

Real-time comment letters: evidence from China

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Abstract

This study examines Chinese comment letters that are issued to firms and announced to investors at the same time, including letters targeting annual reports (annual report letters) and filings relating to planned restructurings (restructuring letters). Specifically, the paper investigates the determinants of a firm's receipt of a comment letter, as well as how the severity of a comment letter affects the recipient's market reaction to the receipt of the letter and future negative consequences. I find that the stock exchanges are more likely to issue comment letters to firms heavily speculated on by the media or searched online by investors. The three-day market reaction to the receipt of an annual report letter is significantly negative and decreases in the number of accusatory statements (e.g. "big bath," "earnings management," and "inflate earnings" etc.) in the letter. The severity of annual report letters is associated with future poor disclosure rating given by the stock exchanges and accounting-related enforcement actions. The severity of restructuring letters is strongly predictive of the cancellation of restructuring deals, especially when firms are accused of using a restructuring deal to disguise a reverse takeover, or ordered to hold a conference call with the media to discuss a deal. Overall, the paper demonstrates that comment letters can uncover significant negative news on a firm and lead to real consequences in an emerging market.

1. Introduction

An emerging literature has studied the determinants and consequences of the SEC comment letters issued to firms publicly listed in the US. Comment letters contain specific questions on firms' filings about financial reporting and disclosure compliance and require firms to address the questions through correspondence. The conversation continues until all the questions are resolved, and only then the entire conversation will be released to the public. However, in most cases, the SEC comment letters do not discover material reporting deficiencies that demand immediate remedies. Short-window abnormal returns to the releases of comment letters are generally very moderate (average two-day abnormal market reaction 0.0005), only 0.5% of reviewed firms materially restate their financials during the correspondence period, and comment letters are infrequently downloaded and rarely covered by the media (Dechow et al., 2016; Ryans, 2018). The lack of widespread discovery of financial misreporting by the SEC comment letters might lie in the fact that US-listed firms already have high quality financial reporting in the first place. If emerging markets adopt the similar review system as the SEC, however, comment letters have the potential to uncover far more serious financial misreporting given the lower disclosure quality on average. Furthermore, comment letters might lead to adverse consequences that are unlikely to happen in the US, such as enforcements or lost investment opportunities. A unique situation in China enables this paper to answer these questions—Chinese stock exchanges adopt the SEC-style review system, except that they publish comment letters as the letters are issued, i.e. Chinese comment letters are real-time.

China's institutions characterized by strong government power, concentrated ownership, a weak judicial system, and poor investor and property protection, do not foster incentives for transparent financial reporting (Piotroski, 2014). For example, Chinese firms do not recognize

economic losses in a timely fashion (Ball et al., 2000) and Chinese stocks strongly co-move with the market due to the lack of firm-specific information flows (Morck et al., 2000). There is also ample evidence of Chinese firms' earnings management (e.g. Chen and Yuan, 2004). On the other hand, incentives such as enhancing the international reputation of Chinese stock exchanges motivate China to actively improve the information environment and investor protection (Economic Information Daily, 2017). For example, after including China in the MSCI Emerging Markets Index, MSCI threatens to expel firms that willfully suspend their stock trading (Reuters, 2017). Correspondingly, Chinese stock exchanges start to clamp down on trading suspensions (Financial Times, 2018). The paper examines the determinants and consequences of comment letters issued by Chinese stock exchanges. Because stock exchanges are incentivized to encounter the lack of investor protection resulting from the other Chinese institutions, they should scrutinize more intensely firms that investors are most eager to extract information from. Moreover, due to the poor financial reporting of Chinese firms, comment letters are likely to reveal significant disclosure problems, even accounting frauds. Comment letters that ask voluminous or damaging questions, or severe comment letters, can convey to the market brand new bad news and trigger more adverse market reactions. Severe comment letters on periodic financial reports update the stock exchanges' assessment about firms' financial misreporting risk and alert the CSRC, China's analog to the SEC. Severe comment letters on filings relating to planned restructurings cast doubt on the quality of or the incentives behind the deals, and management is forced to either answer tough questions or forgo the deals in plain view due to the real-time nature of comment letters. Formally, I hypothesize that the market's attention in a firm is positively associated with the firm's likelihood of receiving a comment letter; the severity of a comment letter is negatively associated with the market reaction to the receipt of the letter and

positively associated with a firm's future negative consequences, including poor disclosure rating given by the stock exchanges, accounting-related enforcement actions from either the stock exchanges or the CSRC, and cancellations of restructurings.

However, there are also reasons to question the efficacy of the review process in China. Although Chinese financial reporting and governance standards and regulations converge to Western countries and look "good on paper," standards and regulations alone will not be effective without changes in enforcement (Christensen et al., 2013). For example, China claims to be an adopter of IFRS, but the international accounting professional bodies do not consider China IFRS-compliant yet (IFRS.org, 2018). Despite Chinese stock exchanges modelling the review process off the SEC, the process can be another "good on paper" mechanism that is perfunctory and lacking in consequences.

I collect two major categories of Chinese comment letters, letters that target annual reports (annual report letters) and letters that target filings relating to planned restructurings (restructuring letters) issued by Shenzhen and Shanghai stock exchanges from 2015 (when the stock exchanges start publicly publishing comment letters) to 2018.¹ Manually reading annual report letters reveals that the stock exchanges conduct their own financial statement analyses and comment on individual financial statement line items. The mean (median) of three-day abnormal returns surrounding the receipt of comment letters is -1%, and the mean (median) of three-day abnormal returns surrounding firm announcements of delaying responses is -0.9%. The sizable negative market reactions suggest that comment letters release significant bad news, and the inability to address the letters is also construed as a negative signal by investors. These results

¹ Restructurings in China are essentially M&As, except that a restructuring is usually a complicated package deal that involves multiple sub-deals, for example, acquiring several targets, selling some assets and seeking additional financing through a security offering all at one go.

cannot be found in US data because the SEC comment letters are only released after the review concludes.

