

Take Actions in Advance: Inquiry Letters and Audit Firm Internal Governance

Bin Liu

School of Economics and Business Administration
Chongqing University
Chongqing, China

Shun XU

School of Economics and Business Administration
Chongqing University
Chongqing, China

Yuanyuan LIU

yyliu@xmu.edu.cn

School of Management
Xiamen University
Xiamen, China

Running Head : Inquiry Letters and Audit Firm Internal Governance

This work was supported by the National Natural Science Foundation of China (Grant No. 72002182), National Social Science Fund of China (Grant No. 22AGL011) and Fundamental Research Funds for the Central Universities (Grant No. 2023CDJSKJJ20).

The views expressed herein are those of the authors and do not reflect any position of the universities.

Bin Liu, Chongqing University, School of Economics and Business Administration,
Chongqing, China; **Shun Xu**, Chongqing University, School of Economics and Business
Administration, Chongqing, China; **Yuanyuan Liu**, Xiamen University, School of
Management, Xiamen, Fujian, China

Keywords: inquiry letter; unquestioned clients; auditor switches; audit firm internal
governance.

JEL Classifications: M41, M42, M48.

* Corresponding author

E-mail Address: yyliu@xmu.edu.cn

Take Actions in Advance: Inquiry Letters and Audit Firm Internal Governance

ABSTRACT:

When clients receive inquiry letters about their annual reports, auditors at the four different levels within audit firms will take preemptive actions in response. Empirical results show the number of inquiry letters received by clients of auditors at the levels of audit firm, office, team, and individual is positively associated with the possibilities of auditor switches from unquestioned clients of high risk, indicating that the external regulatory pressure has an impact on audit firm governance behaviors. Cross-sectional tests show that the positive association is more pronounced for non-state-owned clients, large audit firms, and inexperienced auditors. Further analyses find that receiving inquiry letters increases audit delays for unquestioned clients at the individual and team levels, while increases audit fees at the individual, team, and firm levels. By examining how external regulation internalize into auditor behavior, this paper is valuable in opening up the black box of audit firm internal governance.

I. INTRODUCTION

Auditors serve as gatekeepers of the capital markets, but they are not infallible. To prevent auditor opportunistic behaviors and the resulting audit failures, laws and regulations that specifically address oversights of the audit profession have been prevalent around the world (IOSCO, 2005). Considering that well-constructed internal governance within audit firms can ensure audit quality for a long time (IOSCO, 2009), this study aims to examine whether external regulation can influence auditors' internal governance.

Inquiry letters sent by stock exchanges in China hold a unique position among many external regulations around the world, for their comprehensive coverage and timely oversight of audit firms. By the end of year 2021, Shanghai Stock Exchange and Shenzhen Stock Exchange (SSE and SZSE hereafter) have initiated over 2,900 inquiries regarding the annual reports of listed companies, with approximately 85.2 percent of them requiring auditors to verify and respond.¹ Unlike the US comment letters which are publicly disclosed only after the Securities and Exchange Commission (SEC) review is complete, the whole process of inquiry in China is open to the public from the receipt of letters by companies to the time point when exchanges are satisfied with the responses, which exert regulatory pressures to both companies and their auditors. In addition, the inquiry itself is the "preventive" and "non-punitive" regulation (Lu and Qui, 2023), which favors deterrence ex-ante but not punishment ex-post. In other words,

¹ The number is about four times of disciplinary actions taken against individual auditors (about 620 cases) and ten times those taken against audit firms (about 250 cases).

receiving inquiry letters does not necessarily indicate low audit quality or financial misreporting (Cassell, Dreher, and Myers, 2013; Cao and Pham, 2021), so auditors still have opportunities to take preemptive action to avoid future punishment even after being questioned.

Prior literature has shown that inquiry regulation has significant impacts on auditors' behaviors, including higher audit fees (Gietzmann and Pettinicchio, 2014), conservatism in audit opinion (Hu, Xu, and Xue, 2022), and improvement in audit quality (Tang and Liu, 2022). However, these studies about auditor behaviors mainly focus on companies *being questioned* by inquiry letters. For those questioned clients, their potential deficiencies in financial statements have already been made public by the stock exchanges. Just like their auditors, those clients are also under regulatory pressure and will take action themselves (Bozanic, Dietrich, and Johnson, 2017). Therefore, it is difficult to solely attribute observed changes in auditors' behaviors to either questioned clients or their auditors. In contrast, for clients that have *not been questioned*, their operations and reputation are not directly affected by inquiry letters. In other words, the change in auditors' behaviors towards other non-questioned clients likely stems from the internal governance of audit firms.

Moreover, an audit firm's internal governance is not only accomplished by the firm itself. Most studies about internal governance have treated audit firms as indivisible entities, while there are actually four levels of auditors within the firms, which are the audit firms (DeAngelo, 1981), the audit offices including local branches (Francis and Yu, 2009), the informal groups of audit partners (i.e., audit teams) who have worked

together constantly (Carpenter, 2007; Wang, Wu, and Zhao, 2022), and individual audit partners who conduct audit engagements and sign for annual reports (Gul, Wu, and Yang, 2013). The four auditor levels have a hierarchical principal-agent relationship from top to bottom, while a hierarchical information asymmetry exists from bottom to top.² Furthermore, the four levels of auditors have varying features in engagement roles, authority allocation, risk sharing, and benefits distribution (Ye, Shi, and Liu, 2022). Are there any common motivations for auditors of all four levels to respond to the regulatory pressure? Or do they show uniqueness in audit behaviors? By answering these questions, we try to open the black box of audit firms' internal governance. The research framework of this paper is illustrated in Figure 1.

As shown, inquiry letters received by clients impose regulatory pressure on the auditors at the levels of firm, office, team, and individual, and the regulatory pressure increases with the number of clients subject to inquiries. In order to prevent further losses, auditors are motivated to take preemptive actions towards their unquestioned clients. Accepting or declining a client is the starting point of an audit engagement and plays a fundamental role in subsequent audit activities. It primarily reflects auditors' risk assessment and risk control efforts, which is a core component of audit firm internal governance (Shu, 2000). In other words, declining a client of high risk can mitigate the possibility of future audit failure from the very beginning. Therefore, this study

² The organizational form for audit firms is a partnership, which is subject to moral hazard problems of effort shirking. The cost of exerting effort is borne by the partner assigned to the engagement; however, the benefits are enjoyed by all of the firm's partners (Kandel & Lazear 1992). As a partner's effort is not fully observable, his or her lack of effort can in turn result in the audit firm, as a whole, incurring losses from litigation and reputation damage (Lennox & Wu, 2018). An internal governance system that motivates partners to supply the firm's desired level of effort and quality is needed.

examines whether the regulatory pressure of inquiries increases the probability of auditor switches from clients who have not been questioned yet but are of high risk.

We propose three possible motivations for auditors to take action. The first one is risk control. Although no actual penalties are imposed, being subject to inquiry regulation increases auditors' perceived risk of future penalties (Gietzmann et al., 2014). Auditors are thus motivated to change their behaviors to avoid further sanctions. The second motivation is reputation concern. Being suspected by regulators may result in losses of audit reputation, which will possibly lead to a decline in market share and a decrease in audit fees (Wilson Jr. and Grimlund, 1990; Davis and Simon, 1992). Auditors are thus motivated to change their behavior to prevent further reputation damage. The last one is the learning effect. Experience of being questioned may help auditors identify deficiencies in their audit procedures and regulators' views on reporting and disclosure matters (Bills, Cating, Lin, and Seidel, 2024). They may take lessons from this experience and modify their behaviors accordingly.

We begin our analysis with a sample of Chinese A-share listed firms that have never received inquiry letters from 2015 to 2021. The empirical results show that the number of inquiry letters received by auditors is positively associated with the possibility of auditor switches from unquestioned clients of high risk, indicating that external regulatory pressure from inquiries results in auditors' internal governance behaviors. This effect is observed at all four levels, including the audit firms, offices, teams, and individuals. Our results still hold after conducting a series of robustness tests, including alternative measures of key variables, different regression samples, and

various model specifications. Specifically, we perform textual analysis to distinguish the types of auditor switches, and find that auditors under regulator pressure choose to resign from risky clients rather than be dismissed by clients. Then, we address the endogeneity problems by conducting the Heckman tests and employing a PSM-DID model. Moreover, cross-sectional tests show that the positive association between inquiry letters and auditor switches is more pronounced for non-state-owned clients, large audit firms, and inexperienced auditors. Further analyses examine the impact of inquiry letters on other auditor's responses. For samples without auditor switches, we find that the receipt of inquiry letters by individual auditors and audit teams results in more audit delays, and the inquiry letters received at individual, team, and firm levels would increase audit risk premiums.

The marginal contributions of this paper are as follows. First, it enriches the research on non-punitive external regulation in the field of auditing (Gietzmann et al., 2014; Tang et al., 2022; Hu et al., 2022). Specifically, by focusing on unquestioned clients of high risk, we demonstrate the positive spillover of regulatory pressure along the networks (Kubick, Lynch, Mayberry, and Omer, 2016; Brown, Tian, and Tucker, 2018) formed by common auditors (Cai, Kim, Park, and White, 2016; Francis and Wang, 2021; Hope, Rao, Xu, and Yue, 2023), which shows auditors' preemptive actions to prevent further audit failures and thus has implications for their effectiveness in internal governance.

Our study is related to, but distinguishable from Bill et al. (2024), which find that auditors' private access to clients' comment letters facilitates timely dissemination of

SEC views on reporting and disclosure matters to auditor's clientele that do not receive a comment letter. In contrast, our study emphasizes that auditors try to preempt regulators' scrutiny and reduce the likelihood of further reputation loss and litigation. Our study differs from theirs mainly due to China's unique institutional background. First, public access to SEC comment letters occurs after the conversation ends, while the whole process of inquiry in China is made public. In other words, auditors in China do not have information advantages, which ensures that the spillover effect we observe is the result of auditors' governance behaviors rather than insider information transfer. Second, the two stock exchanges SSE and SZSE review annual reports of listed companies every year rather than in a three-year cycle, and require auditors to provide opinions and explanations, when necessary, which exerts enough regulatory pressure and incentivizes auditors to take preemptive actions. Third, the identities of signing auditors are disclosed on audit reports and are publicly available for a long time in China (Jiu et al., 2020), while such data is only available after 2017 in the U.S. (PCAOB, 2016). Therefore, Bill et al. (2024) focus on the spillover effects through audit firms and offices. Although they also theoretically analyze the importance of audit teams in the process of information dissemination, they do not empirically examine the spillover through audit team as well as audit partner. In contrast, we take advantage of the partner data and empirically test the spillover effects of inquiry letters through the audit team and audit partner, which helps to dissect the internal governance of audit firms.

Second, by using China's unique long-term panel data of auditors at all four level, we build a hierarchical governance framework of "firm-office-team-individual" from

an organizational behavior perspective (Seckler, Gronewold, and Reihlen, 2017; Ye, et al., 2022), and show that all four levels of auditors are influenced by regulatory pressures and thus increase their possibilities of resignation. We also identify and test the three possible motivations, i.e., auditors' risk control, reputation concern, and learning effects, that may drive auditors' responses to inquiry letters. This deepens our understanding of auditor behaviors at different levels (Reichelt and Wang, 2010; Wang et al., 2022; Chen, Sun, and Wu, 2010) and is valuable in opening the black box of governance within audit firms.

Third, this study has policy implications for regulators, audit professionals, and market participants. We provide evidence supporting the implementation of inquiry regulation, especially in emerging markets, as it can not only discipline the listed companies being questioned (Bozanic et al., 2017; Cao et al., 2021; Lu et al., 2023), but also influence the behaviors of letter-received auditors and thus linked unquestioned companies. We also highlight the importance of quality control systems within audit firms (Christensen, Glover, Omer, and Shelley, 2016), especially focusing on constructing client portfolios, which can mitigate audit failures from the very beginning and for a long time (IOSCO, 2009).

