Han et al., 2015). Third, QFII-licensed entities are expected to suppress the impact of overseas speculative "hot money" on the domestic economy, building up an open, competitive, and orderly modern market system (Huang and Zhu, 2015).

Because corporate ownership in China is highly concentrated and a well-developed internal control framework does not exist, controlling shareholders can easily reap private benefits of control by extracting value from the company to the detriment of minority

[3] A-shares refer to companies that are incorporated in China and traded on the Shanghai and Shenzhen exchanges; they are quoted in local renminbi and entail foreign investment regulations.

shareholders. Hence, foreign investors may face severe principal–principal agency problems and information asymmetry (He et al., 2014). In addition, internal control deficiencies and weak internal audits (manifested in less reliable financial reporting) could raise severe information asymmetry between outside investors and insiders, thus increasing firm risk (Ashbaugh-Skaife et al., 2009). Extensive studies have acknowledged that an effective internal control system can provide high-quality assurance, regarding the efficiency of an entity's business operational environment and risk management, reliability of financial reporting and transparency of information disclosure, achievement of the monitoring of internal control deficiencies, and compliance with applicable laws, policies, and regulations (Changchit et al., 2001; Doyle et al., 2007; Chen et al., 2017), thereby serving as a potential mechanism for mitigating conditions of information asymmetry and managerial opportunistic behaviours. Therefore, foreign investors may have incentives to alleviate their information disadvantages and reduce investment risk by enhancing the internal control of investee companies.

In response to the increasing demand for enhanced governance in addressing internal control deficiencies, internal audit, and financial restatement issues (Hu et al., 2017), Chinese regulators have promoted internal control practices and helped facilitate an effective internal control system among listed firms. Indeed, China has made substantial progress in facilitating the effectiveness of internal control over the past few years by introducing a series of localised guidelines. For instance, in May 2008, the *Basic Standard of Enterprise Internal Control* was jointly issued by five regulatory authorities.[4] Later in December 2008, the SSE and SZSE issued the *Notice on the Preparation of 2008 Annual Financial Reports by Public Firms,* a notice which requires listed firms to disclose annual self-evaluation reports on internal control.[5]

[4] See Ji et al. (2017) and http://www.mof.gov.cn/gkml/caizhengwengao/.
[5] *Guidelines for Evaluation of Enterprise Internal Controls* and *Guidelines for Auditing of Enterprise Internal Controls* can be found at http://www.gov.cn/zwgk/2010-05/05/content_1599512.htm.

These efforts suggest that internal controls should be in accordance with higher international standards. Therefore, we believe that the current study is important because the opening of the domestic market to foreign institutional investors, especially those from well-governed countries, is highly likely to have a significant influence on corporate governance, motivating domestic companies to further facilitate the construction of efficient internal control systems.

2.2 Hypothesis development

As mentioned above, QFIIs tend to suffer from severe information disadvantages and higher levels of investment environment uncertainty and risk, due to cultural differences, geographical distances, and minority ownership (Liu et al., 2014; Li et al., 2021). Therefore, they usually have strong incentives and resources/skills/expertise at their disposal to protect their investments in their portfolio firms. Extant literature has documented the influence of QFIIs on Chinese listed companies to mitigate agency problems and information asymmetry. For instance, Huang and Zhu (2015) find that QFII-licensed investors help float non-tradable shares and increase compensation for minority tradable shareholders. Foreign investing parties can reduce the likelihood of earnings management (Lel, 2019). Kim et al. (2020) also find that QFII-licensed investors help reduce Chinese listed companies' stock price crash risk through their external monitoring. Li et al. (2021) argue that QFIIs from high-regulatory-quality jurisdictions tend to introduce their social awareness to investee companies.

An effective internal control system will facilitate the transparency of the information environment, management forecast accuracy, and information quality (Ashbaugh-Skaife et al., 2007; Feng et al., 2009; Ji et al., 2017), which will reduce investors' investment risks. Moreover, an effective internal control system will ultimately drive operational efficiency and financial performance. For example, the disclosure of internal control weaknesses and improvement in internal control quality significantly mitigates firm-level investment inefficiency (Cheng et al.,

2013). An effective internal control system serves as a crucial mechanism to mitigate the loss of economic value and offset risks in negative events (Wang et al., 2018). QFIIs can share the financial success of the entities in which they invest. As such, one would expect that QFIIs also have strong incentives to pay particular attention to internal control issues and pressure management to improve the quality and effectiveness of the internal control system, apart from other corporate governance mechanisms.

In addition, QFIIs are large internationally well-known investors who are experienced in internationally accepted advanced corporate governance practices. This is because corporate governance, including internal control practices, has been well-developed and adopted for several decades in well-governed economies such as the UK and North America (Maijoor, 2000), which are QFIIs' home countries or main investment markets. When investing in the Chinese market, which is characterised by weakly governed institutional environments and inferior internal control, QFIIs are expected by the government and companies to advise good corporate policies (Jiang and Kim, 2015) including internal control practices. They will also transplant their strong awareness of corporate governance and high standards of conduct to the companies in which they invest (Li et al., 2021). This, in turn, will help QFIIs improve their reputations in the Chinese market and may facilitate an increase in their investment quota. Therefore:

Hypothesis 1: *Firms with QFIIs exhibit better internal control quality than those without QFIIs, ceteris paribus.*

When investigating the positive effect of QFIIs on internal control quality, it is necessary to review their home countries' institutional quality that may influence their distinctive governance behaviours and awareness. National governance backgrounds can largely explain the disparities in governance practices across countries (La Porta et al., 2008; Del Bosco and Misani, 2016; Li et al., 2021). From an institutional perspective, a high level of

country-level regulation places pressure on companies to comply with institutional guidelines, requirements, and rules, thereby improving the effectiveness and quality of internal control (DiMaggio and Powell, 1983; Chalmers et al., 2019; Li et al., 2021). Further, Del Bosco and Misani (2016) provide evidence that companies headquartered in countries with higher institutional quality, measured as high Worldwide Governance Indicator (WGI) scores, tend to have better governance systems which ensure their board members and executives act in the best interests of its shareholders, thereby confirming that the quality of institutions is a key driving force behind corporate governance. According to the WGI, institutions in countries with higher national governance quality are more likely to abide by the rules and laws of society and have better enforcement of contracts, investor protection, transparency, and accountability of the governance system and integrity, thereby enhancing the stringency of the business regulatory environment (Del Bosco and Misani, 2016; Li et al., 2021).[6] These characteristics are highly associated with the construction of an effective internal control system.

Well-governed countries largely depend on regulation-based mechanisms that place restrictions on ex-ante behaviours (La Porta et al., 2008). Therefore, QFIIs from high-institutional-quality countries are more likely to exhibit a higher awareness of corporate governance and stricter standards of codes of conduct and comply with the rules and laws to construct governance systems. Hence, when they invest in foreign markets, they may carry out their strong governance behaviours by facilitating internal monitoring and the construction of efficient internal control systems among the companies in which they invest, thereby improving their internal control quality.

Hypothesis 2: *The positive influence of QFIIs on internal control quality is more pronounced in companies with QFIIs from high-institutional-quality countries than in companies with QFIIs from low-institutional-quality countries, ceteris paribus.*

[6] Details are available at https://info.worldbank.org/governance/wgi/Home/Documents.

3. Research design

3.1 Sample and collection

Our firm-level sample includes all Chinese A-share companies listed on either the SSE or the SZSE with internal control index scores from 2005 to 2017. The scores are obtained from the Dibo Internal Control and Risk Management Database,[7] which evaluates the internal control activities of Chinese listed companies by assessing public information from the CSRC, SSE, SZSE, domestic and foreign media, and regulatory authorities. This database is widely used and cited by media, auditors, corporations, and scholars in China (Chen et al., 2017; Wang et al., 2018; Li et al., 2019).

We extract the data on QFII identities and ownership characteristics, such as foreign institutional ownership, name, and headquarters of each foreign institution, from the Wind-Financial Platform and the State Administration of Foreign Exchange.[8] All financial and governance data were obtained from the China Stock Market and Accounting Research (CSMAR) platform. Companies in the financial industry were excluded from this sample. The final sample consists of 2,773 unique companies with 22,310 firm-year observations with QFIIs from 23 countries.