Using the number of times a firm has to confirm or deny news reports and Baidu (largest Chinese language search engine) search index as measures of the market's attention in a firm, I find that the market attention is a significant determinant of the likelihood of the firm's receiving comment letters. The market reaction to the receipt of a comment letter decreases in the number of accusatory statements in the letter where the stock exchange explicitly accuses the firm of managing earnings or expropriating minority shareholders. Four measures of severity for annual report letters are significantly associated with future poor disclosure rating given by the stock exchanges, and three measures are predictive of future accounting-related enforcement actions. Three measures of severity for restructuring letters are significantly predictive of restructuring cancellations. Through manually coding the content of restructuring letters, I find that a firm is more likely to cancel a restructuring deal when the stock exchange accuses the firm of disguising a reverse takeover as a restructuring deal, or when the stock exchange orders the firm to hold a conference call with the media to explain the deal. These results suggest that the stock exchanges compensate poor investor rights in China by putting difficult questions to firms of which investors want most information. Signals of comment letter severity trigger immediate market reactions and strongly predict adverse consequences, including cancelled investment opportunities, poor disclosure rating and enforcement actions the latter two of which will automatically hinder future security offerings and M&As according to Chinese regulations.

This paper contributes to the literature on comment letters (e.g. Cassell et al., 2013; Johnson and Petacchi, 2017; Dechow et al., 2016). This paper complements the literature by exploring comment letters in an emerging market. Thematically, the paper is mostly related to

Ryans (2018) who examines the signals of important (i.e. severe) 10-K comment letters based on disclosure event abnormal returns, EDGAR downloads and textual classifications that lead to future adverse consequences such as restatements, write-downs and internal control weaknesses. This paper adopts different signals for severe comment letters that are easily observable and explores different, arguably more adverse consequences such as enforcement actions. More importantly, this paper also examines comment letters on restructuring plans and the possibility of firms' calling off the restructurings upon receiving comment letters, a consequence that is unlikely to happen with M&As in the US. Few papers study the real changes in corporate activities resulting from the receipt of comment letters, except Li and Liu (2017) who find that IPO issuers adjust the offer price downwards after receiving comment letters. This paper's finding regarding restructuring letters and eventual deal cancellations adds to the evidence on the real effect of comment letters.

This paper should be of interest to Western investors of Chinese stocks, for example, funds that invest heavily in emerging markets including China. The traditional checks and balances in developed markets are absent in China and firms have more opportunities to withhold bad news and obfuscate disclosures. This paper demonstrates the significant firm-specific bad news discovered by Chinese comment letters that is stock price impactful and predictive of future negative consequences, so foreign investors can benefit from incorporating comment letters in their investment decision-making. This paper should also be of interest to regulators in other emerging markets that aim to enhance their public firms' disclosure quality and consider similar regulatory tools as comment letters.

The rest of the paper is organized as follows. Section 2 develops hypotheses. Section 3 introduces sample selection and research design. Section 4 presents the main results. Section 5 includes additional analyses. Section 6 concludes.

2. Hypothesis development

2.1. Determinants of receiving a comment letter

The stock exchanges in China are not explicit about the inner workings behind the comment letter issuance, such as firm characteristics that are of interest to them. According to the scanty news releases, the stock exchanges review all the public firms' annual reports every year but pay particular attention to certain firms (Shenzhen Stock Exchange, 2018).² Both stock exchanges start publishing some but not all comment letters on their websites in recent years, although it appears that firms listed on Shanghai Stock Exchange are required to announce the receipt of comment letters through formal filings.³ Understanding the determinants of the receipt of a comment letter helps answer whether the stock exchanges choose firms in the most need of regulation and whether the stock exchanges safeguard investors' interest by warning investors through comment letters and forcing opaque firms to disclose more information.

Given the lack of guidelines on the stock exchanges' selection of firms to closely review, I hypothesize the determinants of receiving a comment letter according to the general philosophy of the stock exchanges on regulating firms' disclosures. The stock exchanges in their various listing rules emphasize their reliance on the media, and encourage the media to fulfil their own

² The stock exchanges review annual reports more frequently than the SEC that reviews US public firms' filings at least once every three year.

³ In unreported results, I explore which firms' comment letters are published on Shanghai Stock Exchange's official comment letter page and which firms' comment letters are only announced by firms themselves. There is no significant difference in either letter characteristics or firm characteristics. It is unclear how the stock exchanges select comment letters to publish on their comment letter pages.

“societal responsibility” through information discovery or investigative journalism. For example, the stock exchanges require firms to clarify any news story that contains information previously not publicly disclosed. If a firm does not clarify a news story, the stock exchanges sometimes order the firm into commenting on the story. Firms will receive enforcement actions if they fail to properly clarify news reports, such as calling a story fake when later on it is proven to be true. Due to the lax libel law and the weak judicial system in China, firms do not have much leverage against the media who are unafraid of publishing information, sometimes negative information, previously not in the public domain.⁴ In some sense, the stock exchanges almost cooperate with the media to discipline firms. The governance role of the media is prevalent in other markets, too, such as discovering accounting frauds (Miller, 2006) and unfavorable M&A deals (Liu and McConnell, 2012) in the US and reversing poor corporate governance practices in Russia (Dykes et al, 2008). The media in China intensify the regulation on firms through sounding off first and alerting the regulators. The media’s interest might be an indicator that firms do not disclose material information, or that some market participants have more information than other participants, causing an uneven playfield. The media’s interest might result from market speculation that tends to surround firms with incoming or impending major events. Alternatively, the media reflect the market sentiment that might cause overvaluation of some firms. Regardless of information, rumor or sentiment in the news reports, the stock exchanges closely follow the business press that focuses on firms of interest to investors, and these firms should in return receive more regulatory efforts in the form of comment letters.