The rest of this paper proceeds as follows. Section 2 reviews related literature and develops our hypothesis. Section 3 explains our research design and our empirical results are presented in Section 4. We report further analyses in Section 5 and conclude in Section 6.

II. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Inquiry Letters: Background and Literature

The two stock exchanges in China yearly review the annual reports of listed companies and initiate inquiries into any questionable issues. The questioned companies are required to respond within a maximum of 15 working days. When necessary, market intermediates including auditors are also required to provide opinions and explanations. The inquiry letters and the companies' replies will be disclosed to the public immediately after these documents are prepared (Lu and Qui, 2023). The topics of the inquiry letters mainly include suspicious financial indicators, unusual accounting treatments, non-compliant disclosures, and important corporate events, such as related-party transactions, stock pledges or sales by large shareholders, and mergers and acquisitions. The inquiry letters in China differ from the US comment letters in several ways, that the SEC reviews annual reports on a three-year cycle and discloses the contents of comment letters till the entire inquiry process is completed (Geiger, Johnson, Jones, and Kumas, 2022).

Unlike other punitive regulations, the inquiry only indicates that the exchange has doubts about the financial statements. The issue being questioned may not be serious, or may not indicate that something goes wrong in the enterprise. Therefore, the receipt of an inquiry letter will not necessarily result in the imposition of administrative penalties on the enterprise or the audit firm. However, the inquiry reflects the concern of regulators and sends a warning signal to the public, which helps the enterprise, auditor, or other market participants to adjust their behaviors in advance. Studies noted

that inquiry letters have a significant effect on corporate and market behavior, which includes improving the information environment (Bozanic et al., 2017), guiding stock trading behaviors (Cao et al., 2021; Lu et al., 2023), preventing corporate misconducts (Kubick et al., 2016), and improving company governance (Gietzmann, Marra, and Pettinicchio, 2016). In addition, inquiries to the client often have an impact on the auditor because the auditor provides assurance on the financial reports. Studies have documented the changes in auditor behavior towards questioned clients, including higher audit fees (Gietzmann et al., 2014), issuance of non-standard audit opinions (Hu et al., 2022), and better audit quality (Tang et al., 2022).

When studying auditor behavior in a sample of questioned clients, it is difficult to attribute those behavior changes to either questioned clients or auditors themselves. Therefore, it is necessary to examine changes in auditors' behavior toward their unquestioned clients, which is relatively rare in existing studies (Bill et al., 2024). Some literature has explored the behavioral changes of auditors following punitive regulations, such as fines or permission revocation (Fang, Sami, and Zhou, 2023; Chang and Chen, 2020), which usually result in devastating reputation damage, fines, or business suspension for the auditors. In contrast, the business environment of audit firms has remained relatively stable before and after the inquiry, and thus it is a good opportunity to examine the spillover effects of inquiry letters on unquestioned clients via common auditors, which clearly demonstrates auditors' preemptive actions and thus has implications for their effectiveness in internal governance.

Inquiry Letters and Auditor Responses towards Unquestioned Clients

When clients receive inquiry letters about their annual reports, auditors are under regulatory pressure and will take preemptive actions in response. In addition to altering auditors' attitudes toward their questioned clients, inquiry letters may also intervene in the audit behavior toward their unquestioned clients. Here, we propose three possible motivations.

Firstly, auditors, whether at the firm, office, team, or individual level, are motivated to manage regulatory risks. While inquiry itself may not necessarily indicate lower audit quality, a large number of clients receiving inquiry letters within a short period can be viewed as an indication of shortcomings in the auditor's quality control system (Christensen et al., 2016), prompting regulatory authorities to allocate additional attention to the auditor (Chen, Jiang, Liang, and Wang, 2011). This increased attention likely leads to further investigations, thereby increasing the risk of clients or auditors facing penalties or lawsuits. Therefore, the auditor's anticipated cost of audit failure increases with heightened regulatory pressure, which motivates auditors to improve their prudence and independence in audit engagement work (Gietzmann et al., 2014). Reshaping their client portfolios to be compatible with external regulatory risks is one possible response, which consequently leads to auditor switches from their unquestioned clients if necessary. We name this motivation as the risk control.

Secondly, auditors, whether at the firm, office, team, or individual level, need to maintain their reputation. High-quality auditing services assure the reliability of financial statements, which mitigates investor's adverse selection. As it is difficult to

directly observe or measure audit quality, reputation can be a credible indicator of the degree of assurance provided by auditors (Wilson Jr. et al., 1990). Frequent receipt of inquiry letters will damage auditors' reputations and thus harm their business (Chaney and Philipich, 2002; He, Pittman, and Rui, 2015; Chang et al., 2020). Moreover, the accumulation of inquiry letters can attract the attention of the media and investors (Tao and Cao, 2019), and the increased exposure can magnify the reputational damage. Therefore, in order to prevent further reputation loss in the future, auditors will adopt professional skepticism more vigorously, and be more cautious towards their clients. Undertaking fewer risky engagements is an effective way to maintain auditors' reputations and we name this motivation as the reputation concern.

Thirdly, auditors at the firm, office, team, or individual levels can learn from the inquiry process, thereby optimizing their risk response behaviors. Lennox and Li (2014) find that audit firms can accumulate experience through litigation, and thus correct their deficiencies in internal quality control. Cao, Fan, Narayanamoorthy, and Rowe (2018) find that auditors can learn from other audit failures in the same industry and reduce their probability of financial restatements. The inquiry letter covers a wide range of topics and contains a wealth of information, which is helpful for the auditor to accumulate experiences in risk identification and assessment, industry operational features, disclosure norms, regulators' current focus, and others (Tao et al., 2019). These experiences will contribute to further adjustments in audit procedures and professional judgment, which may influence auditors' selection of clients. Overall, we name this motivation as the learning effect.

Auditor Responses at Each Levels within Audit Firms

After discussing the three possible motivations for auditors to take responses following their clients receiving inquiry letters, we analyze auditor behaviors from the perspectives of the four levels, that is audit firms, offices, teams, and individuals. Auditors at different levels differ in their job content, authority allocation, risk sharing, and benefits distribution, and thus their governance roles also have different characteristics (Ye et al., 2022), which in turn affects their responses to external regulatory pressures of inquiry letters.

The firm level. The audit firm, which bears losses from possible litigation and reputation damage as a whole, is the primary entity implementing the internal governance. In an ideal scenario, an audit firm operates as an indivisible entity with a centralized organizational structure. In other words, the audit firm controls the pool of clients and determines the resource allocation and personnel assignment among different projects. Then the audit firm can apply audit methodologies consistently and provide standardized assurance services to different clients, resulting in good audit quality. However, audit firms are often physically distant from clients and audit sites, so they have to allocate decision power to lower levels of auditors due to the costs of information transfer. Then, within an audit firm, there is a hierarchical principal-agent relationship from top to bottom, while a hierarchical information asymmetry exists from bottom to top. In audit firms with low integration and inadequate quality control, the headquarters cannot exert effective oversight over audit activities in lower levels of auditors, which exposes firms to moral hazards, as offices, teams, or individual auditors

may undertake "privatization" of audit engagements for their own benefits.

The office level. Audit branch offices are geographically close to their clients and audit sites, so they usually have information advantages over the headquarters of audit firms. In the background of China, there have been three waves of mergers and acquisitions among audit firms, and it was common for local audit firms to be incorporated into large national firms as their branch offices (Gong, Oliver, Lin, and Wu, 2016). Those branch offices usually have better local practice experience, multiple communication channels with clients, and more opportunities for on-site auditing, which help them understand the company's operations and thus financial statements more comprehensively. Therefore, the office-level regulatory pressure may trigger vigorous auditor responses as a result of better risk assessment. On the other hand, the principal-agent relationship inevitably brings in conflicts of interest between the audit firm and branch offices. While firms prioritize their conformity to laws and regulations, branch offices usually emphasize profit maximizing, by following informal behavioral norms from local experience (Ye et al., 2022). Therefore, the self-serving biases in audit offices likely result in reduced audit procedures in catering to client demands (Francis, Michas, and Yu, 2013). Therefore, in the face of inquiry regulation, the office may be negligent in learning from inquiry letters and be less responsive.

The team level. Audit teams are informal groups of audit partners who have worked together constantly (Carpenter, 2007; Wang et al., 2022), and they are usually the primary units for client engagement and benefit distribution (Cahan, Che, Knechel, and Svanström, 2022). In practice, clients tend to enter into cooperative relationships

with audit teams rather than with their firms or offices (Contessotto, Knechel, and Moroney, 2021). Thus, audit teams usually hold first-hand information about their current or potential clients. As Aghion and Tirole (1997) pointed out, informational advantage will bring substantive authority. If an audit team can contact a specific client and undertake the following audit activities, the team can generally take the engagement as long as the firm or office does not explicitly oppose it. Moreover, if a team determines that a particular engagement carries high risks, the team can decline to take the engagement as long as the firm and office with informational disadvantages are not able to bear the associated risks. In addition, members of an audit team exchange information with and take lessons from each other. Prior literature has shown that auditors within the same team show similar auditing styles (Wang et al., 2022) and opportunistic behaviors alike (Hu, Su, and Wu, 2022). Hence, audit teams as a whole will make risk assessments and decide whether to terminate a client or not.

The individual level. The individual partners are the ones who conduct audit engagements and sign annual reports. Therefore, they bear direct responsibility for the audit outcomes. Prior studies have shown that the experience, working style, and industry expertise of the signing auditors influence their behavior and thus have impacts on audit quality (Gul et al., 2013; Robert, Vanstraelen, and Zerni, 2015; Li, Qi, Tian, and Zhang, 2017; Shi, Wen, Zhou, and Zhu, 2021). Moreover, the Chinese regulators over the auditing industry emphasize the punishment of individual auditors as well as the sanctioning of audit firms. During our sample period, there were about 620 cases of disciplinary actions against individual auditors, which is four times those against audit

firms. Overall, signing individual auditors faces heavy litigation risks and reputation losses under external regulatory pressures, and thus their response to inquiry letters may be stronger than auditors of other levels.

Client Risk and Auditor Switches

Internal governance of an organization includes how the entity is organized, as well as the policies and procedures established to achieve various goals. The governance of audit firms contains the firm's institutional arrangements in client acceptance, personnel deployment, financial arrangements, technical standards, risk control, business norms, and so on, which has a significant influence on audit quality and thus also affects an audit firm's ability to continuously provide audit services to the market (IOSCO, 2009). Based on the auditing principles of risk orientation, auditors need to pay special attention to high-risk enterprises. If an enterprise encounters financial difficulties or faces a harsh external environment, its auditor needs to assess the risk of material misstatement and plan necessary audit procedures. If the auditor believes that the risk of material misstatement cannot be reduced to an acceptable level through audit procedures, or if the client cannot correct the identified misstatements, the auditor will usually decide to terminate the engagement with the client. This process is the basis for the follow-up audit activities and is the most critical component of audit firm internal governance.

The inquiry letters, by publicizing corporate financial reports' potential deficiencies, impose regulatory pressure on auditors. When clients of auditors at the

four levels receive a large number of inquiry letters within a short period, it can be a clear signal that the auditors have deficiencies in their quality control system (Christensen et al., 2016). In other words, the regulatory pressure increases with the number of inquiry letters received. Based on the three proposed motivations, which are risk control, reputation concern, and learning effect, auditors have strong incentives to take preemptive actions when facing enough regulatory pressure from external inquiries. These preemptive response behaviors, including declining risky clients, are not limited to those questioned clients; the positive effects of regulatory effects may also spillover to other unquestioned clients with high audit risks. Then, based on the four-level governance framework of "firm-office-team-individual," external inquiry can impose pressure on each level of auditors and vitalize corresponding internal governance functions. In other words, inquiry letters warn and urge audit firms to improve their quality control systems for future business concerns, which serves as an important pathway for transforming short-term responses into long-term mechanisms within audit firms. Overall, we argue that the inquiry regulatory pressure can influence auditors' client selection behavior and therefore state the following hypothesis.