3.2 Key variables

The internal control quality (*ICI*) is measured by dividing the Dibo internal control index (score) by 10, which alleviates the concern of a relatively scattered distribution of the index (Wang et al., 2018). The Dibo internal control index (score) is a measure of the internal control efficiency at the aggregate level of a company in a given fiscal year. Specifically, the evaluation process involves firm and industry risk, internal audit, internal control deficiencies,

[7] Dibo Internal Control and Risk Management Database was developed by China Shenzhen DIB Company and supported by Sun Yat-sen University and the China Ministry of Finance. It is a leading internal control information provider in China. The Dibo internal control scores are available at http://www.ic-erm.com/index.html. Our sample ranges from 2005 to 2017, commencing in 2005 because the number of firms with QFIIs before then were too few to enable meaningful comparison.
[8] See https://www.wind.com.cn/ and https://www.safe.gov.cn/guangdong/2019/0107/1293.html.

violations of laws and regulations, related-party transactions, litigation, laws, and regulations. This score is constructed based on five aspects: internal control environment, risk assessment, internal monitoring, control activities, and information and communication, and ranges from 1 to 1000, with a higher value of the index representing higher internal control quality.

We also employ two alternative measurements to proxy for internal control quality. First, since the internal control score varies widely across industries, we utilise an industry-median-adjusted score, *ADJ_ICI*, which is measured as the deduction of the internal control index of a company from the median index for peers in the same industry during the year.[9] Second, we use the number of internal control deficiencies (*NO_DEFI*) because the disclosure of internal control weaknesses and deficiency information sends a key message to evaluate a firm's internal control system (Hu et al., 2017; Oradi et al., 2020). Fewer internal control deficiencies within a company imply an efficient internal control system.

Following Huang and Zhu (2015) and Li et al. (2019), we use a categorical variable (*QFII_DUMMY)* to measure the presence of QFIIs. *QFII_DUMMY* equals one if a company has at least one QFII in a fiscal year and zero otherwise. We also create a continuous variable, *QFII_OWN*, measured as the percentage of outstanding shares held by QFIIs, to capture the magnitude of the effect of foreign ownership.

3.3 Model specification

To test our hypotheses, we specify the following ordinary least squares (OLS) regression with year and industry fixed effects:

$$ICI_{i,t} = \alpha + \beta_1 QFII\_DUMMY_{i,t-1} + \beta_2 Control_{i,t-1} + Year\ FE + Industry\ FE + \varepsilon_{i,t} \quad (1)$$

where *ICI* represents the internal control score, which can be replaced by the industry-median-adjusted internal control score (*ADJ_ICI*) and the number of internal control deficiencies (*NO_DEFI*). *QFII_DUMMY* denotes the presence of QFII-licensed investors and can be

[9] The industry classification follows the 2012 CSRC industry categories.

replaced by *QFII_OWN*. We expect β_1 to be significantly positive (negative) if the dependent variable is *ICI* or *ADJ_ICI (NO_DEFI)*.

We controlled for a wide range of factors (*control*). We account for firm size (*FIRMSIZE*) and firm age (*FIRMAGE*) because prior literature documents that larger and older firms are likely to exhibit better internal control quality (Chen and Keung, 2018). We also include leverage (*LEVERAGE*) because high-levered firms may have better internal control under lenders' monitoring (Wu and Yue, 2009). High-growth firms are likely to have internal control weaknesses (Hu et al., 2017); therefore, we control for *GROWTH*. To the extent that internal control quality might differ for firms audited by large audit firms, we include an indicator variable, *BIG4*, to indicate companies audited by the Big Four accounting organisations. The quality of an entity's internal control is a function of the effectiveness of the board of directors (Hu et al., 2017; Oradi et al., 2020). For instance, board size and independence are found to be negatively related to the likelihood of financial fraud and regulatory authority enforcement actions. Hence, we control for board size (*BOARDSIZE*), board independence (*INDEP*), CEO duality (*DUALITY*), and board meetings (*MEETING*). We also control for financial health (*LOSS*), state ownership (*SOE*), and ownership concentration (*OWN_CON*) (Oradi et al., 2020). The definitions of all variables can be found in Appendix A.

In all regressions, standard errors are corrected for heteroskedasticity and clustered at the firm and year levels (Petersen, 2009; Thompson, 2011). We winsorize all continuous variables at the 1st and 99th percentiles of their respective distributions.

4. Empirical results

4.1 Descriptive statistics

Table 1 presents the sample distribution across years (Panel A) and industries (Panel B). Panel A indicates that about 8.8% (1,956/2,2310) of the observations are backed by QFIIs. Specifically, the percentage of companies with QFIIs increased to about 10% (268/2,683) in

2017, up from 2.45% (13/530) in 2005, implying that the QFII scheme launched by the Chinese government has significantly facilitated foreign institutional investment in the domestic capital market.[10] Panel B shows that 58.3% (13,005/22,310) of our observations are from the manufacturing sector. In particular, among 13,005 firm-year observations in the manufacturing sector, 1,198 observations (9.21%) are backed by QFIIs, which is consistent with the findings of Liu et al. (2014) and Li et al. (2021).

[Insert Table 1 here]

Table 2 provides descriptive statistics. *ICI* varies considerably from 0.0000 to 99.5360, with a mean (median) value of 64.7354 (67.6815), which is comparable to the findings of Lu and Cao (2018). This indicates that more than half of the companies in the sample have internal control index scores higher than the average level. The mean (median) value of the industry-median-adjusted internal control index (*ADJ_ICI*) is -2.4127 (0.0000), which varies from -78.3650 to 68.1430. The mean (median) value of the natural logarithm of the number of internal control deficiencies (*NO_DEFI*) is 0.8299 (0.0000). A total of 20.39% of the sample companies conducted financial restatements. Of the companies, 8.77% have at least one QFII during the sample period, and 4.35% (4.42%) of the sample companies have QFIIs from high-institutional-quality (relatively low-institutional-quality) countries. Of the sample companies, 7.02% have at least one QFII among the top ten largest shareholders (*QFII_TOPTEN*).

[Insert Table 2 here]

Table 3 presents the correlations between the main variables. The correlation coefficient between *QFII_DUMMY* (*QFII_HIGHWGI*) and *ICI* is significantly positive,

[10] Furthermore, we report the distribution by the institutional quality of QFIIs' countries of domicile in Appendix B. Among 1,956 firm-year observations with the presence of QFIIs, 49.59% (970 out of 1,956) of the observations have QFIIs from countries with high institutional quality, and 50.41% (986 out of 1,956) of the observations have QFIIs from countries with low institutional quality.

providing initial support for H1. The low correlations among the explanatory variables suggest that multicollinearity is not a concern in our dataset.

[Insert Table 3 here]

4.2 Main regression results

4.2.1 Effects of QFIIs

Table 4 presents the main results for H1. The coefficient of *QFII_DUMMY* in Model 1 is positive and statistically significant (coefficient=0.5105; t=1.9780), indicating that companies with the presence of QFII-licensed investors exhibit a higher subsequent internal control score than those without. Similarly, in Model 2, the estimate of *QFII_OWN* is positive and highly significant (coefficient=0.2569; t=3.4461) at the 1% level, suggesting that foreign ownership is positively associated with internal control quality. Therefore, H1 is supported.

[Insert Table 4 here]

The results are robust when using the industry-median-adjusted internal control index (*ADJ_ICI*) (Models 3-4) and the number of internal control deficiencies (*NO_DEFI*) (Models 5-6) as the dependent variable. For instance, the estimates for *QFII_DUMMY* and *QFII_OWN* in Models 3-4 are both positive and highly significant, confirming a positive link between QFIIs and future internal control quality. The coefficients of *QFII_DUMMY* and *QFII_OWN* in Models 5-6 are significantly negative, suggesting that companies with QFIIs exhibit fewer internal control deficiencies.

The effects of the control variables are broadly consistent with prior findings in existing literature. Specifically, firm size (*FIRMSIZE*) and ownership concentration (*OWN_CON*) are positively associated with internal control quality, while firm age (*FIRMAGE*), leverage ratio (*LEVERAGE*), sales growth (*GROWTH*), and the indicator of negative income in the prior year (*LOSS*) are negatively related to internal control quality.

4.2.2 Effects of the institutional quality of QFIIs' home countries

To test the validity of H2, we divide QFIIs into two categories according to the institutional quality of QFIIs' home countries. Specifically, following Del Bosco and Misani (2016), Liu et al. (2019), and Li et al. (2021), we employ the WGI scores of the World Bank as a proxy for institutional quality and calculate the median value for each year.[11] We then generate two categorical variables. *QFII_HIGHWGI* is assigned a value of one for companies having a QFII-licensed investor from a country/region with an institutional quality score equal to or greater than the median value in a fiscal year, and zero otherwise. *QFII_LOWWGI* is set to one for companies having a QFII from a country/region with an institutional quality score lower than the median value, and zero otherwise. In the case of multiple QFII-licensed investment entities within a company during the year, we follow Li et al. (2021) to identify the dominant QFII institution based on the total percentage of shares by QFIIs.[12] Next, we replace *QFII_DUMMY* with *QFII_HIGHWGI* and *QFII_LOWWGI* in Equation (1) and display the estimates in Models 1, 3, and 5 of Table 5. The estimate of *QFII_HIGHWGI* (*QFII_LOWWGI*) is positive and statistically significant at the 1% level (insignificant) in Models 1 and 3, and the estimate of *QFII_HIGHWGI* (*QFII_LOWWGI*) in Model 5 is significantly negative

[11] WGI includes six dimensions: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption. Consistent with Del Bosco and Misani (2016), we averaged the six indicators (using equal weights) to build a WGI index as a comprehensive national governance quality measure. WGI ranges from -2.5 to 2.5, with higher WGI corresponding to higher levels of institutional quality. Details are available at https://info.worldbank.org/governance/wgi/Home/Documents.