Regulating firms selectively is particularly important for emerging markets where resources and means of governing firms are more limited than developed markets. To maximize

⁴ One firm received enforcement actions from the CSRC for using abusive language against a reporter in a public filing.

the efficacy of resource allocation, the stock exchanges should focus on situations where regulations bear most fruit in terms of helping investors. Unlike developed markets where other capital market participants (e.g. short-sellers and shareholder activists) can gather firm-specific private information and disseminate it either through publication or trading, such sophisticated information processors are not widely available in China because their efforts of information discovery are not rewarded (Jin and Myers, 2006). The stock exchanges as a public body, however, employ financial professionals who have both the skill and the authority to analyze and solicit information from listed firms. The stock exchanges occupy a unique position in China unmatched by other market participants.⁵ Moreover, the stock exchanges have whistleblower and complaint programs where people can, anonymously or not, complain about firms or tip off the stock exchanges on firms' hidden wrongdoings. The stock exchanges can follow up the tips by issuing comment letters to firms. Guided by the market's interest in certain firms, either because of major corporate events surrounding the firms, the industry appeal, or the firms' lack of transparency, the stock exchanges can most effectively target firms whose regulation is most needed and appreciated by investors. Most investors in China are retail investors without sufficient financial acumen to analyze accounting information or shareholders' rights (e.g. litigation) to punish misbehaving firms. The stock exchanges can act as a watchdog on behalf of retail investors by tracking their interest. I state the first hypothesis formally:

H1: Attention of the media and investors in a firm is positively related to the firm's likelihood of receiving a comment letter.

⁵ For example, Chinese stock exchanges require firms to explain the possible causes behind any large swing in the stock prices.

2.2. Severity of comment letters, market reactions to the receipt of comment letters, and future negative consequences

Comment letters that raise more serious questions can cause negative consequences for firms. Especially with the real-time nature, comment letters can alert investors and regulators who can react correspondingly or publicly shame firms into reversing course on problematic practices. When the Western-style institutional corporate governance mechanisms are unavailable, nontraditional monitors such as the media, employees and activist groups can play a more prominent role in disciplining firms' behaviors (Dyck et al., 2008). In China, the stock exchanges as a market-oriented regulator (as opposed to the more political and legislative regulator such as the CSRC) are best equipped to regulate listed firms, as the mandatory disclosures such as quarterly and annual reports and other public announcements are filed with the stock exchanges who set up disclosure rules. Given the poor information environments of emerging markets, questions raised in comment letters are probably not innocuous. The lack of information discovery or information production by financial intermediaries makes the stock exchanges' firm-specific critiques particularly salient for investors. The comment letters can point out accounting irregularities, disclosure deficiencies and questionable corporate governance practices (e.g. related party transactions that benefit other firms controlled by the large shareholders of the listed firm at the expense of the listed firm's minority, retail shareholders). The detailed firm-level analysis by the stock exchanges might not only provide new negative information to investors, but also portend future disciplinary actions on the firm. Through reviewing the filings, the stock exchanges can update their own assessment on firms' financial misreporting risk. The stock exchanges' assessment also filters into the CSRC who not only has the enforcement power but also decides on firms' financing and investing activities.

Security offerings and major restructuring plans in China have to be approved by the CSRC. The stock exchanges can provide advices to the CSRC in these decisions. I expect more severe comment letters will lead to poor market reactions to the receipt of comment letters, as well as real future negative consequences for the recipients, including poor disclosure rating during the stock exchanges' annual disclosure quality assessment and accounting-related enforcement actions. Particularly with planned restructurings, not deterred by effective corporate governance mechanisms, Chinese firms might present investors with questionable restructuring plans. Comment letters have the potential to expose the flaws of restructuring plans to the extent that firms are shamed into abandoning the plans altogether.

It does not necessarily follow that comment letters must lead to negative consequences, though. If the stock exchanges act as another branch of the government's "grabbing hand," comment letters might not point out issues the market is most concerned about. You et al. (2017) find that government-controlled business press is not effective in monitoring firms as market-oriented business press. Moreover, there is also the risk of over-regulating. If the stock exchanges mostly nitpick non-compliance with disclosure rules that are insignificant for investors, comment letters will not yield useful new information for either the CSRC or investors, and consequently no negative consequences other than revised disclosures will ensue. The second hypothesis is stated as follows:

H2a: The market reaction to the receipt of a comment letter decreases in the severity of the comment letter.

H2b: The severity of a comment letter is related to negative consequences experienced by the firm in the future.

3. Sample selection and research design

3.1. Sample selection

This paper studies annual report letters and restructuring letters issued to main board listed firms from 2015 (2016) to 2018 by Shenzhen Stock Exchange (Shanghai Stock Exchange).⁶ I collect comment letters from the official comment letter pages of the two stock exchanges' websites, and then supplement these letters through searching firms' filings that either acknowledge the receipt of a letter or respond to a letter.⁷ For the determinant model, a firm in a year is considered an annual report letter recipient if any filing indicates that the firm receives an annual report letter. There might be type I errors in the identification of annual report letter receipt, particularly for Shenzhen Stock Exchange who does not publish all the comment letters and does not require firms to announce the receipt of comment letters. In the determinant model, I also use the subsample of firms listed on Shanghai Stock Exchange where the receipt of comment letters is more accurately identified. To measure the severity of comment letters, only stock exchanges-published comment letters and full-text comment letters enclosed in firms' filings can be used. I only include main board A-share firms because firms listed on Small and Medium Enterprise Board (SME) or Growth Enterprises Market Board (GEM) are subject to different disclosure rules. The sample contains all the listed main board A-share firms with control variables available in CSMAR. The sample includes 754 annual reports (or firm-years) that receive annual report letters, 694 of which have full-text letter content available; the sample

⁶ The stock exchanges also issue comment letters on quarterly (unaudited) reports and comment letters on ad-hoc filings (similar to 8-Ks in the US). This paper excludes the former type of comment letters due to the small sample size and the latter type of comment letters due to the various underlying filings being commented on.

⁷ The stock exchange websites and cninfo.com.cn have search engines that allow users to search key words among all the filings, and the key word I use is "letter."

includes 643 restructuring letters. Appendix 2 provides one example of annual report letter and one example of restructuring letter.