Hypothesis 1: *the number of inquiry letters received by questioned clients of auditors at the four levels is positively associated with the possibilities of auditor switches from their unquestioned high-risk clients.*

III. RESEARCH DESIGN

Sample and Data

Our sample starts with all Chinese A-share listed companies from 2015 to 2021 as SSE and SZSE have publicly disclosed inquiries letters over annual reports since 2015. We make the following selections. First, we remove stocks in abnormal trading status (i.e., ST or PT labeled),³ companies in the financial industry, and observations with missing data necessary for the calculation of certain variables. Then, we exclude companies audited by Ruihua CPA firm, whose audit failure in 2019 has finally led to a dissolution of this audit firm. As we examine the auditor switch from unquestioned clients (i.e., spillover effects of inquiry letters), we remove companies that have been questioned by inquiry letters. The process of sample selection is presented in Table 1, and the final sample for the main regression includes 18,113 firm-year observations.

We obtain the data of inquiry letters from the Chinese Research Data Services (CNRDS) database, and manually supplement the missing data by referring to the websites of the two exchanges. Data about company fundamentals, corporate governance, and audit-related information come from the China Stock Market and Accounting Research (CSMAR) database. We also use Python to obtain information of individual auditors and audit offices from the information platform of the Chinese Institute of Certified Public Accountants (<http://cmis.cicpa.org.cn>).

³ "ST" and "PT" labeled stocks have been restricted or suspended from trading due to losses over consecutive years. These companies typically do not meet the going concern assumption and their financial data tends to be extreme.

Variable Definition

The dependent variable (*Change*) is an indicator for auditor switch, which equals one if a company's audit firm for the current year is different from that of the previous year and zero otherwise.

The independent variable is the number of inquiry letters over annual reports received by questioned clients of auditors at each level (*Letter_Rec_X*) for one year, and the X is taken to be the Firm, Office, Team, and Auditor. Specifically, the independent variable contains the number of inquiry letters received by the audit firm (*Letter_Rec_Firm*), the audit office (*Letter_Rec_Office*), the audit team (*Letter_Rec_Team*),⁴ and the individual auditor (*Letter_Rec_Auditor*). We add one to the number of inquiries letters and take the natural logarithm to reduce the skewness.

We adopt the Altman bankruptcy risk index (Z-Score) adjusted for China's capital market (Lee, Walker, and Zeng, 2014) to measure client risk, which is a determinant factor of auditors' resignation decisions (Krishnan, and Krishnan, 1997; Landsman, Nelson, and Rountree, 2009). *High_Risk* equals one if the Z-score is above the sample mean and zero otherwise.

Model Specification

To test the hypothesis, we establish the Logit model as in Equation (1):

⁴ We use the "n-clans" algorithm in social network analysis (Mokken, 1979) to identify audit teams. The algorithm defines members within "n" steps of distance in the network as belonging to the same team. If two individual auditors share a co-signing experience, the distance between them is defined as one step. If auditors A and B have a co-signing experience, and B and C also have a co-signing experience, in the absence of any other signing relationship, we define the distance between auditors A and C as two steps. Referring to Wang et al. (2022), we select a group of individual auditors who are no more than 2 steps away from the signing auditor in the past 5 years as the same team.

$$\begin{aligned}
Change_{it+1} = & \alpha_0 + \alpha_1 Letter_Rec_X_{it} \times Low_Risk_{it} \\
& + \alpha_2 Letter_Rec_X_{it} \times High_Risk_{it} + \alpha_3 High_Risk_{it} \\
& + \alpha_4 All_Client_X_{it} + \alpha_{5-13} Client\ CV_{it} + \alpha_{14-17} Audit\ Firm\ CV_{it} \quad (1), \\
& + \alpha_{18-19} Audit\ Office\ CV_{it} + \alpha_{20} Audit\ Team\ CV_{it} \\
& + \alpha_{21-23} Individual\ Auditor\ CV_{it} + i.Industry + i.Year + \varepsilon_{it}
\end{aligned}$$

where the subscripts *i* and *t* refer to firm *i* and year *t*, respectively. The key variables (*Change*, *Letter_Rec_X*, and *High_Risk*) are as defined above. In this model, we test whether auditors at each level are more likely to leave unquestioned clients of high risks when facing regulatory pressure measured by *Letter_Rec_X*. Following Crosignani, Macchiavelli, and Silva (2023), we split the coefficient of *Letter_Rec_X* into two depending on whether the client risk is high or low. In other words, we include the two interaction terms (*Letter_Rec_X* × *High_Risk*) and (*Letter_Rec_X* × *Low_Risk*) in the model, where *Low_Risk* equals one if the Z-score is below the sample mean and zero otherwise. We pay special attention to the coefficient of *Letter_Rec_X* × *High_Risk*. If the α_2 is significantly positive, it supports our hypothesis and indicates that inquiry letter regulation can influence auditor behavior toward high-risk clients and contribute to the quality of audit firm internal controls. By including both interaction terms into this model, the coefficient α_2 (α_1) reflects the absolute effect of inquiry letters on unquestioned clients of high risk (low risk).⁵

⁵ This approach is a linear transformation of the following model,

$$Change = \beta_0 + \beta_1 Letter_Rec_X + \beta_2 Letter_Rec_X \times High_Risk + Controls + FEs + \varepsilon \quad (1')$$

The difference between model (1) and model (1') is how to interpret the estimated coefficients of *Letter_Rec_X* × *High_Risk*. The β_2 in the model (1'), which is also expected to be significantly positive, reflects the differences in auditor switching rates between high- and low-risk clients when facing inquiries. Since our study focuses on the absolute effects of inquiry letters in high-risk clients rather than the incremental effects in comparison with low-risk clients, we choose the model (1) throughout all the tests.

As the number of inquiry letters received at each auditor level may be positively correlated with the total number of clients that the auditors provide services for, we include the number of total audit engagements at each auditor level (*All_Client_X*) in this model to control for possible interference. The X in the variable *All_Client_X* is also taken to be the Firm, Office, Team, and Auditor, and is the same as the X in *Letter_Rec_X* in the same regression. In addition, we also extensively control client fundamentals, and characteristics of audit firm, office, team, and individual. To mitigate the potential effects of outliers, all continuous variables are winsorized at the 1% and 99% quantile levels. The detailed definitions and calculations of all variables are presented in Table 2.

IV. EMPIRICAL RESULTS

Descriptive Statistics

Table 3 presents the results of descriptive statistics. The incidence of auditor switches over the sample period is about 7%. On average, individual signing auditors receive 0.39 inquiry letters over annual reports, audit teams receive 1.98 letters, audit offices receive 6.82 letters, and audit firms receive 25.19 letters. In our regression sample, audit offices, with at least one audit engagement for listed companies, have hired 241 auditors, and there are 21 signing auditors for an audit team, on average. The distributions of all other control variables are similar to existing studies.

Main Regression Results

Table 4 presents the main regression results. Columns (1) to (4) show the effect of inquiry letters on individual auditors, audit teams, offices, and firms respectively. The coefficients of $Letter_Rec_X \times High_Risk$ are our coefficients of interest and are significantly positive at 1% level across all four columns. The results indicate that the regulatory pressures of inquiry letters received by questioned clients of auditors at the four levels within audit firms can significantly raise the likelihood of auditor switches from unquestioned clients of high risk, providing support for our hypothesis. As for the marginal effects at mean in Logit models, we observe that, for every one-unit increase in the number of inquiry letters received, the incidence of auditor changes increases by 1.9% at the individual level, 0.4% at the team level, 1.6% at the office level, and 2.0% at the firm level, respectively. Those results suggest that the spillover effects of inquiry letters are also economically significant across all four auditor levels. In contrast, the coefficients of $Letter_Rec_X \times Low_Risk$ are insignificant across all four columns, suggesting that when facing regulatory pressure auditors are less likely to take preemptive responses for their clients of low operational risk.

Robustness Tests

In this section, we conduct a series of robustness tests to validate our main argument.

Alternative Measures of Inquiry Letters

We employ several alternative measures of inquiry letters to ensure the robustness. First, as the regulatory effect of inquiry letters on auditors may last for more than one year, we replace the independent variable with *Historical_Letter_Rec_X*, which is the total number of inquiry letters received by auditors at each level since 2015. We re-estimate the Equation (1) and report the results in Panel A of Table 5. The coefficients of *Historical_Letter_Rec_X* \times *High_Risk* are still significantly positive at 1% level across columns (1) to (4), which shows the spillover effects of inquiry letters at the individual auditor, team, office, and firm levels, respectively.

Second, we replace the independent variable with *Ratio_Letter_Rec_X*, which equals the number of inquiry letters received divided by the number of clients for auditors at each level. As we mention in the model specification, the number of inquiry letters received at each auditor level may be positively correlated with the total number of clients that auditors provide services for. In the main test, we include *All_Client_X* in Equation (1) to control for possible interference. In this robustness test, we use the ratio of the number of inquiry letters to the number of audit engagements as the independent variable to deal with this issue. The results remain unchanged at levels of individual auditors, audit teams, and audit firms, as the coefficients of *Ratio_Letter_Rec_X* \times *High_Risk* are still significantly positive in columns (1), (2), and (4) of Table 5 Panel B.

Third, we pay special attention to those inquiry letters that require auditors' responses. Among those inquiry letters over annual reports, the two exchanges usually

ask auditors of those annual reports, together with their clients, to provide explanations for specific accounting issues. Those types of inquiry letters may put more pressure on auditors, which thus incentivizes their responsive behaviors. We define the *Reply_Letter_Rec_X* as the number of inquiry letters that require auditors' response at each auditor level and re-estimate the model. Results in Panel C of Table 5 have verified the regulatory impacts at the individual, team, and office levels of auditors.

Textual Measures of Auditor Resignation

When clients receive inquiry letters about their annual reports, auditors are under regulatory pressure and will take preemptive actions in response. In this study, we specifically examine whether those auditors will resign from their unquestioned clients of high risk to avoid further investigation or punishment from regulators. Empirically in the main test, we have found that the number of inquiry letters received by auditors is positively associated with the possibilities of auditor switches.

The literature has pointed out that auditor switches can be categorized into auditor resignation and client dismissal (Johnson and Lys, 1990; Shu, 2000). The former stems from the fact that if the possible punishment for audit failure exceeds the compensation for the audit risks (i.e., audit fees), then auditors have to decline such audit engagement. The latter stems from the fact that if the auditor's competence fails to meet their client's demand for high-quality audit service, then the company switches to a better auditor. In order to validate our argument about the auditor's preemptive responses to inquiry

letters, we need to further distinguish auditor resignation from client dismissal.⁶

Referring to Krishnan and Krishnan (1997), we obtain corporate announcements of auditor switches from the CNINFO⁷ and conduct a textual analysis to identify the reasons why listed companies change accounting firms. Then, we replace the dependent variable in Equation (1) with *Resignation*, which equals one if the reason has been confirmed as auditor resignation and zero otherwise. Table 6 shows the results, and the coefficients of $Letter_Rec_X \times High_Risk$ are significantly positive in columns (1), (2), and (4), supporting the regulation of inquiry letters at the individual auditor, team, and firm levels, respectively.

Alternative Measures of Client Risks

In the main test, we use the Z-Score to measure corporate business risk and define the *High_Risk* in Equation (1). Here, we use whether a company is experiencing losses as an alternative measure of client risks, as those companies have higher business risks and stronger motives to commit accounting fraud (Landsman et al. 2009). We replace *High_Risk* with *Loss*, which equals to one if the client's net income is negative, and zero otherwise. Then we re-estimate Equation (1) and report the results in Panel A of Table 7. The coefficients of $Letter_Rec_X \times Loss$ remain significantly positive across

⁶ We do not use this variable in the main tests as most companies tend to use ambiguous wording in explaining the reasons for changing audit firms. Among the 1989 auditor switches in our sample, vague reasons such as contract expiration and business needs are used in 1429 cases. Among the remaining 560 cases, we identified 216 mandatory rotations, 247 client terminations, and 97 auditor resignations in which the company clearly explains the specific circumstances under which the auditor was unable to complete the engagement.