[12] Taking Jiangling Motors Corporation (stock code: 000550, Shenzhen Stock Exchange), one of the largest exporters of light diesel commercial vehicles in China, as an example, Jiangling has three QFII-licensed investment entities in 2014, namely, China International Capital Corporation Hong Kong Asset Management Limited, Canada Pension Plan Investment Board, and Kuwait Investment Authority; these three investors own 1.25%, 1.53%, and 1.03% of the shares issued by the firm, respectively. The WGI scores of Hong Kong (1.51) and Canada (1.65) are higher than the median WGI (1.46), thus a high institutional quality system, while the WGI score of Kuwait (-0.17) is lower than the median value of WGI, thereby a relatively inferior governance system. Hence, the dominant QFII in Jiangling in 2014 is identified as the high-institutional-quality system because 2.78% is greater than 1.03%.

(insignificant), suggesting that the positive influence of QFIIs on internal control quality is mainly attributable to QFIIs from countries/regions with high institutional quality.

[Insert Table 5 here]

Moreover, we introduce two continuous variables to investigate the influence of QFIIs from high- and low-institutional-quality countries/regions on investees' internal control quality. Specifically, *QFII_HIGHWGI_OWN* is measured as the sum of the percentage of outstanding shares held by QFII institutions originating from regions with high institutional quality. *QFII_LOWWGI_OWN* is defined as the sum of the percentage of outstanding shares held by QFIIs from jurisdictions with relatively low institutional quality. We then substitute *QFII_HIGHWGI_OWN* and *QFII_LOWWGI_OWN* for *QFII_DUMMY* in Equation (1) and report the results in Models 2, 4, and 6. Similarly, the estimate of *QFII_HIGHWGI_OWN* is positive (negative) and significant in Models 2 and 4 (6), while that of *QFII_LOWWGI_OWN* is insignificant.

Collectively, our results consistently reveal that the institutional quality of QFIIs can be viewed as an important channel that transplants QFIIs' governance standards to investee companies, and QFIIs with high governance awareness and high-standard codes of conduct promote the effectiveness of internal control. This evidence strongly supports H2.

4.3 Robustness checks

4.3.1 Alternative measures

We employed a few alternative measures to test robustness. First, financial restatements may be symptomatic of poor internal control (Ashbaugh-Skaife et al., 2007; Hu et al., 2017). As such, we follow Hu et al. (2017) and use the information of financial restatements, such as the probability of a financial restatement (*RESTATEMENT*) and the number of financial restatements (*NO_RESTATEMENT*) as alternative proxies for internal control quality. In doing so, we substitute *RESTATEMENT* and *NO_RESTATEMENT*, respectively, for *ICI* in Equation

(1) and report the results of Models 1-2 in Table 6. The estimate of *QFII_DUMMY* in both models is negative and statistically significant, indicating that companies with QFIIs are associated with a lower probability of future restatements and exhibit fewer financial restatements. Thus, the evidence supports H1.

[Insert Table 6 here]

Second, according to Jin et al. (2016), we also employ the number of QFIIs (*NO_QFII*) as an alternative measure to capture the influence of QFIIs and re-estimate Equation (1). The results in Model 3 of Table 6 show a positive and significant coefficient (t=4.2243) on *NO_QFII*, reconfirming our main findings again.

4.3.2 Accounting for characteristics of the audit committee

The audit committee plays a critical role in monitoring corporate accountability and the quality of financial reports (Carcello and Neal, 2000). For example, a larger audit committee is more likely to improve internal control quality, because the increased resources and enhanced status from more members will make the audit committee more effective in fulfilling its monitoring role (Zhang et al., 2007). In addition, a more independent audit committee will result in a higher quality of internal control (Krishnan, 2005). Hence, we further control for the size (*AUDIT_SIZE*) and independence (*AUDIT_INDEP*) of the audit committee in Models 4 and 5, respectively. Notably, the coefficient of *QFII_DUMMY* in both models remains positive and statistically significant, suggesting that our main result is not affected by the inclusion of audit committee variables.

4.3.3 Influence of domestic institutional investors

Domestic institutional investors affect both internal corporate governance and external monitoring (Ajinkya et al., 2005; Baik et al., 2010; Wang and Chen, 2017), which may affect the influence of QFIIs as foreign investors and institutional investors. Therefore, we additionally account for the influence of domestic institutional ownership (*INS_OWN*) to

determine whether QFIIs have a larger effect than domestic institutional investors. Otherwise, the positive coefficient of *QFII_DUMMY* may simply capture the effect of institutional investors. In Table 6, Model 6 reveals that *QFII_DUMMY* still attracts a significantly positive coefficient; however, the coefficient on *INS_OWN* is insignificant, reaffirming that QFIIs indeed matter to internal control quality and ruling out the alternative explanation.

4.3.4 Excluding companies in the manufacturing industry

In Table 1, Panel B shows that our observations are mainly clustered in the manufacturing industry, implying that our results may simply reflect industry effects. To further rule out such concerns, we ran Equation (1) by excluding the manufacturing sector. The results displayed in Model 7 of Table 6 confirm that our main finding is not driven by the manufacturing industry.

4.3.5 Dynamic system GMM approach

There are some common endogeneity concerns. For example, QFIIs may prefer to invest in companies with better internal control quality. The presence of QFIIs and internal control quality may be driven simultaneously by omitted variables. To address such concerns, we use the Arellano–Bond system GMM method, as suggested by Arellano and Bover (1995) and Blundell and Bond (1998), and include the one-year lagged internal control score as an independent variable in Equation (1).

The result from the dynamic panel system GMM approach presented in Model 1 of Table 7 shows that *QFII_DUMMY* has a significantly positive coefficient (t=3.5111). In addition, the Sargan test of over-identification has a p-value of less than 1%, and the Difference-in-Hansen test of exogeneity has a p-value of 0.151, which validates the

implementation of the dynamic panel data estimation. Simply put, the test presented in this section shows that our results are unlikely to be driven by potential endogeneity.[13]

[Insert Table 7 here]

4.3.6 PSM approach

The differences in observable fundamental characteristics between companies with and without QFIIs may result in biased estimations. Thus, we carry out a PSM approach to address this concern. With the calliper set at 0.001, we conducted a matching process with replacement and used the nearest neighbour technique to match each firm-year observation with QFIIs with a firm-year observation without QFIIs based on a battery of factors used as control variables in Equation (1). We then re-run Equation (1) based on the PSM sample to test the validity of H1.

Table 8 reports the results of the PSM analysis. Panel A shows that companies with QFIIs are associated with higher future internal control quality than companies without (ATT = 1.1196, t=2.39).[14] The univariate results displayed in Panel B indicate that the sample is well balanced because the firm characteristics of the control group are not statistically different from those of the treatment group. The regression result based on the PSM sample is displayed in Panel C. The significantly positive coefficient on *QFII_DUMMY* suggests that our key finding is unlikely to be biased by the sample selection issue.

[Insert Table 8 here]

[13] The GMM estimation could weaken the exogeneity assumption for an array of regressors, hence providing consistent estimates even if the reverse causality issue is present (Leszczensky and Wolbring, 2019). To further rule out the potential reverse causality, we follow Dyck et al. (2019) and Li et al. (2021) to implement the Granger causality test; specifically, we regress *QFII_DUMMY* on lagged *ICI* and lagged *QFII_DUMMY*, with the same set of control variables included. The result is displayed in Appendix C. In Model 1 where the dependent variable is *QFII_DUMMY*, the estimate on *LAG_ICI* is insignificant, indicating that companies with high internal control quality are not likely to attract QFIIs.

[14] Our results still hold if we conduct a matching process without replacement and are available upon request.

5. The mechanism influencing internal control

Key shareholders can influence corporate policies and business strategies through their voting power or shareholder activism (Lee and Lounsbury, 2011; Oh et al., 2011; Li et al., 2021). Similarly, if QFIIs are recognised as key shareholders, they may be entitled to significantly influence corporate policies (Huang and Zhu, 2015; Li et al., 2021). Thus, we further explored the mechanism through which QFIIs improve internal control quality. We introduce two categorical variables, *QFII_TOPTEN* and *QFII_NON_TOPTEN*, to capture the extent of the influence of QFIIs on internal control quality. *QFII_TOPTEN* equals one if the percentage of outstanding shares held by QFIIs is among the top ten largest shareholders of a company and zero otherwise. *QFII_NON_TOPTEN* equals one if the percentage of outstanding shares by QFIIs is not among the top ten largest shareholders of a company and zero otherwise.