3.2. Determinants of firms' receiving a comment letter

I focus on annual report letters to study the determinants of firms' receiving a comment letter, because annual reports are mandatory filings that every firm needs to report, whereas comment letters on the other filings are contingent on the existence of the underlying events. Also, restructuring letters usually comment on restructuring deals that are classified as "major restructuring" and most deals classified as "major restructuring" do receive comment letters, so there is not much selection in the issuance of restructuring letters.⁸

3.2.1. Attention of the media and investors

To measure the attention in a firm by the media, I use *MediaRpt* that is the number of times the firm has to clarify media reports within a year. Firms have to file a filing with the stock exchanges after the media publish previously unknown information, and firms can confirm, refute or partially confirm and partially refute the stories. *MediaRpt* is used instead of general media coverage (e.g. number of all news reports in a year) for two reasons. First, media coverage can either stem from firms' own disclosure, such as news reports relaying earnings announcements (i.e. information dissemination), or from the media of their own accord such as reporters conducting their own research or broadcasting sources' proprietary information (i.e. information discovery). *MediaRpt* captures information discovery that arguably reflects the

⁸ A major restructuring is so classified if any of the following criteria is met: 1) assets sold or purchased exceed 50% of total assets in the firm's most recent audited consolidated financial statements; 2) assets sold or purchased produce sales that exceed 50% of sales in the firm's most recent audited consolidated financial statements; 3) net assets sold or purchased exceed 50% of net assets in the firm's most recent audited consolidated financial statements and 50 million RMB. I find only 32 major restructuring filings are not commented on by the stock exchanges for unknown reasons.

media's attention in a firm more accurately because the media proactively seek information rather than passively repeat what a firm announces. Second, measuring general media coverage is empirically challenging because a firm can be identified by its full company name, stock name's Chinese abbreviation, or trading symbol in six-digit numbers. Chinese stock name abbreviation changes frequently either due to restructurings (e.g. drastically different stock abbreviation because the main business completely changes following a restructuring) or special treatment resulting from poor accounting performance (e.g. ST or ST* in front of a stock's Chinese abbreviation). The most stable representation of a company is the six-digit trading number, but in the Chinese language media databases articles cannot be reliably retrieved through searching trading numbers.

To measure investor attention, I employ Baidu search index of stocks' trading numbers. Baidu is the largest Chinese language search engine similar to Google, and it also produces a search index for keywords similar to Google index. Previous literature on Google index finds that the index is an informative measure of investor sentiment or investor attention (e.g. Da et al., 2011). As mentioned earlier, stocks or firms can be most reliably identified through the six-digit trading numbers and the chance of a combination of six numbers having a generic meaning is very low, so I retrieve Baidu indices based on trading numbers. $\ln Baidu$ is the logarithm of the average of search indices for a firm in a year.

3.2.2. Control variables

The following variables serve as potential signals for poor disclosure quality and might also affect how the stock exchanges select firms to comment on:

LnMktCap – the size of a firm measured by the logarithm of market capitalization and smaller firms usually have poorer disclosure quality. The stock exchanges might be more likely to issue comment letters to smaller firms because they tend to have more disclosure problems. On the other hand, larger firms are more visible and reach a wider range of investors, so the stock exchanges can benefit more investors by probing into larger firms.

SpecialT and *ROA* – poorly performing firms tend to have poorer disclosure quality (Lang and Lundholm, 1993) and the stock exchanges will probably focus more on firms with recent poor accounting performance. I use *ROA*, return on assets, and *SpecialT*, an indicator for having “special treatment” warning in the trading symbol, as measures of poor accounting performance.⁹

Accruals – firms with higher amount of accruals are more likely to have managed their earnings to achieve more favorable net income. I expect *Accruals* to be positively related to the likelihood of receiving a comment letter.

Abet – stock performance, measured as a firm’s yearly buy-and-hold return net of buy-and-hold market return, might affect the chance of being targeted by the stock exchanges through two channels. First, poor stock performance might reflect poor accounting performance and wealth loss to investors, and firms experiencing poor stock performance deserve the stock exchanges’ probing more. Second, more stellar stock market performance also spurs investors’ attention in the stock, and the stock exchanges might look into the firm more closely to examine the fundamentals that might or might not warrant the stock valuation.

MB and *Growth* – high growth firms also deserve more regulatory attention because of higher uncertainty surrounding them possibly due to newer business model or heightened market

⁹ ST is added to the front of stock Chinese abbreviation when the firm experiences losses in the most recent two years; ST* is added to the front of stock Chinese abbreviation when the experiences losses in the most three years.

sentiment. I measure growth through *MB*, market to book value of equity, and *Growth*, annual sales growth.

Lev – firms in financial distress, measured by *Lev*, calculated by total liabilities to total assets, are more financially vulnerable and closer to become bankrupt and delisted. The stock exchanges tend to be vigilant towards these firms.

BoardSize and *BoardIdpt* – corporate governance can affect disclosure quality and a larger board, *BoardSize*, or a more independent board, *BoardIdpt*, might ensure better quality disclosure and need less scrutiny by the stock exchanges.

Big4 and *CleanOp* – annual reports audited by Big Four auditors (*Big4*) are more compliant with disclosure rules and should be less likely to receive comments, while a standard unqualified audit opinion (*CleanOp*) attests to the quality of an annual report. Firms with larger auditors and clean audit opinions have better quality disclosure and need the stock exchanges' inquiry less.

ICWeakness – internal control weaknesses indicate a higher risk of financial misreporting and serve as a red flag for the stock exchanges. In the US, firms with internal control problems are placed under stricter scrutiny by the SEC in the review process.

H1 is tested using the following logit model:

$$\begin{aligned}
 \Pr(\text{Letter_Ann}) = & \alpha + \beta_1 \text{MktInterest} + \beta_2 \text{Big4} + \beta_3 \text{CleanOp} + \beta_4 \text{ICWeakness} \\
 & + \beta_5 \text{BoardSize} + \beta_6 \text{BoardIdpt} + \beta_7 \text{SpecialT} + \beta_8 \text{LnMktCap} \\
 & + \beta_9 \text{AbRet} + \beta_{10} \text{MB} + \beta_{11} \text{Lev} + \beta_{12} \text{Growth} + \beta_{13} \text{Accruals} \\
 & + \beta_{14} \text{ROA} + \text{Industry FEs} + \text{Year FEs} + \varepsilon
 \end{aligned} \tag{1}$$

Letter_Ann is an indicator variable that equals 1 if firm *i*'s annual report in year *t* is a target of an annual report letter and 0 otherwise. *MktInterest* can be either *MediaRpt* or *LnBaidu*. Model (1)

also includes industry and year fixed effects, and industry is based on 2012 CSRC classifications. H1 predicts that *MktInterest*'s coefficient β_1 should be positive. The dependent variable *Letter_Ann* might have measurement errors because the stock exchanges do not exercise full disclosure of all the issued comment letters. To alleviate the measurement errors, I also run Model (1) using only firms listed on Shanghai Stock Exchange where the disclosure of comment letters is more transparent.