⁷ The Cninfo Website (www.cninfo.com.cn) is a platform authorized by the China Securities Regulatory Commission for listed companies to disclose financial statements, company notices, and other important information to the public.

columns (1) to (4), indicating that under the influence of inquiry letters, auditors at all four levels increased their possibilities of audit change for the high-risk clients.

Then, we use whether a company has restated its financial statements to measure client risk, as the restatements indicate the low quality of a company's accounting information and relate to the company's audit risk (DeFond and Zhang, 2014). We replace *High_Risk* with *Restatement*, which equals to one if the year t financial statement of the client i has been restated later, and zero otherwise. Then we re-estimate Equation (1) and report the results in Panel B of Table 7. The coefficients of $Letter_Rec_X \times Restatement$ remain significantly positive across columns (1) to (4), indicating that auditors at all four levels can identify the restatement risk of clients and are more likely to leave those clients under the influence of inquiry letters.

Additional Fixed Effects

In the main test, we control industry and year fixed effects, together with a series of control variables for characteristics of the audit firm, office, team, individual, and clients. In this section, we include additional fixed effects to alleviate endogeneity problems due to omitted variables. As reported in Table 7 Panel A, the coefficients of $Letter_Rec_X \times High_Risk$ are still significantly positive across all four columns when we control audit firm-fixed effects, suggesting that our results are robust to time-invariant features of audit firms. Moreover, when the audit firm makes decisions about where to establish a branch office, regional characteristics such as economic development or potential clients may play a role, which may cause bias in results

interpretation. In order to control for the regional characteristics, we add fixed effects of provinces where the audit office is located. As shown in Panel B, our findings still hold when we control audit firm fixed effects and office location fixed effects at the same time. In other words, the receipt of inquiry letters is still a factor that influences the auditor's decision.

Endogeneity Issues

The receipt of inquiry letters may be influenced by auditors' characteristics, which may be correlated with the possibility of auditor switches at the same time. Therefore, we control a series of variables in the main regression model. In this section, we conduct the two-step Heckman tests to further alleviate concerns regarding endogeneity issues. In the first step, we use the sample missing rate of the industry as the exclusion restrictions variable, and calculate the Inverse Mills Ratio. In the second step, we run the Equation (1) together with the IMR and report the result in Table 9. Again, our results remain unchanged at all four audit levels.

Moreover, we adopt a PSM-DID model to eliminate the possible endogeneity problems. First, we classify those unquestioned firms whose auditors have received inquiry letters as the treatment group, and use the propensity score matching method to select those unquestioned firms whose auditors have never received inquiry letters as the control group. Second, we define *First_Letter_Rec_X* as an indicator variable that equals one since the company's auditor at each level has received an inquiry letter for the first time and zero otherwise. Then, we run the difference-in-differences regression

in the matched sample, and the coefficient on *First_Letter_Rec_X*High_Risk* captures the difference in the possibility of auditor switches from the high-risk clients for the treatment firms relative to the control firms after versus before the receipt of inquiry letters. As shown in Table 10, the coefficients of interest are significantly positive, indicating that auditors at each level are more likely to leave their unquestioned clients of high risk after this audit entity receives an inquiry letter for the first time.

Cross-sectional Analyses

In this section, we perform several cross-sectional tests to further investigate the variance in the association between auditor switches and number of inquiry letters received.

SOEs vs. Non-SOEs

State-owned enterprises (SOEs) often play a crucial role in providing employment opportunities and supporting livelihoods in Chinese society. Therefore, SOEs usually have advantages in obtaining loans from financial institutions and policy support from local governments (Chen, Sun, Tang, and Wu, 2011), which makes them more stable in operational conditions and less prone to bankruptcy. In addition, SOEs are endowed with political connections (Wang, Tian, and He, 2020), and thus they often face lower regulatory pressure and litigation risks than their private counterparts (Bruton, Peng, Ahlstrom, Stan, and Kchan, 2013). Therefore, we expect that the audit risks of state-owned clients are perceived to be lower, and thus auditors are less motivated to leave those SOEs in response to regulatory pressure from inquiry letters.

We partition our sample into two groups based on clients' nature of property rights and re-estimate Equation (1) in both groups. Table 11 demonstrates the regression results, which show that the impact of inquiry letters differs between the state-owned and non-state-owned enterprises. The coefficients of $Letter_Rec_X \times High_Risk$ are significantly positive at least at the 5% level for non-state companies across all four audit levels, while the coefficients are insignificant for SOEs. In addition, the differences in coefficient estimates between the two subsamples are significant at individual, office, and firm levels. These results suggest that when questioned clients receive inquiry letters, auditors are more concerned about the audit risks of private companies. Thus, the regulatory pressure will likely lead to auditor resignation from those unquestioned non-SOEs, which is consistent with their risk control motivations in preventing further inquiries, penalties, and even lawsuits.

Top Ten vs. Other Audit Firms

Top-ranked audit firms usually have better reputations in undertaking large-scale audit engagements and providing high-quality audit services (DeAngelo, 1981). These auditors have invested high quasi-rents to build and maintain their reputations, so the marginal impact of reputational loss is more significant. In contrast, auditors in small and medium-sized audit firms have less reputation concern, and also their ability to select customers is limited as they already have less bargaining power in the audit market. Consequently, in the face of regulatory pressure, auditors in large audit firms are more motivated and capable of re-constructing their client portfolios.

To test our prediction, we partition our sample into two groups based on whether the audit firms are top ten or not, and re-estimate Equation (1) in both groups. Table 12 demonstrates the regression results, which show that the impact of inquiry letters differs between the top ten and non-top ten audit firms. Specifically, for the top ten audit firms, the coefficients on $Letter_Rec_X \times High_Risk$ are significantly positive at least at the 5% level across all four audit levels, suggesting that regulatory pressure from inquiry letters has motivated auditors to replace their high-risk clients. For non-top ten audit firms, the coefficients on $Letter_Rec_X \times High_Risk$ are significantly positive in both team and office levels of auditors, while they are insignificant in levels of individual auditors and audit firms. In addition, the difference in coefficient estimates between the two subsamples is significant at individual and firm levels of auditors. In conclusion, reputation concerns of audit firms and individuals have played a role in motivating their preemptive responses to inquiry letters.

Experienced vs. Inexperienced Auditors

Auditing experience is often derived from on-the-job learning, learning from others, and learning from mistakes (Westermann, Bedard, and Earley, 2008), the latter of which is how individual auditors gain experience from inquiry letters. When clients of auditors receive inquiry letters, auditors can summarize the content of letters and learn from addressing those questions, which helps improve the risk assessment of clients, the process of audit engagements, and the firm systems of internal quality control. It is noted that the incremental knowledge gained from each event diminishes as an

individual has accumulated enough experience. Therefore, we expect that the signing auditors of less experience may benefit more from the events of inquiry letters.

Therefore, we partition our sample into two groups based on auditors' experience, which is measured as the average number of years since they obtained the CPA certificates. Table 13 demonstrates the regression results in both two groups. Specifically, for the inexperienced auditors, the coefficients on *Letter_Rec_X* \times *High_Risk* are significantly positive at individual, team, and audit firm levels. For the experienced auditors, the coefficients are only insignificant at the individual level. In addition, the differences in coefficient estimates between the two subsamples are also significant at the team and firm level. In conclusion, the learning effect of audit teams and audit firms have played a role in motivating their preemptive responses to inquiry letters.

V. FURTHER ANALYSES

When auditors face regulatory pressure from inquiries, terminating the audit contract with a high-risk client is the most direct means of reducing risk and preserving reputation. However, if the auditor is unable to terminate the contract or assess that the client's risk does not meet the criteria for termination, they can perform other audit procedures to keep the risk within acceptable limits or charge a higher risk premium. Therefore, in this section, we restrict the sample to unquestioned companies that have not experienced any audit change, and test whether inquiry pressure affects other audit behaviors and which level of governance, that is individual, team, office, or firm,

dominates these behavioral changes.

Inquiry Letters and Audit Delays

Putting more effort in engagement, and thus conducting additional audit procedures, is an important way for auditors to cope with risk. As inquiry pressure elevates auditors' perceived risk and amplifies the reputational damage of future audit failures, auditors are incentivized to increase their efforts and conduct additional audit procedures to reduce the likelihood of misstatements. Following Al-Mulla and Bradbury (2022), we use audit delays to measure the auditor's effort and whether the auditor implements additional audit procedures. We replace the dependent variable in regression Equation (1) with *Delays*, which equals the natural logarithm of days between financial year-end date and financial statements releasing date.

Panel A of Table 14 demonstrates the regression results, which show that receiving inquiry letters increases the audit delays in unquestioned clients. The coefficients of $Letter_Rec_X \times High_Risk$ are significantly positive at the individual and team levels, while the coefficients are insignificant at the office and firm levels. These results suggest that when facing the pressure of inquiry letters, the decision of whether and how to increase audit procedures is made by the individual partners and audit teams, as partners are the ones who conduct audit engagements and sign annual reports, and team members always exchange information with and take lessons from each other.

Inquiry Letters and Audit Fees

Increasing audit fees is another important means for auditors to cope with audit

risk (Choi, Kim, Liu, and Simunic, 2008), which includes both compensating the costs of performing additional audit procedures and charging higher risk premiums. Referring to Ghosh and Pawlewicz (2009), We replace the dependent variable in regression Equation (1) with $\Delta Fees$, which is the change in audit fees and measured as the difference in audit fees between the current year and previous year divided by the audit fees in the previous year.

Panel B of Table 14 demonstrates the regression results, which show the impact of inquiry letters on audit fees for unquestioned clients. The coefficients of $Letter_Rec_X \times High_Risk$ are significantly positive at the individual, team, and firm levels, which suggests that partners, teams and firms will increase fees charged to high-risk clients when facing inquiry pressure. These results suggest that when facing the pressure of inquiry letters, the decision of whether and how to charge higher audit fees is made by the individual partners, audit teams, and audit firms. As demonstrated in the prior section, partners and teams will put more effort in risky engagements, while the audit firms may choose to compensate for the potential risk by raising the audit fees.

VI. CONCLUSION

This paper provides empirical evidence supporting that external regulatory pressure from inquiries can result in auditors' internal governance behaviors, by showing that the number of inquiry letters received by auditors of all four levels is positively associated with the likelihood of auditor switches from unquestioned risky clients. These conclusions still hold with a series of robustness tests. The cross-sectional

analyses show that the main effect varies with the characteristics of clients and auditors, demonstrating auditors' motivations of risk control, reputation concern and learning effects. Further analyses points to the fact that receiving inquiry letters among various levels of auditors also increases audit delays and fees for their unquestioned clients. Through this study, we have gained the following insights. The exchanges can continue the implementation of inquiry regulation, as it can not only discipline listed companies being questioned, but also improve the internal governance of audit firms; while audit firms should attach importance to their quality control systems, especially focusing on constructing client portfolios which can mitigate audit risks from the very beginning.