We then re-run Equation (1) by replacing *QFII_DUMMY* with *QFII_TOPTEN* and *QFII_NON_TOPTEN*. The results in Models 1 and 2 of Table 9 with *ICI* and *ADJ_ICI* as the dependent variables, respectively, show a positive and highly significant estimate of *QFII_TOPTEN* and an insignificant estimate of *QFII_NON_TOPTEN*. This means that the positive link between QFIIs and internal control quality becomes more salient if QFII is among the top ten shareholders. In Model 3 of Table 9, with *NO_DEFI* as the dependent variable, we find that the coefficients of *QFII_TOPTEN* and *QFII_NON_TOPTEN* are both significantly negative, and, more importantly, the magnitude of the estimate on *QFII_TOPTEN* is greater than that of the estimate on *QFII_NON_TOPTEN*. In sum, our evidence indicates that when QFIIs are the top ten largest shareholders, they may have a great scope to facilitate the effectiveness of internal control through their power and voice within investee companies.

[Insert Table 9 here]

6. Interplay between QFIIs and internal control quality on firm performance

Prior literature finds that higher quality of corporate internal control leads to superior financial performance (Stoel and Muhanna, 2011; Kuhn et al., 2013) and mitigates the loss of economic value in negative events (Wang et al., 2018). Hence, we posit that the improvement in internal control quality linked to QFIIs may lead to better financial performance. To test this conjecture, we employ the following model specification:

$$ROA_{i,t} = \alpha + \beta_1 QFII\_DUMMY_{i,t-1} + \beta_2\, QFII\_DUMMY_{i,t-1} \times ICI_{i,t-1} + \beta_3 ICI_{i,t-1} + \beta_4 Control_{i,t-1} + Year\ FE + Industry\ FE + \varepsilon_{i,t} \quad (2)$$

where we use return on assets (*ROA*) to measure financial performance. The interaction term between *QFII_DUMMY* and *ICI* captures the incremental effect of internal control quality through the presence of QFII-licensed investors on firm performance. We expect the estimate of the interaction term to be significantly positive. In addition, we control for *FIRMSIZE*, *LEVERAGE*, *OCF*, *SOE*, *GROWTH*, and *BIG4*. In Table 10, Model 1 shows significantly positive estimates of *QFII_DUMMY* and *ICI*, indicating that QFIIs and better internal control quality will improve future operating performance. More importantly, in Model 2, the interaction term, *QFII_DUMMY* × *ICI*, has a significantly positive coefficient, suggesting that the increase in internal control quality attributable to QFIIs results in better performance.

[Insert Table 10 here]

7. Conclusions

In this study, we investigate the role of QFIIs in companies' internal control quality in the Chinese context. Using a large sample between 2005 and 2017, we provide robust evidence that companies with QFIIs experience an increase in future internal control scores and exhibit fewer internal control deficiencies. Moreover, QFII ownership is positively linked to the quality of internal control. This positive influence is more pronounced in companies with QFIIs than countries with high institutional quality, which is consistent with their motives. Our

findings remained robust throughout robustness tests, including using alternative measures of key variables, controlling for additional effects of the size of the audit committee, the audit committee independence, and domestic institutional ownership, as well as a subsample excluding manufacturing companies. Our findings continue to hold after applying dynamic GMM and PSM methods. Further, the positive influence of QFIIs on internal control quality appears more salient when the QFII is among the top ten largest shareholders, which provides foreign investors with sufficient voting power to push companies to induce the construction of an effective internal control system. Finally, we find that the improvement in internal control quality attributable to QFIIs drives firm performance.

Our study also opens up a potential avenue for future research. The CSRC extensively enacted a series of guidelines and reforms to relax the QFII selection criteria to attract more foreign capital to the domestic Chinese equity markets after 2016. Later in 2019, the CSRC announced simplified rules that removed the relevant criteria of assets under management and years of experience for the foreign investors. As such, one may argue that this relaxation could raise concerns on the quality of the newly joined qualified foreign investors, potentially deteriorating the subsequent internal control quality. However, given that the majority of the newly approved QFIIs (i.e., the Vanguard Group, J.P. Morgan Securities, Nomura Limited, and Marshall Wace) by the Chinese regulatory authorities are reputable and top-tier financial institutions and still subject to a high level of governance standards in their home countries and securities commissions,[15] we conjecture that they still have motives and ability to transplant their high-quality governance practices and awareness to their investee companies in China, consistently pushing towards internal control quality. Moreover, given the mounting empirical evidence that QFIIs have consistently helped enhance the corporate governance of Chinese listed firms for decades (Huang and Zhu, 2015; Cao et al., 2017; Kim et al., 2020), the reforms

[15] For details, please see http://www.csrc.gov.cn/pub/csrc_en/OpeningUp/RelatedLists/QFIIs/.

after 2016 are less likely to distort the positive influence of QFIIs on their investee companies. Due to the data availability, we are unable to empirically examine the role of QFIIs in corporate governance practices after these recent reforms. Hence, it would be interesting for future studies to see whether the relaxation of the restrictions on the QFII qualification and selection criteria may play a part in the interplay between QFIIs and internal control.

Overall, this study offers valuable implications for company-level stakeholders and regulatory authorities. Our findings indicate that foreign institutional investors, especially those from countries with high institutional quality, could exert a positive influence on the internal control systems of investee companies. In addition, QFIIs may facilitate the attainment of broader economic goals by constructing an efficient internal control system. Thus, other developing economies sharing similar institutional backgrounds could consider introducing a similar scheme that attracts foreign investment institutions, to help their domestic companies achieve higher internal governance quality and economic outcomes.

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Table 1 Sample distribution

Panel A: Annual distribution

Year	QFII_DUMMY=1	QFII_DUMMY=0	No. of Obs.
2005	13	517	530
2006	74	849	923
2007	158	996	1,154
2008	127	1,108	1,235
2009	106	1,258	1,364
2010	179	1,300	1,479
2011	178	1,392	1,570
2012	123	1,812	1,935
2013	142	2,086	2,228
2014	195	2,180	2,375
2015	224	2,129	2,353
2016	169	2,312	2,481
2017	268	2,415	2,683
Total	1,956	20,354	22,310

Panel B: Distribution by industry

CSRC industry classification	QFII_DUMMY = 1	QFII_DUMMY = 0	No. of Obs.
A: Agriculture, Forestry, Animal Husbandry and Fishery	26	317	343
B: Mining	69	604	673
C: Manufacturing	1,198	11,807	13,005
D: Production and Supply of Electric Power, Heat Power, Gas and Water	68	943	1,011
E: Construction	51	529	580
F: Wholesale and Retail Trade	112	1,407	1,519
G: Transport, Storage and Postal Services	159	688	847
H: Accommodation and Catering Service	12	95	107
I: Information Transmission, Software and Information Technology Services	71	1,295	1,366
K: Real Estate	84	1,252	1,336
L: Leasing and Business Services	20	328	348
M: Scientific Research and Technical Services	9	152	161
N: Water Conservancy, Environment and. Public Facilities Management	37	283	320
P: Education	0	48	48
Q: Health and Social Work	6	83	89
R: Culture, Sports and Entertainment	27	279	306
S: Comprehensive (Miscellaneous)	7	244	251
Total	1,956	20,354	22,310