3.3. Severity of comment letters, market reactions to the receipt of comment letters, and future negative consequences

3.3.1. Severity of comment letters

Within comment letter recipients, I further explore the variation in the severity of the letters, market reactions to the receipt of these letters, and future negative consequences triggered by the more serious letters.¹⁰

For annual report letters, the severity of comment letters is measured by *Issues* (number of issues raised in a comment letter), *AccuseStat* (number of accusatory statements made by the stock exchange in a comment letter), *Delay* (indicator for firms' delaying responses), and *Revise* (indicator for firms' revising annual reports after receiving annual report letters). A higher *Issues* suggests that more disclosure deficiencies are found and more clarifications are needed, possibly a proxy for a larger quantity of bad news. When comment letters are more negatively worded and more accusatory, these letters are particularly damaging. For example, some comment letters explicitly ask firms whether they manage earnings, inflate earnings, intentionally relax credit

¹⁰ Because comment letters are not randomly issued, examining future negative consequences of the receipt of comment letters *per se* has a selection issue. Therefore, I opt for examining variation within comment letter recipients. Unsurprisingly, in unreported results comment letter recipients are more likely to experience future negative consequences than non-recipients.

policy to boost sales, manipulate timing of revenue recognition, selling assets to bolster investment income, or book excessive expenses and losses (e.g. asset impairment) to engage in “big bath,” accusations covering both accruals management and real earnings management. Other accusatory languages include “explain whether the arrangement harms small investors’ interest” or “ask your auditor to comment on the *truthfulness* of the transaction or the account balance.” The accusatory languages are different from the more neutral languages that give firms the benefit of the doubt (e.g. “ask your auditor to express her opinions on the matter”); rather, the stock exchanges appear to form a negative opinion about the firms’ intent behind their certain accounting choices and transactions. *AccuseStat* counts the number of accusatory statements in a comment letter and measures the extent of possible fraudulent (as construed by the stock exchanges) behaviors by a firm. When firms cannot reply to comment letters before the deadline set by the stock exchanges (usually seven days from the letter issuance date) and ask for an extension, it indicates the struggle to answer difficult questions. The real-time nature of Chinese comment letters accentuates firms’ inability to address comment letters on time as the request for an extension is made publicly. In the US, investors will not know that a firm asks for more time until after the review concludes and indeed many letter recipients do request more time. Lastly, if comment letters force firms to revise annual reports afterwards, it indicates that firms’ reporting issues pointed out by the letters are relatively more material.

For restructuring letters, *Issues* and *Delay* are similarly defined as for annual report letters. However, what is different with restructuring letters is that firms have the option of withdrawing the deal in question, consequently removing the target of the letters and the need to respond. That is, *Revise* proxies for firms’ determination and only firms that intend to carry deals through will strive to reply to the stock exchanges. Accordingly, I drop *Revise* but use instead the variable

NoReply that indicates whether firms rely to the stock exchanges at all. The inability or lack of willingness to reply suggests that restructuring letters expose flaws of the deals unanswerable by the letter recipients.

3.3.2. Market reactions to the receipt of comment letters

I use three-day market-adjusted cumulative returns (*CAR_Letter*) to measure market reactions to the receipt to comment letters. Market returns are value-weighted A-share stock returns listed on both stock exchanges. Only annual report letters are used to calculate *CAR_Letter* because firms usually halt trading of their stocks when planning restructuring deals and restructuring letters are issued during stock trading suspensions. The OLS model for testing H2a is as follows:

$$CAR_Letter = \alpha + \beta_1 Severity + Controls + Industry FEs + Year FEs + \varepsilon \quad (2)$$

The test variable *Severity* can be *Issues* and *AccuseStat* in Model (2) because only these two measures of *Severity* are observable to investors when the receipt of a comment letter is announced. H2a predicts that β_1 will be negative in Model (2). That is, more issues and accusatory statements in a comment letter should trigger more negative market reactions when the letter is publicly announced. Control variables are the same as in Model (1).

3.3.3. Future negative consequences

For annual report letters, I use *BadRating* and *Enforcement* as measures for future negative consequences. *BadRating* is an indicator for firms' receiving a below-average letter grade for disclosure quality. The stock exchanges assess listed firms' overall disclosure quality

every year by giving them a letter grade that can be A, B, C or D.¹¹ The rating is an assessment based on all types of disclosures, not just annual reports. However, given the importance of and the voluminous information in annual reports, the quality of annual reports should be a crucial input of the rating. Shenzhen (Shanghai) Stock Exchange's assessment period is from May (July) 1 of year t to April (June) 30 of year $t+1$, and the results are usually publicly announced in July (August) of year $t+1$ (Shanghai Stock Exchange, 2017; Shenzhen Stock Exchange, 2017).¹² Because all listed firms in China have December 31 as the fiscal year end, annual reports of year t have to be released before April of year $t+1$ and almost all annual report letters (on annual reports of fiscal year t) are issued between March and June of year $t+1$. Therefore, the letter grades are published after the review of annual reports. *BadRating* is set to 1 if the letter grade is C or D, i.e. below average. The effects of receiving a *BadRating* far exceed simple loss of reputation—the stock exchanges gauge their future regulatory resources and provide opinions on firms' future security offerings and M&As (that need governmental approval) to the CSRC based on the letter grades (Shanghai Stock Exchange, 2017). Poor disclosure quality rating implies that management will spend more time addressing the regulators' inquiries instead of business operations, and firms might be denied future external financing and investment opportunities.