REFERENCE

- Aghion, P., and Tirole, J. 1997. Formal and Real Authority in Organizations. *Journal of Political Economy*, 105(1): 1–29. <https://doi.org/10.1086/262063>
- Al - mulla, M., and Bradbury, M. E. 2022. Auditor, client and investor consequences of the enhanced auditor’ s report. *International Journal of Auditing*, 26(2): 134 – 150. <https://doi.org/10.1111/ijau.12255>
- Bills, K. L., Cating, R., Lin, C., and Seidel, T. A. 2024. The spillover effect of SEC comment letters through audit firms. *Review of Accounting Studies*. <https://doi.org/10.1007/s11142-023-09819-z>
- Bozanic, Z., Dietrich, J. R., and Johnson, B. A. 2017. SEC comment letters and firm disclosure. *Journal of Accounting and Public Policy*, 36(5): 337–357. <https://doi.org/10.1016/j.jaccpubpol.2017.07.004>
- Brown, S. V., (Shaolee) Tian, X., and Wu Tucker, J. 2018. The Spillover Effect of SEC Comment Letters on Qualitative Corporate Disclosure: Evidence from the Risk Factor Disclosure. *Contemporary Accounting Research*, 35(2), 622–656: <https://doi.org/10.1111/1911-3846.12414>
- Bruton, G. D., Peng, M. W., Ahlstrom, D., Stan, C., and Xu, K. 2015. State-owned Enterprises Around the WORLD as Hybrid Organizations. *Academy of Management Perspectives*, 29(1): 92–114. <https://doi.org/10.5465/amp.2013.0069>
- Cahan, S. F., Che, L., Knechel, W. R., and Svanström, T. 2022. Do Audit Teams Affect Audit Production and Quality? Evidence from Audit Teams’ Industry Knowledge*. *Contemporary Accounting Research*, 39(4): 2657–2695. <https://doi.org/10.1111/1911-3846.12807>
- Cai, Y., Kim, Y., Park, J. C., and White, H. D. 2016. Common auditors in M&A transactions. *Journal of Accounting and Economics*, 61(1): 77–99. <https://doi.org/10.1016/j.jacceco.2015.01.004>
- Cao, S. S., Fan, Y., Narayanamoorthy, G. S., and Rowe, S. P. 2018. Auditor Litigation: Deterrence Implications for Non-Sued Auditors. *SSRN Electronic Journal*. <https://doi.org/10.2139/ssrn.3204957>
- Cao, V. N., and Pham, A. V. 2021. Behavioral spillover between firms with shared auditors: The monitoring role of capital market investors. *Journal of Corporate Finance*, 68, 101914. <https://doi.org/10.1016/j.jcorpfin.2021.101914>
- Carpenter, T. D. 2007. Audit Team Brainstorming, Fraud Risk Identification, and Fraud Risk Assessment: Implications of SAS No. 99. *The Accounting Review*, 82(5): 1119–1140. <https://doi.org/10.2308/accr.2007.82.5.1119>
- Cassell, C. A., Dreher, L. M., and Myers, L. A. 2013. Reviewing the SEC’s Review Process: 10-K Comment Letters and the Cost of Remediation. *The Accounting Review*, 88(6): 1875–1908. <https://doi.org/10.2308/accr-50538>
- Chaney, P. K., and Philipich, K. L. 2002. Shredded Reputation: The Cost of Audit Failure. *Journal of Accounting Research*, 40(4): 1221–1245. <https://doi.org/10.1111/1475-679X.00087>
- Chang, W.-C., and Chen, J.-P. 2020. Auditor sanction and reputation damage: Evidence from changes in non-client-company directorships. *The British Accounting Review*, 52(3): 100894. <https://doi.org/10.1016/j.bar.2020.100894>

- Chen, D., Jiang, D., Liang, S., and Wang, F. 2011. Selective enforcement of regulation. *China Journal of Accounting Research*, 4(1–2): 9–27. <https://doi.org/10.1016/j.cjar.2011.04.002>
- Chen, S., Sun, S. Y. J., and Wu, D. 2010. Client Importance, Institutional Improvements, and Audit Quality in China: An Office and Individual Auditor Level Analysis. *The Accounting Review*, 85(1): 127–158. <https://doi.org/10.2308/accr.2010.85.1.127>
- Chen, S., Sun, Z., Tang, S., and Wu, D. 2011. Government intervention and investment efficiency: Evidence from China. *Journal of Corporate Finance*, 17(2): 259–271. <https://doi.org/10.1016/j.jcorpfin.2010.08.004>
- Choi, J., Kim, J., Liu, X., and Simunic, D. A. 2008. Audit Pricing, Legal Liability Regimes, and Big 4 Premiums: Theory and Cross - country Evidence*. *Contemporary Accounting Research*, 25(1): 55 – 99. <https://doi.org/10.1506/car.25.1.2>
- Christensen, B. E., Glover, S. M., Omer, T. C., and Shelley, M. K. 2016. Understanding Audit Quality: Insights from Audit Professionals and Investors. *Contemporary Accounting Research*, 33(4): 1648–1684. <https://doi.org/10.1111/1911-3846.12212>
- Contessotto, C., Knechel, W. R., and Moroney, R. 2021. How do audit team industry and client - specific experience impact audit effort and audit fees? *International Journal of Auditing*, 25(1): 249 – 268. <https://doi.org/10.1111/ijau.12219>
- Croignani, M., Macchiavelli, M., and Silva, A. F. 2023. Pirates without borders: The propagation of cyberattacks through firms' supply chains. *Journal of Financial Economics*, 147(2): 432–448. <https://doi.org/10.1016/j.jfineco.2022.12.002>
- Davis, L. R., and Simon, D. T. 1992. The Impact of SEC Disciplinary Actions on Audit Fees. *Auditing: A Journal of Practice & Theory*, 11(1): 58–68.
- DeAngelo, L. E. 1981. Auditor size and audit quality. *Journal of Accounting and Economics*, 3(3): 183–199. [https://doi.org/10.1016/0165-4101\(81\)90002-1](https://doi.org/10.1016/0165-4101(81)90002-1)
- DeFond, M., and Zhang, J. 2014. A review of archival auditing research. *Journal of Accounting and Economics*, 58(2–3): 275–326. <https://doi.org/10.1016/j.jacceco.2014.09.002>
- Fang, J., Sami, H., and Zhou, H. 2023. Do sanctioned audit firms strive to restore their damaged reputation under imperfect institutional settings? *Journal of International Accounting, Auditing and Taxation*, 50, 100530. <https://doi.org/10.1016/j.intaccaudtax.2023.100530>
- Francis, J. R., and Wang, W. 2021. Common Auditors and Private Bank Loans*. *Contemporary Accounting Research*, 38(1): 793–832. <https://doi.org/10.1111/1911-3846.12617>
- Francis, J. R., and Yu, M. D. 2009. Big 4 Office Size and Audit Quality. *The Accounting Review*, 84(5): 1521–1552. <https://doi.org/10.2308/accr.2009.84.5.1521>
- Francis, J. R., Michas, P. N., and Yu, M. D. 2013. Office Size of Big 4 Auditors and Client Restatements. *Contemporary Accounting Research*, 30(4): 1626–1661. <https://doi.org/10.1111/1911-3846.12011>
- Geiger, M. A., Johnson, B., Jones, K. L., and Kumas, A. 2022. Information Leakage Around SEC Comment Letters. *Management Science*, 68(11): 8449–8463. <https://doi.org/10.1287/mnsc.2021.4259>
- Ghosh, A., and Pawlewicz, R. 2009. The Impact of Regulation on Auditor Fees: Evidence from the Sarbanes-Oxley Act. *AUDITING: A Journal of Practice & Theory*, 28(2): 171–197. <https://doi.org/10.2308/aud.2009.28.2.171>

- Gietzmann, M. B., and Pettinicchio, A. K. 2014. External Auditor Reassessment of Client Business Risk Following the Issuance of a Comment Letter by the SEC. *European Accounting Review*, 23(1): 57–85. <https://doi.org/10.1080/09638180.2013.774703>
- Gietzmann, M., Marra, A., and Pettinicchio, A. 2016. Comment Letter Frequency and CFO Turnover: A Dynamic Survival Analysis. *Journal of Accounting, Auditing & Finance*, 31(1): 79–99. <https://doi.org/10.1177/0148558X15579493>
- Gong, Q., Li, O. Z., Lin, Y., and Wu, L. 2016. On the Benefits of Audit Market Consolidation: Evidence from Merged Audit Firms. *The Accounting Review*, 91(2): 463–488. <https://doi.org/10.2308/accr-51236>
- Gul, F. A., Wu, D., and Yang, Z. 2013. Do Individual Auditors Affect Audit Quality? Evidence from Archival Data. *The Accounting Review*, 88(6): 1993–2023. <https://doi.org/10.2308/accr-50536>
- He, X., Pittman, J., and Rui, O. 2016. Reputational Implications for Partners After a Major Audit Failure: Evidence from China. *Journal of Business Ethics*, 138(4): 703–722. <https://doi.org/10.1007/s10551-015-2770-6>
- Hope, O., Rao, P., Xu, Y., and Yue, H. 2023. Information sharing between mutual funds and auditors. *Journal of Business Finance & Accounting*, 50(1–2): 152–197. <https://doi.org/10.1111/jbfa.12636>
- Hu, N., Xu, J., and Xue, S. 2022. Regulatory risk and auditors' reporting conservatism: Evidence from Chinese comment letters. *Journal of Accounting and Public Policy*, 41(6): 106997. <https://doi.org/10.1016/j.jaccpubpol.2022.106997>
- International Organization of Securities Commissions (IOSCO). 2005. Survey Report On Regulation And Oversight Of Auditors.
- International Organization of Securities Commissions (IOSCO). 2009. Transparency of Firms that Audit Public Companies.
- Jiu, L., Liu, B., and Liu, Y. 2020. How a Shared Auditor Affects Firm-Pair Comparability: Implications of Both Firm and Individual Audit Styles. *Auditing: A Journal of Practice & Theory*, 39(3): 133–160. <https://doi.org/10.2308/ajpt-17-008>
- Johnson, W. B., and Lys, T. 1990. The market for audit services. *Journal of Accounting and Economics*, 12(1–3): 281–308. [https://doi.org/10.1016/0165-4101\(90\)90051-5](https://doi.org/10.1016/0165-4101(90)90051-5)
- Kandel, E., and Lazear, E. P. 1992. Peer Pressure and Partnerships. *Journal of Political Economy*, 100(4), 801–817. <https://doi.org/10.1086/261840>
- Krishnan, J., and Krishnan, J. 1997. Litigation Risk and Auditor Resignations. *Accounting Review*, 72(4): 539.
- Kubick, T. R., Lynch, D. P., Mayberry, M. A., and Omer, T. C. 2016. The Effects of Regulatory Scrutiny on Tax Avoidance: An Examination of SEC Comment Letters. *The Accounting Review*, 91(6): 1751–1780. <https://doi.org/10.2308/accr-51433>
- Landsman, W. R., Nelson, K. K., and Rountree, B. R. 2009. Auditor Switches in the Pre- and Post-Enron Eras: Risk or Realignment? *The Accounting Review*, 84(2): 531–558. <https://doi.org/10.2308/accr.2009.84.2.531>
- Lee, E., Walker, M., and Zeng, C. 2014. Do Chinese government subsidies affect firm value? *Accounting, Organizations and Society*, 39(3): 149–169. <https://doi.org/10.1016/j.aos.2014.02.002>