Table 2 Summary statistics

Variable	N	Mean	SD	Min	P25	P50	P75	Max
ICI	22,310	64.7354	14.9141	0.0000	61.9920	67.6815	71.1550	99.5360
ADJ_ICI	22,310	-2.4127	14.5454	-78.3650	-4.3060	0.0000	3.6600	68.1430
NO_DEFI	20,145	0.8299	23.7366	0.0000	0.0000	0.0000	0.0000	2015.0000
RESTATEMENT	24,285	0.2039	0.4029	0.0000	0.0000	0.0000	0.0000	1.0000
NO_RESTATEMENT	24,285	0.2595	0.5946	0.0000	0.0000	0.0000	0.0000	11.0000
QFII_DUMMY	22,310	0.0877	0.2828	0.0000	0.0000	0.0000	0.0000	1.0000
QFII_OWN (QFII_DUMMY=1)	1,956	1.9415	2.2767	0.0115	0.5691	1.1914	2.3457	20.9283
NO_QFII	22,310	0.0731	0.2494	0.0000	0.0000	0.0000	0.0000	2.0794
QFII_HIGHWGI	22,310	0.0435	0.2039	0.0000	0.0000	0.0000	0.0000	1.0000
QFII_LOWWGI	22,310	0.0442	0.2055	0.0000	0.0000	0.0000	0.0000	1.0000
QFII_TOPTEN	22,310	0.0702	0.2555	0.0000	0.0000	0.0000	0.0000	1.0000
QFII_NON_TOPTEN	22,310	0.0175	0.1311	0.0000	0.0000	0.0000	0.0000	1.0000
FIRMSIZE	22,310	21.8420	1.3301	10.8422	20.9555	21.7060	22.5754	28.5087
FIRMAGE	22,310	2.1506	0.6883	0.0000	1.6094	2.3026	2.7081	3.2958
LEVERAGE	22,310	0.4734	0.2294	0.0532	0.3013	0.4716	0.6305	1.2988
GROWTH	22,310	0.2185	0.5893	-0.7188	-0.0283	0.1165	0.2941	3.9429
LOSS	22,310	0.1092	0.3119	0.0000	0.0000	0.0000	0.0000	1.0000
OWN_CON	22,310	0.1812	0.1783	0.0011	0.0309	0.1101	0.3006	0.6613
SOE	22,310	0.4864	0.4998	0.0000	0.0000	0.0000	1.0000	1.0000
BOARDSIZE	22,310	2.2789	0.1824	1.3863	2.1972	2.3026	2.3026	2.9957
INDEP	22,310	0.3675	0.0527	0.0000	0.3333	0.3333	0.4000	0.5714
DUALITY	22,310	0.2113	0.4083	0.0000	0.0000	0.0000	0.0000	1.0000
MEETING	22,310	2.2864	0.3435	0.6931	2.0794	2.3026	2.4849	4.0604
BIG4	22,310	0.0607	0.2388	0.0000	0.0000	0.0000	0.0000	1.0000
AUDIT_SIZE	12,120	0.2862	0.5853	0.0000	0.0000	0.0000	0.0000	2.0794
AUDIT_INDEP	12,120	0.1269	0.2681	0.0000	0.0000	0.0000	0.0000	1.0000
INS_OWN (%)	22,272	48.1909	22.5142	0.0661	32.7600	50.6264	65.2226	92.4232
ROA	22,281	0.0480	0.0738	-0.3613	0.0250	0.0476	0.0782	0.2475
OCF	22,281	0.0505	0.0918	-0.2648	0.0036	0.0486	0.0990	0.3458

Note: All variables are defined in Appendix A.

Table 3 Correlation matrix

	Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
(1)	ICI	1.0000								
(2)	ADJ_ICI	0.9758*	1.0000							
(3)	NO_DEFI	0.0109	0.0133*	1.0000						
(4)	QFII_DUMMY	0.0966*	0.0943*	-0.0040	1.0000					
(5)	QFII_HIGHWGI	0.0830*	0.0819*	-0.0045	0.6877*	1.0000				
(6)	QFII_LOWWGI	0.0506*	0.0485*	-0.0011	0.6937*	-0.0458*	1.0000			
(7)	FIRMSIZE	0.3192*	0.3133*	0.0439*	0.1530*	0.1341*	0.0775*	1.0000		
(8)	FIRMAGE	-0.1212*	-0.1113*	0.0060	0.0300*	0.0247*	0.0168*	0.2193*	1.0000	
(9)	LEVERAGE	-0.2038*	-0.2082*	0.0140*	-0.0165*	-0.0064	-0.0164*	0.2406*	0.3492*	1.0000
(10)	GROWTH	-0.0718*	-0.0696*	-0.0040	-0.0038	-0.0055	0.0003	-0.0868*	-0.0146*	0.0094
(11)	LOSS	-0.4504*	-0.4339*	-0.0046	-0.0486*	-0.0366*	-0.0306*	-0.1264*	0.1161*	0.2469*
(12)	OWN_CON	0.0356*	0.0439*	0.0161*	0.0646*	0.0591*	0.0303*	0.3542*	0.2974*	0.0835*
(13)	SOE	0.0737*	0.0577*	0.0269*	0.0747*	0.0559*	0.0473*	0.2754*	0.3376*	0.2272*
(14)	BOARDSIZE	0.1185*	0.1021*	0.0283*	0.0560*	0.0426*	0.0347*	0.2387*	0.0579*	0.1172*
(15)	INDEP	-0.0120*	-0.0044	-0.0026	-0.0014	-0.0007	-0.0012	0.0380*	-0.0252*	-0.0235*
(16)	DUALITY	-0.0351*	-0.0286*	-0.0073	-0.0168*	-0.0145*	-0.0088	-0.1288*	-0.1792*	-0.1175*
(17)	MEETING	0.0022	0.0116*	0.0336*	-0.0183*	-0.0093	-0.0160*	0.2043*	0.0553*	0.1271*
(18)	BIG4	0.1390*	0.1301*	0.0702*	0.1177*	0.0995*	0.0632*	0.3408*	0.0584*	0.0563*
		(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)
(10)	GROWTH	1.0000								
(11)	LOSS	0.0380*	1.0000							
(12)	OWN_CON	-0.0507*	-0.0145*	1.0000						
(13)	SOE	-0.0606*	0.0387*	0.1975*	1.0000					
(14)	BOARDSIZE	-0.0495*	-0.0266*	0.0256*	0.2762*	1.0000				
(15)	INDEP	0.0204*	0.0041	0.0581*	-0.1010*	-0.4383*	1.0000			
(16)	DUALITY	0.0210*	-0.0141*	-0.0903*	-0.2656*	-0.1712*	0.1033*	1.0000		
(17)	MEETING	0.0575*	-0.0188*	0.0133*	-0.1007*	-0.0569*	0.0685*	0.0249*	1.0000	
(18)	BIG4	-0.0229*	-0.0312*	0.1369*	0.1294*	0.1188*	0.0215*	-0.0649*	0.0247*	1.0000

Note: The * indicates statistical significance at least the 0.1 level. All variables are defined in Appendix A.

Table 4 Effect of QFIIs on internal control quality

Dep. Var. =	ICI	ICI	ADJ_ICI	ADJ_ICI	NO_DEFI	NO_DEFI
	(1)	(2)	(3)	(4)	(5)	(6)
	Baseline		Industry-median-adjusted internal control index		The number of internal control deficiencies (weaknesses)	
QFII_DUMMY	0.5105**		0.6234**		-1.0521**	
	(1.9780)		(2.4123)		(-2.2721)	
QFII_OWN		0.2569***		0.2996***		-0.2225**
		(3.4461)		(4.0268)		(-1.9773)
FIRMSIZE	4.6356***	4.6369***	4.3426***	4.3451***	-0.0088	-0.0307
	(43.6172)	(43.8109)	(40.6417)	(40.8535)	(-0.0741)	(-0.2567)
FIRMAGE	-1.5967***	-1.5962***	-1.4447***	-1.4439***	-0.1765	-0.1785
	(-10.7471)	(-10.7457)	(-9.7805)	(-9.7774)	(-1.1008)	(-1.1091)
LEVERAGE	-15.6709***	-15.6605***	-14.9712***	-14.9613***	0.4963	0.5433
	(-26.5289)	(-26.5081)	(-25.1047)	(-25.0895)	(0.9721)	(1.0559)
GROWTH	-0.4737**	-0.4771**	-0.4906**	-0.4944**	-0.1092	-0.1097
	(-2.0871)	(-2.1018)	(-2.1648)	(-2.1813)	(-0.8553)	(-0.8580)
LOSS	-16.0203***	-16.0086***	-15.3133***	-15.3001***	-0.3541	-0.3551
	(-38.2103)	(-38.1875)	(-36.3339)	(-36.3081)	(-1.3471)	(-1.3499)
OWN_CON	2.8618***	2.9145***	3.1204***	3.1832***	-0.5449	-0.6221
	(5.1117)	(5.2024)	(5.5474)	(5.6561)	(-0.7097)	(-0.7915)
SOE	-0.2104	-0.2042	-0.3095	-0.3021	0.9317**	0.9197**
	(-1.0526)	(-1.0214)	(-1.5442)	(-1.5070)	(2.4523)	(2.4473)
BOARDSIZE	0.6041	0.5771	0.3925	0.3612	2.2915***	2.2944***
	(1.1328)	(1.0820)	(0.7309)	(0.6727)	(2.8828)	(2.8832)
INDEP	1.8002	1.7571	1.3728	1.3232	0.8556	0.8535
	(1.0486)	(1.0235)	(0.7949)	(0.7661)	(0.5208)	(0.5198)
DUALITY	0.0563	0.0503	0.0689	0.0622	0.1864	0.1842
	(0.2683)	(0.2396)	(0.3288)	(0.2970)	(0.5726)	(0.5657)
MEETING	-0.2797	-0.2841	-0.0649	-0.0706	2.4242	2.4400
	(-1.0720)	(-1.0889)	(-0.2476)	(-0.2693)	(1.6212)	(1.6264)
BIG4	0.1585	0.1575	0.1515	0.1523	6.4168**	6.3716**
	(0.4438)	(0.4426)	(0.4291)	(0.4328)	(2.4330)	(2.4322)
_constant	-21.5041***	-21.4669***	-80.2283***	-80.2030***	-11.8941***	-11.5189***
	(-8.8361)	(-8.8424)	(-32.6555)	(-32.7301)	(-2.9275)	(-2.9386)
Year-FE	Yes	Yes	Yes	Yes	Yes	Yes
Industry-FE	Yes	Yes	Yes	Yes	Yes	Yes
No. of obs.	22,310	22,310	22,310	22,310	20,145	20,145
Adj. R-square	0.380	0.380	0.345	0.346	0.010	0.009

Notes: This table reports the results of OLS regressions of the influence of QFIIs on companies' internal control index and the number of reported internal control deficiencies. The dependent variable is the overall internal control index score (*ICI*) in Models (1) and (2), the industry-median-adjusted internal control score (*ADJ_ICI*) in Models (3) and (4), and the number of reported internal control deficiencies (*NO_DEFI*) in Models (5) and (6). All variables are defined in Appendix A. In all specifications, independent variables except *GROWTH* and *LOSS* are lagged by one year. Industry and year dummies are included in each regression. We cluster standard errors by year and firm. The 0.01, 0.05, and 0.1 significance levels are denoted by ***, **, and * (two-tailed), respectively.