Enforcement is an indicator that equals 1 if firm i 's annual report for year t receives accounting-related enforcement actions from the stock exchanges or the CSRC after the receipt of annual report letters. Annual report letters can uncover accounting irregularities, intentional earnings management or even accounting frauds, which can inform the stock exchanges and the CSRC who have the authority to punish the offending firms. More severe annual report letters are more likely to lead to *Enforcement*. Although enforcement actions do not directly incur a

¹¹ Both stock exchanges issue a disclaimer that letter grades should not be construed as investment ratings.

¹² Shanghai Stock Exchange only recently makes the results available for the 2017-2018 assessment period.

huge amount of monetary punishment or trigger shareholder litigations that might lead to exorbitant settlements as in developed markets, enforcement actions significantly affect firms' future financing and investing activities. For example, firms that receive accounting-related enforcement actions in the past 36 months are not allowed to issue shares or corporate bonds (CSRC, 2006; CSRC, 2015).

For restructuring letters, the future negative consequence is *Cancellation* that indicates whether a firm cancels the deal that is the target of a restructuring letter. Major restructuring announcements in China usually trigger hugely positive abnormal returns, with an average (median) 13% (15%) three-day CAR; by contrast, cancellations of major restructurings lead to an average and median -3% three-day CAR.¹³ Therefore, for investors who are attracted by firms' planned restructurings, cancellations can cause them significant wealth loss. Cancelling a deal after receiving a comment letter suggests that the firm is incapable of bringing the deal any further because the letter casts serious doubt on the deal for investors and the CSRC (who needs to sign off on the deal eventually) to see. *Cancellation* represents an embarrassing and unambiguously negative consequence for receiving a restructuring letter. The logit model for testing H2b is as follows:

$$\Pr(NegCon) = \alpha + \beta_1 Severity + Controls + Industry FEs + Year FEs + \varepsilon \quad (3)$$

In Model (3), the dependent variable *NegCon* can be *BadRating* or *Enforcement* for annual report letters, or *Cancellation* for restructuring letters. *Severity* can be *Issues*, *AccuseStat*, *Delay* or *Revise* for annual report letters, or *Issues*, *NoReply* or *Delay* for restructuring letters. Control variables are the same as in Model (1). With restructuring letters, additional characteristics of

¹³ Short-window returns are calculated based on major restructuring announcements and cancellation announcements in CSMAR until January of 2019.

restructuring deals are included in Model (3), including *Draft* (indicator for a restructuring plan being at the preliminary “draft” stage, as opposed to more advanced “proposal” or “report” stages), *LnDealVal* (logarithm of deal value), *IssueStk* (indicator for issuing stocks as part of the restructuring), *AssetPchse* (indicator for asset purchase as part of the restructuring), *AssetSale* (indicator for asset sale as part of the restructuring), *AddFunds* (planning additional financing to support the restructuring) and *RelatedPty* (restructuring deal being a related party transaction). H2b predicts that β_1 will be positive in Model (3).

4. Results

Table 1 Panel A analyzes the most frequently asked topics in annual report letters, and only topics that appear in at least 50 letters are displayed.¹⁴ An annual report letter usually itemizes comments based on individual financial statement line item, footnote or pre-formatted section, so the classification of topics is relatively straightforward and requires limited subjective judgement. Table 1 reveals that the most frequently questioned line item is accounts receivable. The comments usually notice the large amount of accounts receivable, the drastic change in the balance of accounts receivable or the low accounts receivable turnover ratio, implicitly questioning the validity of credit sales or whether the receivables are recoverable. The second most asked topic is quarterly results that are previously announced in the quarterly reports and a mandatory section in the annual report. The question often demands explanations on the bizarre quarterly result patterns that are beyond normal seasonality. For example, some firms have unusually large gross margin ratios in their fourth quarters compared to the other three quarters. Some letters explicitly accuse firms of manipulating their fourth quarter results through more relaxed credit sales. This topic highlights the poor quality of financial reporting when firms are

¹⁴ The topics are not mutually exclusive because one letter can entail multiple topics.

not monitored by independent parties, because quarterly reports are not audited. The third frequent topic is about inventory impairment, and asset impairment is a recurring theme—more than 200 annual report letters question accounts receivable impairment, and more than 80 annual report letters ask about goodwill impairment and other receivable impairment. Table 1 Panel A stands in sharp contrast with topics in the SEC comment letters. Ryans (2018) documents that the most frequent topic is “Omitted exhibit disclosures” that exists in 12% of the SEC comment letters. The stock exchanges seem to conduct financial statement analyses and take note of large year-on-year changes in sales (“Sales”) and gross margin ratios unusual for the industry norm (“Gross margin”). The stock exchanges even occasionally reference commercial databases (e.g. Wind) when describing firms’ deviation from industry norms. The stock exchanges also comment on the business risk resulting from firms’ concentrated transactions with and overreliance on major customers (“Big customers”) and major suppliers (“Big suppliers”). Interestingly, the stock exchanges sometimes directly ask the firm to explain the dramatic difference between net income and operating cash flows, essentially a comment on the large amount of accruals (“Accruals”). Table 1 Panel B analyzes 31 annual reports in which firms revise accounting numbers (i.e. not just revise texts) after receiving annual report letters and summarizes the most frequently revised items. The most revised item is item 2.4 in Chinese annual reports that tabulates main financials for four quarters of a fiscal year including sales, net profit attributable to shareholders of the listed firm, net profit (excluding nonrecurring items) attributable to shareholders of the listed firm, and operating cash flows. Panel A shows that comment on quarterly results is the second most frequent and this comment leads 17 firms to acknowledge mistakes in their quarterly reports and basically restate their quarterly results.

Financial statements are revised in some cases, and notably the mostly revised financial statement is Statement of Cash Flows.