- Lennox, C. S., and Wu, X. 2018. A Review of the Archival Literature on Audit Partners. *Accounting Horizons*, 32(2): 1–35. <https://doi.org/10.2308/acch-51942>
- Lennox, C., and Li, B. 2014. Accounting misstatements following lawsuits against auditors. *Journal of Accounting and Economics*, 57(1): 58–75. <https://doi.org/10.1016/j.jacceco.2013.10.002>
- Li, L., Qi, B., Tian, G., and Zhang, G. 2017. The Contagion Effect of Low-Quality Audits at the Level of Individual Auditors. *The Accounting Review*, 92(1): 137–163. <https://doi.org/10.2308/accr-51407>
- Lu, J., and Qiu, Y. 2023. Does non-punitive regulation diminish stock price crash risk? *Journal of Banking & Finance*, 148, 106731. <https://doi.org/10.1016/j.jbankfin.2022.106731>
- Mokken, R. J. 1979. Cliques, clubs and clans. *Quality & Quantity*, 13(2): 161–173. <https://doi.org/10.1007/BF00139635>
- Public Company Accounting Oversight Board (PCAOB). 2016. Auditor Reporting of Certain Audit Participants. Rule 3211. Washington, DC: PCAOB.
- Reichelt, K. J., and Wang, D. 2010. National and Office - Specific Measures of Auditor Industry Expertise and Effects on Audit Quality. *Journal of Accounting Research*, 48(3): 647 – 686. <https://doi.org/10.1111/j.1475-679X.2009.00363.x>
- Robert Knechel, W., Vanstraelen, A., and Zerni, M. 2015. Does the Identity of Engagement Partners Matter? An Analysis of Audit Partner Reporting Decisions. *Contemporary Accounting Research*, 32(4): 1443–1478. <https://doi.org/10.1111/1911-3846.12113>
- Seckler, C., Gronewold, U., and Reihlen, M. 2017. An error management perspective on audit quality: Toward a multi-level model. *Accounting, Organizations and Society*, 62: 21–42. <https://doi.org/10.1016/j.aos.2017.08.004>
- Shi, H., Wen, W., Zhou, G., and Zhu, X. (Kevin). 2021. Do Individual Auditors Have Their Own Styles? Evidence from Clients' Financial Statement Comparability in China. *Accounting Horizons*, 35(3): 187–215. <https://doi.org/10.2308/HORIZONS-18-002>
- Su, L. (Nancy). 2016. Is Audit Behavior Contagious? Teamwork Experience and Audit Quality by Individual Auditors. *SSRN Electronic Journal*. <https://doi.org/10.2139/ssrn.2816435>
- Tang, J., and Liu, C. 2024. Financial comment letters, geographic proximity and audit quality. *Asia-Pacific Journal of Accounting & Economics*, 31(2): 196–220. <https://doi.org/10.1080/16081625.2022.2147969>
- Tao, H., and Cao, S. 2019. Exchange' s Non-penalty Regulation on Audit Quality: Inquiry Letters' Information Effect and Supervision Effect. *Journal of Audit & Economics*, 2019(2): 8 – 18. (In Chinese).
- Wang, L., Wu, D., and Zhao, Y. 2022. Network Connectedness and the Convergence of Audit Styles. *SSRN Electronic Journal*. <https://doi.org/10.2139/ssrn.4086247>
- Wang, R., Tian, Y., and He, X. 2020. Technical efficiency characteristics and the policy sensitivity of environmental protection enterprises: Micro evidence from China. *Journal of Cleaner Production*, 256, 120752. <https://doi.org/10.1016/j.jclepro.2020.120752>
- Westermann, K. D., Bedard, J. C., and Earley, C. E. 2015. Learning the “Craft” of Auditing: A Dynamic View of Auditors' On - the - Job Learning. *Contemporary Accounting Research*, 32(3): 864 – 896. <https://doi.org/10.1111/1911-3846.12107>
- Wilson Jr., T. E., and Grimlund, R. A. 1990. An Examination of the Importance of an Auditor's Reputation. *Auditing: A Journal of Practice & Theory*, 9(2): 43–59.

- Ye, F., Shi, W., and Liu, F. 2022. Audit Style: An Exploratory Analysis Framework. *Auditing Research*, 2022(1), 73–81. (In Chinese).
- Zhan Shu, S. 2000. Auditor resignations: Clientele effects and legal liability. *Journal of Accounting and Economics*, 29(2): 173–205. [https://doi.org/10.1016/S0165-4101\(00\)00019-7](https://doi.org/10.1016/S0165-4101(00)00019-7)

APPENDIX

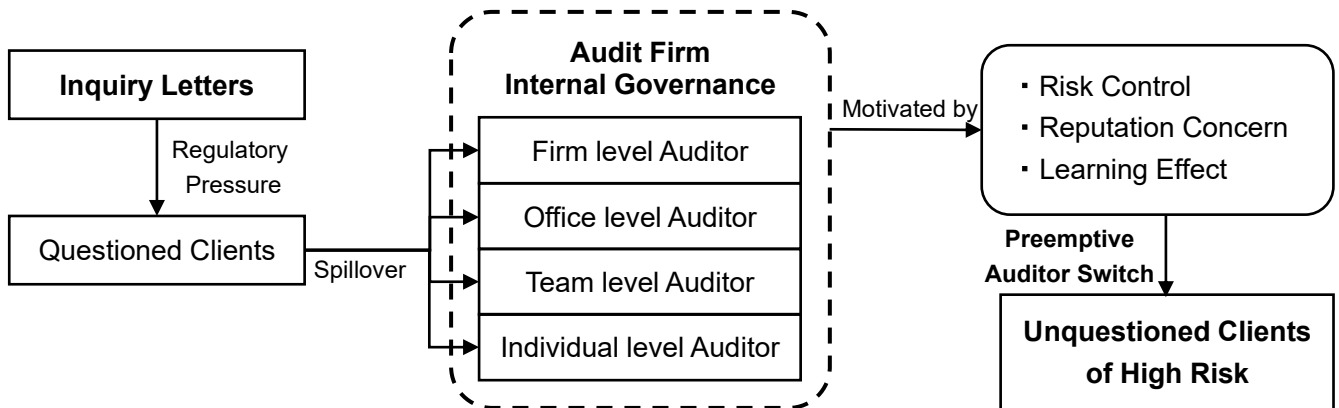


Figure 1 Research Framework

Table 1 Sample Selection Process

Sample of all A-share listed companies from 2015 to 2021	26117
Less: Companies in financial industry, and ST or PT labeled stocks	2557
Companies with missing data	3093
Companies audited by Rui Hua CPA firm in 2019	321
Companies questioned by inquiries letters	2033
Final sample for main regression	18113

Table 2 Variable Definitions

Variables	Definitions and Calculations
Dependent Variable:	
<i>Change</i>	An indicator variable for auditor switches, which equals one if a company's auditing firm for the current year is different from that of the previous year, and zero otherwise.
Independent Variable:	
<i>LetterRec_X</i>	The natural logarithm of one plus the number of inquiry letters over annual reports received by questioned clients of auditors at each level for one year. X is taken to be the Firm, Office, Team, and Auditor, respectively.
<i>High_Risk</i>	An indicator variable for high business risk of the unquestioned client, which equals one if the Altman's bankruptcy risk index (Z-Score) adjusted for China's capital market is higher than the sample mean and zero otherwise.
Control Variables at all Four Levels of Auditors:	
<i>All_Client_X</i>	The natural logarithm of one plus the number of clients served by the auditor at each auditor level. X is taken to be Firm, Office, Team, and Auditor, respectively.
Control Variables of Clients:	
<i>C_ROA</i>	Profitability of the company, calculated as net income divided by total assets.
<i>C_Loss</i>	An indicator variable that equals one if the company's net income is negative, and zero otherwise.
<i>C_NR</i>	An indicator variable that equals one if the company's yearly stock return is negative, and zero otherwise.
<i>C_LnA</i>	The size of the company, taken as the natural logarithm of total assets.
<i>C_TbQ</i>	Tobin's Q of the company, and is calculated by using the formula: (market value of equity + book value of debts)/total assets.
<i>C_Lev</i>	Leverage of the company, calculated as total liabilities divided by total assets.
<i>C_SOE</i>	An indicator variable that equals one if the company is state-owned, and zero otherwise.
<i>C_Cash</i>	The ratio of cash to total assets
<i>C_BigOne</i>	The number of shares held by the company's largest shareholders divided by the shareholdings of other large shareholders
Control Variables at the Audit Firm Level:	
<i>A_Income</i>	The natural logarithm of the total annual income of the audit firm.
<i>A_Salary</i>	The natural logarithm of average salary of CPAs in the audit firm.
<i>A_Bigfour</i>	An indicator variable that equals one if the audit firm is an international Big4 CPA firm, and zero otherwise.
<i>A_Bigten</i>	An indicator variable that equals one if the audit firm is a top ten CPA firm in China, and zero otherwise.
Control Variables at the Audit Office Level:	
<i>A_If_Office</i>	An indicator variable that equals one if any of the signing auditors for the client comes from the branch office rather than the headquarter, and zero otherwise.
<i>A_Auditor_Num</i>	The natural logarithm of one plus the number of auditors within the audit office.
Control Variables at the Audit Team Level:	

<i>A_Team_Size</i>	The natural logarithm of one plus the number of signing auditors within the audit team.
--------------------	---

Control Variables at the Individual Auditor Level:

<i>A_Experience</i>	The average number of years since the signing auditors for the client have obtained CPA certificates.
<i>A_Gender</i>	Auditor gender index. Male and female auditor are assigned a value of 0.5 and 0, respectively. The auditor gender index is calculated by summing up the gender values of all signing auditors for a client.
<i>A_Level</i>	Index of auditor position level. The position level of signing auditors is divided into three categories: senior, intermediate, and junior, with a value of 1, 0.5, and 0 respectively. This index is calculated by summing up the position-level values of all signing auditors for a client.

Table 3 Descriptive Statistics

Table 3 presents the descriptive statistics for the key variables used in our research. All continuous variables are winsorized at the 1st and 99th percentiles. Detailed variable definitions are reported in Table 2.

	Min	Mean	Max	Std	Obs.
<i>Change</i>	0.00	0.07	1.00	0.25	18,113
<i>Letter_Rec_Auditor</i>	0.00	0.24	1.95	0.39	18,113
<i>Letter_Rec_Team</i>	0.00	0.80	3.14	0.74	18,113
<i>Letter_Rec_Office</i>	0.00	1.50	3.76	1.09	18,113
<i>Letter_Rec_Firm</i>	0.00	2.79	4.43	1.11	18,113
<i>High_Risk</i>	0.00	0.50	1.00	0.50	18,113
<i>All_Client_Auditor</i>	0.69	1.59	3.00	0.48	18,113
<i>All_Client_Team</i>	0.69	2.63	4.97	0.93	18,113
<i>All_Client_Office</i>	0.69	3.58	5.90	1.32	18,113
<i>All_Client_Firm</i>	1.10	5.07	6.37	1.01	18,113
<i>C_ROA</i>	-0.46	0.04	0.22	0.07	18,113
<i>C_Loss</i>	0.00	0.10	1.00	0.30	18,113
<i>C_Cash</i>	0.00	0.17	0.98	0.12	18,113
<i>C_LnA</i>	15.98	22.37	28.64	1.34	18,113
<i>C_TbQ</i>	0.80	2.17	17.65	1.58	18,113
<i>C_Lev</i>	0.05	0.42	0.93	0.20	18,113
<i>C_NR</i>	0.00	0.51	1.00	0.50	18,113
<i>C_BigOne</i>	1.01	7.63	102.08	11.99	18,113
<i>C_SOE</i>	0.00	0.33	1.00	0.47	18,113
<i>A_Income</i>	8.99	11.98	13.43	0.91	18,113
<i>A_Salary</i>	46.00	151.13	472.21	66.97	18,113
<i>A_Auditor_Num</i>	0.00	4.89	6.93	1.27	18,113
<i>A_If_Office</i>	0.00	0.56	1.00	0.50	18,113
<i>A_Team_Size</i>	0.69	2.59	4.64	0.86	18,113
<i>A_Level</i>	0.00	0.69	3.00	0.62	18,113
<i>A_Experience</i>	1.00	21.71	42.00	5.10	18,113
<i>A_Gender</i>	0.00	0.67	1.50	0.35	18,113
<i>A_Bigten</i>	0.00	0.60	1.00	0.49	18,113
<i>A_Bigfour</i>	0.00	0.06	1.00	0.24	18,113

Table 4 Inquiry Letters and Auditor Switches

Table 4 estimates the relationship between inquiry letters received (*Letter_Rec_X*) and auditor switches from unquestioned clients (*Change*). Columns (1) to (4) show the impact of inquiry letters at the individual auditor, team, office, and firm levels, respectively. The coefficients of *Letter_Rec_X* \times *High_Risk* are our coefficients of interest. T-statistics are reported in parentheses. All continuous variables are winsorized at the 1st and 99th percentiles. Regressions use robust standard errors. *, **, and *** indicate significance at two-tailed probability levels of 10%, 5%, and 1%. Detailed variable definitions are reported in Table 2.