Table 5 Effect of the institutional quality of QFIIs' home countries on internal control quality

Dep. Var. =	ICI	ICI	ADJ_ICI	ADJ_ICI	NO_DEFI	NO_DEFI
	(1)	(2)	(3)	(4)	(5)	(6)
QFII_HIGHWGI	0.9966***		1.1560***		-1.4726***	
	(2.9256)		(3.3850)		(-2.7170)	
QFII_LOWWGI	0.0405		0.1084		-0.6626	
	(0.1131)		(0.3023)		(-1.5287)	
QFII_HIGHWGI_OWN		0.3447***		0.3920***		-0.2688*
		(3.7034)		(4.0856)		(-1.8884)
QFII_LOWWGI_OWN		0.1366		0.1732		-0.1662
		(1.0657)		(1.3803)		(-1.4325)
FIRMSIZE	4.6316***	4.6358***	4.3382***	4.3439***	-0.0044	-0.0299
	(43.5489)	(43.7918)	(40.5655)	(40.8321)	(-0.0369)	(-0.2507)
FIRMAGE	-1.5962***	-1.5966***	-1.4441***	-1.4442***	-0.1760	-0.1782
	(-10.7430)	(-10.7475)	(-9.7764)	(-9.7795)	(-1.0984)	(-1.1074)
LEVERAGE	-15.6686***	-15.6597***	-14.9687***	-14.9604***	0.4944	0.5428
	(-26.5224)	(-26.5049)	(-25.0974)	(-25.0861)	(0.9686)	(1.0550)
GROWTH	-0.4732**	-0.4761**	-0.4901**	-0.4933**	-0.1089	-0.1098
	(-2.0851)	(-2.0972)	(-2.1627)	(-2.1765)	(-0.8530)	(-0.8583)
LOSS	-16.0208***	-16.0108***	-15.3139***	-15.3024***	-0.3540	-0.3543
	(-38.2132)	(-38.1888)	(-36.3371)	(-36.3099)	(-1.3467)	(-1.3478)
OWN_CON	2.8520***	2.9136***	3.1097***	3.1823***	-0.5385	-0.6227
	(5.0933)	(5.2008)	(5.5274)	(5.6544)	(-0.7024)	(-0.7921)
SOE	-0.2081	-0.2025	-0.3070	-0.3003	0.9295**	0.9189**
	(-1.0413)	(-1.0130)	(-1.5319)	(-1.4981)	(2.4493)	(2.4465)
BOARDSIZE	0.6091	0.5794	0.3980	0.3636	2.2850***	2.2939***
	(1.1424)	(1.0864)	(0.7414)	(0.6773)	(2.8785)	(2.8828)
INDEP	1.8097	1.7569	1.3833	1.3229	0.8326	0.8531
	(1.0544)	(1.0233)	(0.8012)	(0.7659)	(0.5064)	(0.5196)
DUALITY	0.0561	0.0493	0.0687	0.0611	0.1877	0.1847
	(0.2674)	(0.2346)	(0.3279)	(0.2917)	(0.5765)	(0.5673)
MEETING	-0.2792	-0.2836	-0.0644	-0.0701	2.4229	2.4395
	(-1.0703)	(-1.0869)	(-0.2456)	(-0.2673)	(1.6205)	(1.6261)
BIG4	0.1508	0.1594	0.1432	0.1544	6.4274**	6.3717**
	(0.4226)	(0.4482)	(0.4056)	(0.4388)	(2.4351)	(2.4321)
_constant	-21.4331***	-21.4521***	-80.1505***	-80.1874***	-11.9725***	-11.5347***
	(-8.8041)	(-8.8355)	(-32.6113)	(-32.7198)	(-2.9360)	(-2.9402)
Year-FE	Yes	Yes	Yes	Yes	Yes	Yes
Industry-FE	Yes	Yes	Yes	Yes	Yes	Yes
No. of obs.	22,310	22,310	22,310	22,310	20,145	20,145
Adj. R-square	0.380	0.380	0.345	0.346	0.009	0.009

Notes: This table displays the results of the influence of the institutional quality of QFIIs' countries on *ICI*, *ADJ_ICI*, and *NO_DEFI*. All variables are defined in Appendix A. In all specifications, independent variables except *GROWTH* and *LOSS* are lagged by one year. Industry and year dummies are included in each regression. We cluster standard errors by year and firm. The 0.01, 0.05, and 0.1 significance levels are denoted by ***, **, and * (two-tailed), respectively.

Table 6 Robustness tests

Dep. Var. =	RESTATEMENT	NO_RESTATEMENT	ICI	ICI	ICI	ICI	ICI
	The probability of a restatement	The number of restatements	Number of QFIIs	Characteristics of audit committee		Domestic institutional investors	Excluding manufacturing firms
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
QFII_DUMMY	-0.0585*	-0.0246**		0.9281**	0.9233**	0.5070**	0.7794*
	(-1.6453)	(-2.0710)		(2.3078)	(2.2969)	(1.9635)	(1.7996)
NO_QFII			1.2367***				
			(4.2243)				
AUDIT_SIZE				0.3128			
				(1.1046)			
AUDIT_INDEP					0.4692		
					(0.7724)		
INS_OWN						0.0018	
						(0.4140)	
FIRMSIZE	-0.0413***	-0.0181***	3.9678***	2.4945***	2.4960***	4.6231***	3.8746***
	(-4.4176)	(-4.6015)	(37.4310)	(16.5010)	(16.5179)	(42.7153)	(24.4585)
FIRMAGE	0.0111	0.0043	-2.8956***	-2.7232***	-2.7139***	-1.5983***	-2.4391***
	(0.8167)	(0.8028)	(-19.0338)	(-12.2074)	(-12.1727)	(-10.6592)	(-10.6215)
LEVERAGE	0.2316***	0.1032***	-0.0633	-1.7761*	-1.7763*	-15.6365***	-0.0382
	(4.7716)	(4.8031)	(-1.2813)	(-1.7761)	(-1.7757)	(-26.4390)	(-1.4862)
GROWTH	0.0389**	0.0165**	-0.6012**	-0.3733	-0.3740	-0.4842**	-1.0742***
	(2.4530)	(2.0223)	(-2.4942)	(-1.1305)	(-1.1324)	(-2.1304)	(-3.2796)
LOSS	0.2475***	0.1287***	-18.7591***	-16.8665***	-16.8650***	-16.0292***	-18.7661***
	(7.9491)	(7.5211)	(-43.9338)	(-24.2158)	(-24.2154)	(-38.1910)	(-26.9981)
OWN_CON	-0.1725**	-0.0873***	2.3347***	3.4592***	3.4615***	2.7980***	1.2917
	(-2.5644)	(-3.3720)	(4.1022)	(4.5879)	(4.5897)	(4.5767)	(1.4895)
SOE	-0.0810***	-0.0366***	-0.2502	-0.6685**	-0.6602**	-0.2255	0.3094
	(-3.5308)	(-3.9545)	(-1.2162)	(-2.0320)	(-2.0096)	(-1.1042)	(0.9659)
BOARDSIZE	0.0518	0.0181	0.1821	0.0691	0.0928	0.5913	-0.0684
	(0.8243)	(0.7237)	(0.3297)	(0.0763)	(0.1025)	(1.1071)	(-0.0807)
INDEP	0.0628	0.0693	1.0581	7.8241***	7.8214***	1.7802	-5.0659*
	(0.3086)	(0.8440)	(0.5939)	(3.0227)	(3.0216)	(1.0344)	(-1.7584)
DUALITY	0.0268	0.0053	0.0373	-0.2260	-0.2275	0.0520	-0.6378
	(1.1543)	(0.5396)	(0.1713)	(-0.8134)	(-0.8185)	(0.2466)	(-1.5845)
MEETING	0.1314***	0.0506***	-1.3433***	-1.9860***	-1.9873***	-0.2654	-1.1980***
	(4.4487)	(4.2917)	(-5.0168)	(-5.1713)	(-5.1754)	(-1.0168)	(-3.0089)
BIG4	-0.1592***	-0.0455***	0.8455**	0.9060*	0.9068*	0.1540	0.9992*
	(-3.4775)	(-3.2751)	(2.3108)	(1.6555)	(1.6552)	(0.4296)	(1.9276)
_constant	0.0412	0.6782***	-8.5221***	18.4187***	18.3129***	-21.3425***	-4.8034
	(0.1652)	(6.4581)	(-3.4757)	(4.9280)	(4.9002)	(-8.7495)	(-1.3247)
Year-FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry-FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes
No. of obs.	24,285	24,285	22,310	12,120	12,120	22,272	9,305
Adj./Pseudo R-square	0.0328	0.0322	0.340	0.231	0.231	0.379	0.351