Table 2 presents descriptive statistics for firms listed on the main boards of Shenzhen (Shanghai) Stock Exchange from 2014 (2015) to 2017 that do or do not receive annual report letters from 2015 (2016) to 2018. Two-sample t-tests and Wilcoxon tests are conducted to compare the mean and median of the variables for annual report letter recipients (*Letter_Ann*=1) and non-recipients (*Letter_Ann*=0). There are 754 annual reports that receive letters and 7095 annual reports that do not receive letters, so the unconditional probability of receiving an annual report letter is 9.6% for the two stock exchanges combined (the more accurate unconditional probability is $431/(431+2608)=14.2\%$ for Shanghai Stock Exchange). The three-day *CAR_Letter* (when annual report letters are received not inside any trading suspension) has a mean value of -1.4% and a median value of -1.2%, both statistically different from zero, showing the significant negative news annual report letters convey to the market. I also calculate the three-day market-adjusted cumulative returns centered on the dates when firms file a request for an extended deadline for the letter response, the variable *CAR_Delay* has a mean and median value of -0.9%, also significantly different from zero, suggesting the additional bad news for firms that cannot address comment letters in a timely fashion. Within letter recipients, more than half the firms receive *BadRating* and around 24% of the firms receive *Enforcement* following the review by the stock exchanges. The average of *Issues* is 11, and the average *AccuseStat* is 0.7. More than a quarter of the firms cannot respond to the stock exchanges on time (*Delay*) and 35% of the firms have to revise their annual reports following the stock exchanges' review (*Revise*).

Both *MediaRpt* and *LnBaidu* are significantly higher for letter recipients than non-recipients at the 1% level, suggesting that the stock exchanges specifically target firms the

market pays more attention to. As expected, firms hiring *Big4* auditors, receiving *CleanOp* and not having *ICWeakness* are less likely to receive annual report letters. Letter recipients have smaller *BoardSize* than non-recipients but similar *BoardIdpt*. Recipients are more likely to have *SpecialT* and lower *ROA* than non-recipients. Letter recipients have significantly higher *MB* and *Lev* and smaller *LnMktCap* than non-recipients. The mean of *Growth* is higher for recipients but the median is lower, and there is no significant difference in *Accruals*. Overall, smaller, badly performing, poorly governed but highly valued firms are more likely to become targeted, and the stock exchanges are more likely to inquire into firms the market is most eager to gather information on.

Table 3 Panel A reports the logit regression results of the determinant model of receiving annual report letters. In column (1), *MediaRpt* is significantly positive at the 1% level, consistent with the expectation that firms attracting more media speculation are more likely to become the stock exchanges' targets. The marginal effect at the mean for one more clarification of news stories is the equivalent of 2.1% increase in the likelihood of receiving an annual report letter (a 22% increase with respect to the sample average). In column (2), *LnBaidu* is also significantly positive at the 1% level, suggesting that more heavily searched firms are more likely to receive annual report letters. Among other variables, *ICWeakness*, *SpecialT*, *MB*, *Lev*, *Growth*, and *Accruals* have consistently positive coefficients, *Big4*, *CleanOp*, and *ROA* have negative coefficients and *LnMktCap* is negative in column (2). The results suggest that smaller, poorly performing, more leveraged and faster growing firms with larger amount of accruals, low-quality auditors, qualified audit opinions and internal control weaknesses are more likely to receive annual report letters. To reduce the type I errors in *Letter_Ann* where some comment letters might be neither published by the stock exchanges nor announced by the recipients, Panel B

restricts the sample to firms listed on Shanghai Stock Exchange. *MediaRpt* stays significantly positive at the 1% level and *LnBaidu* is significantly positive at the 5% level with the smaller sample. Among the control variables, *ICWeakness*, *SpecialT* and *MB* are no longer significant, but *Big4*, *CleanOp*, *Lev*, *Growth*, *Accruals* and *ROA* remain consistently significant. Table 3 indicates that the stock exchanges not only select firms with signals that are indicative of poor quality financial reporting, but also firms the market has intense interest in.

Table 4 reports the OLS models of market reactions to the receipt of annual report letters. In column (1), the test variable *Issues* is statistically insignificant, so there is no evidence that more questions asked in an annual report letter convey a larger amount of bad news to investors. An annual report letter can demand more clarifications and details on a larger number of issues, but such demand might not necessarily imply a higher chance of financial misreporting. By contrast, in column (2), *AccuseStat* is significantly negative at the 5% level. The coefficient suggests that one more accusatory statement translates to -0.004 decrease in *CAR_Letter*, which is the equivalent of 29% decrease of *CAR_Letter*'s average value. Investors react negatively to accusatory statements in annual report letters possibly because these statements show intentionally fraudulent financial reporting or transactions that expropriate minority shareholders, which further foreshadow future disciplinary actions from the regulators. Among the control variables, the only significant variable is *CleanOp*, that is, firms receiving qualified audit opinions fare worse in the market upon the release of annual report letters, possibly because they receive more damaging questions from the stock exchanges that reveal additional bad news to the market.

Table 5 reports the logit models of *BadRating* by the stock exchanges. In column (1), the coefficient of *Issues* is significantly positive at the 1% level and suggests that for an average firm

receiving comments on one more issue increases the chance of future *BadRating* by 3.4%. In column (2), the coefficient of *AccuseStat* is significantly positive at the 1% level, and for an average firm one more accusatory statement increases the chance of receiving *BadRating* by 6.2%, an effect almost twice the size of *Issues* consistent with intuition. In column (3), *Delay* is positive at the 1% level and postponing the response to the stock exchanges translates to a 21% higher probability of receiving *BadRating*. Similarly, in column (4), *Revise* is also significantly positive at the 1% level and revising annual reports upon receiving annual report letters means an 18% higher chance of future *BadRating*. The results suggest that annual report letters uncover concrete disclosure deficiencies and elicit more signals about firms' disclosure quality from firms' responses, such as the ability to address the letters in a timely fashion and the need to revise annual reports after comment letters. Annual report letters help the stock exchanges update their belief in firms' disclosure quality that they later impart to investors through a concise letter grade rating. Among the other variables, the consistently negative coefficients of *CleanOp* and *LnMktCap* and positive coefficients of *ICWeakness* and *Accruals* suggest that smaller firms with larger amount of accruals, qualified audit opinions and internal control weaknesses are more likely to receive bad disclosure quality rating. Interestingly, the coefficient of *AbRet* is significantly positive in every column. A possible explanation is that firms hide bad news through misleading disclosure or non-disclosure to manipulate market perception, that is, strong stock market performance is a result of opaque disclosure that is eventually detected by the stock exchanges.