<i>Y = Change</i>	(1) X= Auditor	(2) X= Team	(3) X= Office	(4) X= Firm
<i>Letter_Rec_X</i> \times <i>Low_Risk</i>	0.064 (0.48)	0.057 (0.80)	0.086 (1.24)	0.120 (1.04)
<i>Letter_Rec_X</i> \times <i>High_Risk</i>	0.306*** (3.97)	0.179*** (2.84)	0.232*** (3.98)	0.248*** (2.73)
<i>High_Risk</i>	0.181*** (2.89)	0.139 (1.40)	0.009 (0.07)	-0.125 (-0.67)
<i>All_Client_X</i>	-0.217*** (-2.76)	-0.076 (-0.72)	0.105 (1.04)	-0.578*** (-7.47)
<i>C_ROA</i>	-1.129 (-1.01)	-1.145 (-1.03)	-1.134 (-1.02)	-1.120 (-0.99)
<i>C_Loss</i>	0.080 (0.38)	0.085 (0.41)	0.091 (0.43)	0.088 (0.42)
<i>C_Cash</i>	-0.680* (-1.90)	-0.690* (-1.91)	-0.680* (-1.93)	-0.658* (-1.83)
<i>C_LnA</i>	-0.042 (-0.99)	-0.040 (-0.95)	-0.039 (-0.95)	-0.043 (-1.01)
<i>C_TbQ</i>	0.056* (1.74)	0.056* (1.78)	0.059* (1.88)	0.053* (1.68)
<i>C_Lev</i>	-0.258 (-0.93)	-0.253 (-0.91)	-0.260 (-0.92)	-0.269 (-0.97)
<i>C_NR</i>	0.037 (0.38)	0.038 (0.39)	0.041 (0.40)	0.037 (0.37)
<i>C_BigOne</i>	-0.003 (-1.21)	-0.003 (-1.20)	-0.003 (-1.26)	-0.003 (-1.19)
<i>C_SOE</i>	0.262** (2.50)	0.265** (2.51)	0.282*** (2.73)	0.238** (2.26)
<i>A_Income</i>	-0.035 (-0.39)	-0.030 (-0.32)	-0.072 (-0.81)	0.312** (2.39)
<i>A_Inc_Aud</i>	0.003* (1.92)	0.003* (1.78)	0.003* (1.70)	0.003* (1.67)
<i>A_Auditor_Num</i>	0.211*** (6.65)	0.205*** (6.20)	0.026 (0.34)	0.229*** (7.01)
<i>A_If_Office</i>	0.681*** (7.38)	0.673*** (7.11)	0.740*** (6.59)	0.686*** (7.39)
<i>A_Team_Size</i>	-0.076 (-1.61)	-0.121 (-1.05)	-0.169*** (-3.42)	-0.064* (-1.76)
<i>A_Experience</i>	-0.053 (-1.15)	-0.052 (-1.12)	-0.037 (-0.83)	-0.045 (-1.03)
<i>A_Level</i>	-0.005 (-0.83)	-0.006 (-0.99)	-0.005 (-0.83)	-0.004 (-0.75)
<i>A_Gender</i>	-0.031 (-0.40)	-0.042 (-0.56)	-0.031 (-0.40)	-0.040 (-0.53)
<i>A_Bigten</i>	-0.140 (-1.17)	-0.149 (-1.23)	-0.181 (-1.45)	0.036 (0.29)

<i>A_Bigfour</i>	-1.044** (-2.25)	-0.949** (-1.98)	-0.540 (-1.31)	-1.566*** (-3.50)
<i>Constant</i>	-2.556*** (-2.75)	-2.675*** (-2.95)	-1.896** (-1.99)	-4.461*** (-3.61)
Year FE	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes
Marginal Effects at Mean:				
<i>Letter_Rec_X</i>	0.019*** (3.85)	0.004*** (2.69)	0.016*** (3.48)	0.020** (2.07)
Observations	18,113	18,113	18,113	18,113
Pseudo R2	0.030	0.030	0.032	0.033

Table 5 Alternative Measures of Inquiry Letters

Table 5 reports the robustness tests for alternative measures of independent variables. In Panel A, we use *Historical_Letter_Rec_X*, which is the total number of inquiry letters received by auditors at each level since 2015; in Panel B, we use *Ratio_Letter_Rec_X*, which equals the number of inquiry letters received divided by the number of clients for auditors at each level; in Panel C, we use *Reply_Letter_Rec_X*, which is the number of inquiry letters that require auditors' response at each auditor level. Columns (1) to (4) show the impact of inquiry letters at the individual auditor, team, office, and firm levels, respectively. T-statistics are reported in parentheses. All continuous variables are winsorized at the 1st and 99th percentiles. *, **, and *** indicate significance at two-tailed probability levels of 10%, 5%, and 1%. Detailed variable definitions are reported in Table 2.

Panel A	(1)	(2)	(3)	(4)
Y= <i>Change</i>	X= Auditor	X= Team	X= Office	X= Firm
<i>Historical_Letter_Rec_X</i>	0.051	0.136*	0.130*	0.219*
× <i>Low_Risk</i>	(0.47)	(1.89)	(1.82)	(1.88)
<i>Historical_Letter_Rec_X</i>	0.189***	0.211***	0.233***	0.318**
× <i>High_Risk</i>	(3.14)	(3.21)	(3.31)	(2.54)
<i>High_Risk</i>	0.159*	0.127	-0.005	-0.129
	(1.77)	(0.89)	(-0.03)	(-0.57)
Controls	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes
Observations	18,113	18,113	18,113	18,113
Pseudo R2	0.030	0.030	0.033	0.031
Panel B	(1)	(2)	(3)	(4)
Y= <i>Change</i>	X= Auditor	X= Team	X= Office	X= Firm
<i>Ratio_Letter_Rec_X</i>	0.165	0.376	0.639	2.480***
× <i>Low_Risk</i>	(0.51)	(0.94)	(1.51)	(3.74)
<i>Ratio_Letter_Rec_X</i>	0.458***	0.643**	0.210	1.291***
× <i>High_Risk</i>	(2.60)	(2.44)	(0.65)	(2.69)
<i>High_Risk</i>	0.198***	0.196***	0.267***	0.367***
	(2.95)	(2.90)	(4.22)	(3.59)
Controls	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes
Observations	18,113	18,113	18,113	18,113
Pseudo R2	0.026	0.026	0.026	0.028
Panel C	(1)	(2)	(3)	(4)
Y= <i>Change</i>	X= Auditor	X= Team	X= Office	X= Firm
<i>Reply_Letter_Rec_X</i>	0.360*	0.178**	-0.002	-0.079**
× <i>Low_Risk</i>	(1.82)	(2.42)	(-0.03)	(-2.04)
<i>Reply_Letter_Rec_X</i>	0.528***	0.258***	0.146**	0.015
× <i>High_Risk</i>	(5.68)	(3.77)	(2.03)	(0.28)
<i>High_Risk</i>	0.209***	0.195**	0.065	0.026
	(2.96)	(2.39)	(0.59)	(0.19)
Controls	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes
Observations	18,113	18,113	18,113	18,113
Pseudo R2	0.032	0.030	0.031	0.032

Table 6 Textual Measures of Auditor Resignation

Table 6 estimates the relationship between inquiry letters received (*Letter_Rec_X*) and auditor resignation from unquestioned clients (*Resignation*). Columns (1) to (4) show the impact of inquiry letters at the individual auditor, team, office, and firm levels, respectively. The coefficients of *Letter_Rec_X* × *High_Risk* are our coefficients of interest. T-statistics are reported in parentheses. All continuous variables are winsorized at the 1st and 99th percentiles. Regressions use robust standard errors. *, **, and *** indicate significance at two-tailed probability levels of 10%, 5%, and 1%. Detailed variable definitions are reported in Table 2. Samples are missing for the inability to implement logit maximum likelihood estimation.

<i>Y = Resignation</i>	(1)	(2)	(3)	(4)
	X= Auditor	X= Team	X= Office	X= Firm
<i>Letter_Rec_X</i> × <i>Low_Risk</i>	-0.236 (-0.42)	-0.235 (-0.70)	-0.423 (-1.26)	0.399 (1.56)
<i>Letter_Rec_X</i> × <i>High_Risk</i>	0.466* (1.94)	0.391* (1.74)	0.211 (1.03)	0.770** (2.27)
<i>High_Risk</i>	0.198*** (2.95)	0.196*** (2.90)	0.267*** (4.22)	0.367*** (3.59)
Controls	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes
Audit Firm FE	Yes	Yes	Yes	Yes
Observations	15,303	15,303	15,303	15,303
Pseudo R2	0.085	0.087	0.090	0.088

Table 7 Alternative Measures of Client Risks

Table 7 reports the robustness tests for alternative measures of client risks. In Panel A, we use *Loss* to measure client risks, which equals one if the client's net income is less than zero; in Panel B, we use *Restatement* to measure client risks, which equals one if the annual report issues restatements. Columns (1) to (4) show the impact of inquiry letters at the individual auditor, team, office, and firm levels, respectively. T-statistics are reported in parentheses. All continuous variables are winsorized at the 1st and 99th percentiles. *, **, and *** indicate significance at two-tailed probability levels of 10%, 5%, and 1%. Detailed variable definitions are reported in Table 2. Samples are missing for the inability to implement logit maximum likelihood estimation.

Panel A	(1)	(2)	(3)	(4)
Y= <i>Change</i>	X= Auditor	X= Team	X= Office	X= Firm
<i>Letter_Rec_X</i> × (1 - <i>Loss</i>)	0.192* (1.90)	0.158 (1.24)	0.169*** (3.06)	0.192** (1.98)
<i>Letter_Rec_X</i> × <i>Loss</i>	0.318** (2.02)	0.124** (2.42)	0.179** (2.04)	0.196* (1.66)
<i>Loss</i>	0.045 (0.25)	0.057 (0.34)	0.073 (0.28)	0.076 (0.33)
Controls	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes
Observations	18,113	18,113	18,113	18,113
Pseudo R2	0.029	0.028	0.030	0.031
Panel B	(1)	(2)	(3)	(4)
Y= <i>Change</i>	X= Auditor	X= Team	X= Office	X= Firm
<i>Letter_Rec_X</i> × (1 - <i>Restatement</i>)	0.152 (1.56)	0.051 (0.78)	0.115* (1.84)	0.136 (1.47)
<i>Letter_Rec_X</i> × <i>Restatement</i>	0.285** (2.53)	0.246*** (3.47)	0.257*** (3.69)	0.311*** (2.82)
<i>Restatement</i>	0.254*** (4.22)	0.115 (1.25)	0.064 (0.56)	-0.238* (-1.76)
Controls	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes
Observations	18,113	18,113	18,113	18,113
Pseudo R2	0.031	0.031	0.033	0.034

Table 8 Additional Fixed Effects

Table 7 reports the robustness tests for including additional fixed effects in the model. In Panel A, we control audit firm fixed effects; in Panel B we control audit firm fixed effects and office location fixed effects. Columns (1) to (4) show the impact of inquiry letters at the individual auditor, team, office, and firm levels, respectively. The coefficients of *Letter_Rec_X* × *High_Risk* are our coefficients of interest. T-statistics are reported in parentheses. All continuous variables are winsorized at the 1st and 99th percentiles. *, **, and *** indicate significance at two-tailed probability levels of 10%, 5%, and 1%. Detailed variable definitions are reported in Table 2.