Notes: In Models (1) and (2), the dependent variable is the probability of a financial restatement (*RESTATEMENT*) and the number of restatements (*NO_RESTATEMENT*), respectively. In Model (3), the key independent variable is the number of QFIIs (*NO_QFII*) of a company in a fiscal year, and *NO_QFII* is in the natural logarithm form. Models (4) and (5) controls for the characteristics of the audit committee (*AUDIT_SIZE* and *AUDIT_INDEP*). Model (6) controls for domestic institutional investors' ownership *(INS_OWN)*. The regression result of a sub-sample excluding

companies in the manufacturing sector is displayed in Model (7). All variables are defined in Appendix A. Industry and year dummies are included in each regression. We cluster standard errors by year and firm. The 0.01, 0.05, and 0.1 significance levels are denoted by ***, **, and * (two-tailed), respectively.

Table 7 Dynamic GMM approach

Dep. Var. = ICI	Dynamic panel-data estimation
	System GMM
	(1)
QFII_DUMMY	0.5563***
	(3.5111)
LAG_ICI	0.2550***
	(51.4778)
FIRMSIZE	2.6048***
	(21.8397)
FIRMAGE	-5.1031***
	(-25.3502)
LEVERAGE	-10.4796***
	(-16.3436)
GROWTH	-0.5961***
	(-8.0786)
LOSS	-12.0942***
	(-82.9737)
OWN_CON	-4.6197***
	(-12.6155)
SOE	5.5954***
	(14.2619)
BOARDSIZE	6.2281***
	(7.0032)
INDEP	3.7743*
	(1.7356)
DUALITY	-0.7758***
	(-3.6860)
MEETING	0.2989
	(1.5865)
BIG4	-2.0637***
	(-3.0742)
_constant	-26.2760***
	(-4.8469)
Sargan test over-identification (p-value)	0.000
Difference-in-Hansen test of exogeneity (p-value)	0.151
Wald Chi^2	78403.07
No. of obs.	20,732
No. of Firms	2,554

Notes: This table displays the result from the dynamic GMM approach. We treat *QFII_DUMMY*, *LAG_ICI*, *FIRMSIZ*E, *FIRMAGE*, *LEVERAGE*, *GROWTH*, *LOSS*, *OWN_CON*, *SOE*, *BOARDSIZE*, *INDEP*, *DUALITY*, *MEETING*, and *BIG4* as endogenous variables. Levels of these variables, which are lagged twice, are used as instruments in the first-differenced equation, and first-differences of these same variables that are lagged once, as additional instruments in the level equation. Z-statistics are displayed in parentheses. All variables are defined in Appendix A. The 0.01, 0.05, and 0.1 significance levels are denoted by ***, **, and * (two-tailed), respectively.

Table 8 PSM approach

Panel A: Estimated ATT

	ATT (T-stat)	Treatment group	Control group	No. of Obs.	Treatment group: Control group
Dep. Var. = ICI		(mean)	(mean)		
QFII_DUMMY	1.1196**(2.39)	69.3921	68.2725	19,610	1,765 : 17,845

Panel B: Univariate balanced test for pairs of treatment and control groups after matching

Matching criteria	Treatment group (mean)	Control group (mean)	%bias reduction	Difference	p-Value
FIRMSIZE	22.3130	22.3230	98.6	-0.0100	0.844
FIRMAGE	2.1682	2.1987	29.3	-0.0305	0.159
LEVERAGE	0.4584	0.4506	67.2	0.0078	0.258
GROWTH	0.2100	0.1913	-372.4	0.0187	0.262
LOSS	0.0669	0.0771	80.1	-0.0102	0.241
OWN_CON	0.2024	0.2057	91.1	-0.0033	0.621
SOE	0.6147	0.6147	100.0	0.0000	1.000
BOARDSIZE	2.3175	2.3169	98.4	0.0006	0.926
INDEP	0.3655	0.3635	-862.4	0.0020	0.254
DUALITY	0.1892	0.1847	74.2	0.0045	0.730
MEETING	2.2566	2.2611	69.4	-0.0045	0.693
BIG4	0.1337	0.1331	99.4	0.0006	0.961

Panel C: PSM sample

Dep. Var. =	ICI
	(1)
QFII_DUMMY	1.3738***
	(2.9305)
FIRMSIZE	4.5563***
	(6.7914)
FIRMAGE	-0.3690
	(-0.5715)
LEVERAGE	-11.9889**
	(-2.5394)
GROWTH	2.5203***
	(2.6545)
LOSS	-12.6777***
	(-5.5313)
OWN_CON	3.2145
	(1.1700)
SOE	-2.3724**
	(-2.1596)
BOARDSIZE	5.0006
	(1.1841)
INDEP	-2.6073
	(-0.3648)
DUALITY	-0.8456
	(-0.7496)
MEETING	-1.2092
	(-0.8621)
BIG4	1.7716
	(1.5225)
_constant	-19.9102
	(-1.0247)
Year-FE	Yes
Industry-FE	Yes
No. of obs.	19,610
Adj. R-square	0.452

Notes: Panel A reports the estimated ATT, which is the difference between the average internal control index score of treatment companies and that of the control companies. Panel B presents the univariate balanced test for pairs of treatment and control companies after matching. All matching criteria are all in year *t-1*. Panel C reports the result by re-estimating Eq. (1) based on the PSM sample. All variables are defined in Appendix A. We cluster standard errors by firm and by year. The 0.01, 0.05, and 0.1 significance levels are denoted by ***, **, and * (two-tailed), respectively.

Table 9 Mechanism that QFIIs use to induce changes in the internal control quality

Dep. Var. =	ICI	ADJ_ICI	NO_DEFI
	Voice of QFII-licensed investors		
	(1)	(2)	(3)
QFII_TOPTEN	0.6643**	0.8021***	-1.0821**
	(2.3764)	(2.8663)	(-2.2685)
QFII_NON_TOPTEN	-0.0962	-0.0811	-0.9513**
	(-0.1642)	(-0.1385)	(-1.9735)
FIRMSIZE	4.6360***	4.3430***	-0.0088
	(43.6163)	(40.6417)	(-0.0741)
FIRMAGE	-1.6023***	-1.4512***	-0.1752
	(-10.7686)	(-9.8082)	(-1.0910)
LEVERAGE	-15.6711***	-14.9714***	0.4958
	(-26.5275)	(-25.1032)	(0.9706)
GROWTH	-0.4729**	-0.4897**	-0.1094
	(-2.0834)	(-2.1606)	(-0.8574)
LOSS	-16.0219***	-15.3152***	-0.3537
	(-38.2151)	(-36.3391)	(-1.3449)
OWN_CON	2.8322***	3.0861***	-0.5395
	(5.0672)	(5.4941)	(-0.7007)
SOE	-0.2121	-0.3115	0.9321**
	(-1.0611)	(-1.5540)	(2.4535)
BOARDSIZE	0.6049	0.3935	2.2907***
	(1.1343)	(0.7327)	(2.8817)
INDEP	1.7789	1.3481	0.8593
	(1.0358)	(0.7803)	(0.5231)
DUALITY	0.0569	0.0696	0.1863
	(0.2710)	(0.3320)	(0.5724)
MEETING	-0.2740	-0.0583	2.4233
	(-1.0491)	(-0.2221)	(1.6202)
BIG4	0.1584	0.1515	6.4180**
	(0.4436)	(0.4289)	(2.4334)
_constant	-21.5078***	-80.2325***	-11.8938***
	(-8.8364)	(-32.6511)	(-2.9274)
Year-FE	Yes	Yes	Yes
Industry-FE	Yes	Yes	Yes
No. of obs.	22,310	22,310	20,145
Adj. R-square	0.380	0.345	0.010

Notes: All variables are defined in Appendix A. We cluster standard errors by firm and year. All regressions control for industry and year fixed effects. The 0.01, 0.05, and 0.1 significance levels are denoted by ***, **, and * (two-tailed), respectively.

Table 10 Incremental effect of internal control quality on firm performance

Dep. Var. =	ROA	ROA
	(1)	(2)
QFII_DUMMY	0.0148***	-0.0059
	(11.0853)	(-0.4683)
ICI	0.0028***	0.0027***
	(3.8187)	(3.4505)
QFII×ICI		0.0032*
		(1.6515)
FIRMSIZE	0.0043***	0.0043***
	(6.9490)	(6.9616)
LEVERAGE	-0.0351***	-0.0352***
	(-9.0655)	(-9.0972)
OCF	0.2130***	0.2131***
	(33.9653)	(33.9760)
SOE	-0.0077***	-0.0077***
	(-7.2371)	(-7.2186)
GROWTH	0.0118***	0.0118***
	(11.8039)	(11.8284)
BIG4	0.0018	0.0018
	(1.0263)	(0.9757)
_constant	-0.1017***	-0.1007***
	(-7.8560)	(-7.7285)
Year-FE	Yes	Yes
Industry-FE	Yes	Yes
No. of obs.	22,281	22,281
Adj. R-square	0.145	0.145

Notes: This table displays the influence of the enhanced internal control quality attributable to QFIIs on operating performance, measured by *ROA.* To better interpret the magnitude of the internal control score, *ICI* is in the form of the natural logarithm. All variables are defined in Appendix A and lagged by one year. Industry and year dummies are included. We cluster standard errors by firm and year. All regressions control for industry and year fixed effects. The 0.01, 0.05, and 0.1 significance levels are denoted by ***, **, and * (two-tailed), respectively.

Appendix A. Variable definitions and data sources

	DEFINITION
DEPENDENT VARIABLES	
ICI	Score of internal control ranging, and all the initial scores are divided by 10. Source: Dibo Internal Control and Risk Management Database.
ADJ_ICI	The industry-median-adjusted internal control index score is measured as the deduction of the internal control index score of a firm from the median score for all listed firms in the same industry for a given year.
NO_DEFI	The number of internal control deficiencies. Source: CSMAR.
RESTATEMENT	A dummy variable that equals 1 if the financial statements of a firm are restated in a given fiscal year, and 0 otherwise. Source: Annual reports of Chinese listed firms and Dibo Internal Control and Risk Management Database.
NO_RESTATEMENT	The number of financial restatements. Source: Annual reports of Chinese listed firms and Dibo Internal Control and Risk Management Database.
KEY INDEPENDENT VARIABLES	
QFII_DUMMY	A categorical variable assigned a value of one if a Chinese listed company has QFII-licensed investment entities in a fiscal year; otherwise, it is set to zero. Source: Wind-Financial Platform.
QFII_OWN	The percentage of outstanding shares held by QFII-licensed investment entities in a fiscal year.
NO_QFII	Natural logarithm of the total number of QFII entities of a company in a fiscal year.
QFII_HIGHWGI	A categorical variable set to one for companies with QFII-licensed investment entities from a country with high institutional quality (with a WGI score equal to or higher than the median WGI score); this variable is assigned a value of zero for companies without QFII-licensed entities or companies with QFII-licensed investment entities from a country with low institutional quality (with a WGI score below the median WGI score) in a fiscal year. Source: Wind-Financial Platform, the State Administration of Foreign Exchange, and the WGI scores from the World Bank (https://info.worldbank.org/governance/wgi/Home/Documents).
QFII_LOWWGI	A categorical variable assigned a value of one for companies with QFII-licensed investment entities from a country with low institutional quality (with a WGI score below the median WGI score); this variable is set to zero for companies without QFII-licensed investment entities or companies with QFIIs from a country with high institutional quality (with a WGI score equal to or greater than the median WGI score) in a fiscal year.
QFII_HIGHWGI_OWN	The sum of the percentage of outstanding shares held by QFII-licensed investment entities from a country with high institutional quality (with a WGI score equal to or above the median level of sample countries in a fiscal year).
QFII_LOWWGI_OWN	The sum of the percentage of outstanding shares held by QFII-licensed investment entities from a country with low institutional quality (with a WGI index score below the median WGI).
QFII_TOPTEN	A categorical variable assigned a value of one if the percentage of QFII's shareholding is greater than or equal to that of the 10th shareholder of a company in a fiscal year; this variable is set to zero if the percentage of shareholding is less than that of the 10th shareholder or if a company does not have a QFII-licensed investment entity in the same year.
QFII_NON_TOPTEN	A categorical variable assigned a value of one if the percentage of QFII's shareholding is less than that of the 10^{th} shareholder of a company in a fiscal year; this variable is set to zero if the percentage of QFII's shareholding is greater than or equal to that of the 10^{th} shareholder or if a company does not have a QFII-licensed investment entity in the same year.
CONTROL VARIABLES AND VARIABLES IN THE EXTENDED ANALYSIS	
FIRMSIZE	Book value of total assets (in the form of natural logarithm).
FIRMAGE	The number of years since stock listing (in the form of natural logarithm).
LEVERAGE	Book value of total liabilities divided by the book value of total assets.
GROWTH	The percentage change in annual sales.
LOSS	A categorical variable assigned a value of one if the company in the prior year reported negative net income, and it is set to zero otherwise.
OWN_CON	Ownership concentration is measured as the percentage of a company's outstanding shares that are owned by the largest shareholder.
SOE	A categorical variable that is set to one if a company's ultimate controlling shareholder is the central or a local government, or a government agency; otherwise, it is assigned a value of zero.
BOARDSIZE	Total number of directors in the boardroom, in the form of natural logarithm.
INDEP	The percentage of independent directors in the boardroom.
DUALITY	A categorical variable set to one if the CEO of a company and its chairperson in the boardroom is the same, and it receives a value of zero otherwise.
MEETING	Natural logarithm of the number of board meetings held each year.
BIG4	A categorical variable equal to one if the company is audited by a Big 4 auditor in a fiscal year; otherwise, it is set to zero. The Big Four accounting organisations include PricewaterhouseCoopers, Ernst & Young, Deloitte, and KPMG.
AUDIT_SIZE	Natural logarithm of the total number of audit committee members.
AUDIT_INDEP	The percentage of independent members on the audit committee.
INS_OWN	The percentage of outstanding shares held by domestic institutional investors.
ROA	Earnings before interests and taxes (EBIT) divided by the book value of total assets.
OCF	Operating cash flow over the book value of total assets.

Appendix B. Additional information on sample distribution

No. of Obs. with the presence of QFIIs			
	Institutional quality		
Year	High WGI countries	Low WGI countries	Total
2005	6	7	13
2006	31	43	74
2007	86	72	158
2008	63	64	127
2009	39	67	106
2010	116	63	179
2011	47	131	178
2012	71	52	123
2013	69	73	142
2014	97	98	195
2015	124	100	224
2016	87	82	169
2017	134	134	268
Total	970	986	1,956

Notes: We obtain the country-level WGI scores from the World Bank and calculate the median value for each year. If a QFII is from a country with a WGI score equal to or above the median value in a fiscal year, it is then classified as high institutional quality; otherwise, it is sorted into low institutional quality group.

Appendix C. Additional test on the reverse causality issue

Dep. Var. =	QFII_DUMMY
	(1)
	Probit regression
LAG_ICI	0.0024
	(1.5000)
QFII_DUMMY	1.1300***
	(26.5950)
FIRMSIZE	0.1480***
	(8.6922)
FIRMAGE	0.0255
	(0.9875)
LEVERAGE	-0.5325***
	(-5.7175)
GROWTH	0.1100***
	(4.5977)
LOSS	-0.0939
	(-1.5867)
OWN_CON	0.3315***
	(3.4449)
SOE	0.0757**
	(2.0091)
BOARDSIZE	0.0828
	(0.8544)
INDEP	-0.0275
	(-0.0943)
DUALITY	0.0799**
	(2.1080)
MEETING	-0.0263
	(-0.5924)
BIG4	0.1091*
	(1.7234)
_constant	-4.7663***
	(-12.5863)
Year-FE	Yes
Industry-FE	Yes
No. of obs.	19,586
Pseudo R-square	0.152
Wald Chi-Square	1412.39

Notes: This table reports the result of a probit regression of the influence of lagged internal control quality on the likelihood of the presence of a QFII in the subsequent year. The key independent variable is the overall firm-level internal control index score (*LAG_ICI*). All variables are defined in Appendix A. Industry and year dummies are included in each regression. The 0.01, 0.05, and 0.1 significance levels are denoted by ***, **, and * (two-tailed), respectively.