Panel A	(1)	(2)	(3)	(4)
Y= <i>Change</i>	X= Auditor	X= Team	X= Office	X= Firm
<i>Letter_Rec_X</i> × <i>Low_Risk</i>	0.043 (0.35)	0.014 (0.22)	0.056 (0.81)	0.057 (0.39)
<i>Letter_Rec_X</i> × <i>High_Risk</i>	0.293*** (3.89)	0.134*** (2.64)	0.179*** (3.19)	0.183* (1.14)
<i>High_Risk</i>	0.209*** (3.18)	0.171* (1.77)	0.072 (0.64)	-0.059 (-0.36)
Controls	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes
Audit Firm FE	Yes	Yes	Yes	Yes
Observations	18,067	18,067	18,067	18,067
Pseudo R2	0.068	0.067	0.068	0.067
Panel B	(1)	(2)	(3)	(4)
Y= <i>Change</i>	X= Auditor	X= Team	X= Office	X= Firm
<i>Letter_Rec_X</i> × <i>Low_Risk</i>	0.074 (0.60)	0.026 (0.44)	0.052 (0.74)	0.076 (0.51)
<i>Letter_Rec_X</i> × <i>High_Risk</i>	0.290*** (3.78)	0.133*** (2.65)	0.155*** (2.58)	0.199* (1.68)
<i>High_Risk</i>	0.199*** (3.01)	0.164* (1.69)	0.081 (0.67)	-0.069 (-0.43)
Controls	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes
Audit Firm FE	Yes	Yes	Yes	Yes
Office Location FE	Yes	Yes	Yes	Yes
Observations	18,048	18,048	18,048	18,048
Pseudo R2	0.081	0.080	0.082	0.080

Table 9 Heckman Test

Table 9 reports the second step of the Heckman tests. Columns (1) to (4) show the impact of inquiry letters at the individual auditor, team, office, and firm levels, respectively. The coefficients of *Letter_Rec_X* × *High_Risk* are our coefficients of interest. T-statistics are reported in parentheses. All continuous variables are winsorized at the 1st and 99th percentiles. *, **, and *** indicate significance at two-tailed probability levels of 10%, 5%, and 1%. Detailed variable definitions are reported in Table 2.

<i>Y = Change</i>	(1)	(2)	(3)	(4)
	X= Auditor	X= Team	X= Office	X= Firm
<i>Letter_Rec_X</i> × <i>Low_Risk</i>	0.427*** (2.93)	0.260 (1.59)	0.404*** (4.67)	0.242* (1.88)
<i>Letter_Rec_X</i> × <i>High_Risk</i>	0.295** (2.18)	0.145* (1.91)	0.162** (2.45)	0.145** (2.46)
<i>High_Risk</i>	0.161** (2.51)	0.108 (1.14)	-0.034 (-0.25)	-0.200 (-1.13)
<i>IMR</i>	-1.000*** (-3.21)	-1.278 (-1.42)	-2.376*** (-4.89)	-2.881*** (-4.03)
Controls	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes
Observations	18,113	18,113	18,113	18,113
Pseudo R2	0.031	0.030	0.033	0.034

Table 10 PSM-DID Test

Table 10 reports the results of a PSM-DID model. *First_Letter_Rec_X* is an indicator variable which equal ones since the company's auditor has received an inquiry letter for the first time and zero otherwise. Columns (1) to (4) show the impact of inquiry letters at the individual auditor, team, office, and firm levels, respectively. The coefficients of *First_Letter_Rec_X* × *High_Risk* are our coefficients of interest. T-statistics are reported in parentheses. All continuous variables are winsorized at the 1st and 99th percentiles. *, **, and *** indicate significance at two-tailed probability levels of 10%, 5%, and 1%. Detailed variable definitions are reported in Table 2. Samples are missing for the absence of common support regions in the PSM.

<i>Y= Change</i>	(1)	(2)	(3)	(4)
	X= Auditor	X= Team	X= Office	X= Firm
<i>First_Letter_Rec_X</i> × <i>Low_Risk</i>	0.127 (1.23)	0.021 (0.14)	1.255*** (5.60)	2.076** (2.44)
<i>First_Letter_Rec_X</i> × <i>High_Risk</i>	0.228** (2.32)	0.400*** (2.88)	0.569*** (3.24)	0.974*** (2.63)
<i>High_Risk</i>	0.235** (2.20)	-0.071 (-0.43)	0.755*** (3.21)	4.227*** (5.12)
Controls	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes
Observations	18,013	14,158	9,166	1,652
Pseudo R2	0.106	0.135	0.146	0.402

Table 11 SOEs vs. Non-SOEs

Table 11 estimates the relationship between inquiry letters received (*Letter_Rec_X*) and auditor switches from unquestioned clients (*Change*) for state-owned versus non-state-owned enterprises. The coefficients of *Letter_Rec_X* \times *High_Risk* are our coefficients of interest. T-statistics are reported in parentheses. All continuous variables are winsorized at the 1st and 99th percentiles. *, **, and *** indicate significance at two-tailed probability levels of 10%, 5%, and 1%. Detailed variable definitions are reported in Table 2. Samples are missing for the inability to implement logit maximum likelihood estimation.

	X= Auditor		X= Team		X= Office		X= Firm	
Y= <i>Change</i>	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	SOE	Non-SOE	SOE	Non-SOE	SOE	Non-SOE	SOE	Non-SOE
<i>Letter_Rec_X</i>	0.016	0.064	-0.047	0.075	0.038	0.119	-0.165	0.291**
\times <i>Low_Risk</i>	(0.06)	(0.59)	(-0.39)	(0.94)	(0.30)	(1.03)	(-1.32)	(2.04)
<i>Letter_Rec_X</i>	0.106	0.368***	0.138	0.134**	0.098	0.284***	-0.172	0.480***
\times <i>High_Risk</i>	(0.86)	(4.09)	(1.22)	(2.53)	(0.75)	(4.38)	(-1.28)	(5.24)
<i>High_Risk</i>	0.043	0.265***	-0.070	0.296**	-0.020	0.074	0.075	-0.198
	(0.33)	(3.12)	(-0.41)	(2.53)	(-0.12)	(0.46)	(0.27)	(-0.98)
Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Diff. in Coeff	p=0.08*		p=0.43		p=0.10*		p=0.00***	
Observations	5,937	12,117	5,937	12,117	5,937	12,117	5,937	12,117
Pseudo R2	0.023	0.053	0.023	0.051	0.023	0.054	0.026	0.057

Table 12 Top Ten vs Other Audit Firms

Table 12 estimates the relationship between inquiry letters received (*Letter_Rec_X*) and auditor switches from unquestioned clients (*Change*) for the top ten verses the non-top ten audit firms. The coefficients of *Letter_Rec_X* \times *High_Risk* are our coefficients of interest. T-statistics are reported in parentheses. All continuous variables are winsorized at the 1st and 99th percentiles. *, **, and *** indicate significance at two-tailed probability levels of 10%, 5%, and 1%. Detailed variable definitions are reported in Table 2.

Y= <i>Change</i>	X= Auditor		X= Team		X= Office		X= Firm	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Top Ten	Non-Top Ten	Top Ten	Non-Top Ten	Top Ten	Non-Top Ten	Top Ten	Non-Top Ten
<i>Letter_Rec_X</i>	-0.018	0.114	0.044	-0.087	-0.010	-0.287	0.597***	-0.111
\times <i>Low_Risk</i>	(-0.15)	(0.32)	(0.59)	(-0.43)	(-0.13)	(-1.35)	(4.28)	(-0.66)
<i>Letter_Rec_X</i>	0.382***	0.122	0.166***	0.237*	0.176**	0.249**	0.909***	0.060
\times <i>High_Risk</i>	(3.82)	(0.87)	(2.66)	(1.76)	(2.07)	(1.97)	(6.41)	(0.56)
<i>High_Risk</i>	0.118	0.448**	0.119	0.221	-0.112	-0.095	-0.775***	0.096
	(1.49)	(2.47)	(0.92)	(1.01)	(-0.95)	(-0.34)	(-2.94)	(0.27)
Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Diff. in Coeff	p=0.10*		p=0.33		p=0.28		p=0.00***	
Observations	10,957	7,156	10,957	7,156	10,957	7,156	10,957	7,156
Pseudo R2	0.038	0.052	0.035	0.054	0.037	0.061	0.037	0.055

Table 13 Experienced vs. Inexperienced Auditors

Table 13 estimates the relationship between inquiry letters received (*Letter_Rec_X*) and auditor switches from unquestioned clients (*Change*) for experienced versus inexperienced auditors. The coefficients of *Letter_Rec_X* \times *High_Risk* are our coefficients of interest. T-statistics are reported in parentheses. All continuous variables are winsorized at the 1st and 99th percentiles. *, **, and *** indicate significance at two-tailed probability levels of 10%, 5%, and 1%. Detailed variable definitions are reported in Table 2.

	X= Auditor		X= Team		X= Office		X= Firm	
Y= <i>Change</i>	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Experienced	Inexperienced	Experienced	Inexperienced	Experienced	Inexperienced	Experienced	Inexperienced
<i>Letter_Rec_X</i> \times <i>Low_Risk</i>	0.178 (0.94)	-0.123 (-0.75)	-0.083 (-0.62)	0.222*** (2.76)	-0.091 (-0.72)	-0.064 (-0.70)	0.002 (0.01)	0.265* (1.74)
<i>Letter_Rec_X</i> \times <i>High_Risk</i>	0.296** (2.49)	0.314** (2.38)	0.063 (0.58)	0.280*** (2.87)	0.139 (1.11)	0.073 (0.75)	0.042 (0.22)	0.465*** (3.48)
<i>High_Risk</i>	0.099 (0.84)	0.253** (2.15)	0.257*** (2.65)	0.072 (0.49)	0.007 (0.04)	-0.010 (-0.04)	0.050 (0.20)	-0.241 (-1.13)
Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Diff. in Coeff	p=0.42		p=0.05**		p=0.49		p=0.00***	
Observations	9,586	8,527	9,016	9,097	8,864	9,249	9,125	8,972
Pseudo R2	0.050	0.032	0.055	0.043	0.040	0.082	0.041	0.056

Table 14 Inquiry Letters and Other Auditor Responses

Table 14 reports the impact of inquiry letters on two other audit behaviors. In Panel A, the dependent variables are audit delays (*Delays*); in Panel B, the dependent variables are the changes in audit fees ($\Delta Fees$). Columns (1) to (4) show the impact of inquiry letters at the individual auditor, team, office, and firm levels, respectively. The coefficients of *Letter_Rec_X* \times *High_Risk* are our coefficients of interest. T-statistics are reported in parentheses. *, **, and *** indicate significance at two-tailed probability levels of 10%, 5%, and 1%. Detailed variable definitions are reported in Table 2.

Panel A	(1)	(2)	(3)	(4)
Y= <i>Delays</i>	X= Auditor	X= Team	X= Office	X= Firm
<i>Letter_Rec_X</i> \times <i>Low_Risk</i>	-0.004 (-0.65)	0.005 (0.99)	0.004 (0.76)	0.003 (0.59)
<i>Letter_Rec_X</i> \times <i>High_Risk</i>	0.017* (1.73)	0.008** (2.12)	0.003 (0.72)	0.008 (1.49)
<i>High_Risk</i>	0.001 (0.18)	0.004 (0.38)	0.007 (0.77)	-0.007 (-0.59)
Controls	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes
Observations	16,925	16,925	16,925	16,925
R2	0.105	0.105	0.105	0.105
Panel B	(1)	(2)	(3)	(4)
Y= $\Delta Fees$	X= Auditor	X= Team	X= Office	X= Firm
<i>Letter_Rec_X</i> \times <i>Low_Risk</i>	0.004 (0.53)	0.006 (1.02)	0.002 (0.36)	0.014* (1.90)
<i>Letter_Rec_X</i> \times <i>High_Risk</i>	0.017* (1.87)	0.011** (2.39)	0.004 (0.68)	0.016* (1.88)
<i>High_Risk</i>	0.002 (0.34)	0.001 (0.19)	0.002 (0.16)	0.001 (0.08)
Controls	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes
Observations	16,925	16,925	16,925	16,925
R2	0.015	0.015	0.015	0.015