Table 6 reports the logit models of firms' receiving future accounting-related enforcement actions. In column (1), the coefficient of *Issues* is significantly positive at the 1% level and implies that for an average firm one more issue increases the probability of this annual

report receiving *Enforcement* in the future by 1%, while the unconditional probability of receiving *Enforcement* within letter recipients is 24%. In column (2), *AccuseStat* is statistically significant at the 1% level and one more accusatory statement indicates a 3.9% higher chance of receiving *Enforcement* for an average firm, almost quadrupling the effect of *Issues*. In column (3), the coefficient of *Delay* is significantly positive at the 10% level and suggests that an average firm delaying its response to annual report letters has a 7.4% higher chance of receiving *Enforcement* than an average firm replying on time. In column (4), *Revise* has the expected positive sign but is not statistically significant. The result is not entirely surprising, as Table 1 Panel B suggests that only a handful of firms revise the actual accounting numbers after receiving annual report letters. Overall, Table 6 partially supports the hypothesis that annual report letters help discover accounting frauds for which the regulators later can punish firms. Three other variables are consistently related to *Enforcement*, including *CleanOp*, *ICWeakness* and *Growth*.¹⁵

Table 7 compares restructuring letter recipients who cancel the restructuring deal upon receiving a restructuring letter and letter recipients who do not cancel the restructuring deal. There are 131 cancellations (*Cancellation*=1) and 512 non-cancellations (*Cancellation*=0), so the unconditional likelihood of cancelling a restructuring deal is 20%. Two-sample t tests and Wilcoxon tests reveal an interesting pattern—most of the letter-level or deal-level variables (from *Issues* to *RelatedPty*) are statistically different but most of the firm-level variables (from *Big4* to *ROA*) are statistically indistinguishable. *Issues*, *NoReply* and *Delay* are all significantly higher for the cancellation group. *Draft* is significantly higher for the cancellation group, because

¹⁵ In unreported results, I use *CAR_Letter* as another measure of the severity of the annual report letters, and *CAR_Letter* is negatively related to *BadRating* at the 10% level as expected but insignificantly related to *Enforcement*. *CAR_Letter* reflects the perception of bad news *surprises* to investors rather than the absolute amount of bad news captured by the severity measures in the main tests.

it is easier for a firm to give up on a deal that is still in a preliminary stage. There is no significant difference in *LnDealVal* or *AssetSale* between the two groups, but the cancellation group has significantly higher *IssueStk*, *AssetPchse*, *AddFunds* and *RelatedPty*. The mean values of *LnMktCap* and the median values of *MB* are weakly different at the 10% level between the two groups, but the other firm-level variables are statistically the same. Overall, firms that call off restructuring deals and firms that carry out restructurings are not fundamentally different. It is more likely that the deals themselves and the comment letters that query these deals play a role in the cancellation decision.

Table 8 reports the logit models of restructuring deal cancellations. In column (1), the coefficient of *Issues* is significantly positive at the 5% level and one more issue translates to a moderate 0.4% increase in the probability of *Cancellation* for an average firm. In column (2), *NoReply* loads significantly at the 1% level and the effect of not responding at all is a large 25% higher likelihood of *Cancellation*. In column (3), *Delay* is significantly positive at the 10% level, so even within firms that reply to the stock exchanges, delaying the response still increases the chance of *Cancellation* by 5.9%. Among the control variables, *Draft* is significantly positive at the 1% level in all the specifications, indicating that it is easier to abandon a deal in the earlier stage. *LnDealVal* is consistently significantly negative, suggesting that smaller deals are more likely to be cancelled. *IssueStk* is significantly positive in column (3), indicating that deals involving the issuance of stocks are more likely to be abandoned among firms that respond to the stock exchanges. The other variables are almost all insignificant, so cancelling a deal has more to do with deal and comment letter characteristics, not firm fundamentals.

5. Additional analyses

To better understand which comments are mostly powerful in shaming firms to abandon problematic restructuring plans, I manually code topics in restructuring letters using two independent methods. In the first method, I create 10 topics based on the thematic content of the comments, including comments on whether a restructuring should be classified a reverse takeover (*Comm_RevTkr*), quality of underlying assets (*Comm_Quality*), pricing of the transactions (*Comm_Pricing*), issues relating to post-closing contingent payment (*Comm_Promise*), deal counterparties (*Comm_CounterPty*), related party transactions (*Comm_RelatedPty*), disputed ownership issues relating to underlying assets (*Comm_Control*), supplementary financing (*Comm_AddFunds*), issues relating to previous restructuring efforts (*Comm_PriorDeal*) and accounting issues (*Comm_Acctg*). This method succinctly summarizes the letter content, but involves substantial subjective judgement. In the second, more objective method, I count the number of various regulations being referenced by a restructuring letter, including “Guidelines on Firms’ Holding Media Conference Calls to Discuss Restructuring Deals” (*Comm_ConCall*), “Restructuring Guidelines” (*Comm_Guidelines*), “Rule 26” (*Comm_Rule26*), “Memo 6-concerning Asset Appraisal” (*Comm_Memo6*), “FAQs of Listed Companies’ Governing Laws and Rules” (*Comm_FAQ*), “Several Q&As concerning Restructurings” (*Comm_Q&A*), “Listed Companies’ Governing Guideline Number Four” (*Comm_Govern4*), and all the other rules (*Comm_Others*).

Although ex-ante it is hard to predict which comments are most damaging to firms’ restructuring plans, some anecdotal reporting in the Chinese business press offers some suggestions. Board secretaries have expressed their dread of holding a conference call with the media to discuss a restructuring deal and believed the conference call could hinder the deal from proceeding forwards (China Securities Journal, 2016). For restructurings that are considered

reverse takeovers, firms are mandated to hold conference calls; otherwise the stock exchanges have the discretion to order firms to do so (*Comm_ConCall*). A conference call invites the public to scrutinize a deal by asking management challenging questions, potentially exposing the deal's problems in addition to what is discovered by the comment letters. Comment letters and conference calls can also work in concert, as the media can force a firm to answer questions raised in a comment letter when the firm keeps postponing the official response (Sohu.com, 2018). Chinese regulators are particularly worried about reverse takeovers being disguised as regular restructuring deals (Shanghai Securities News, 2018). Although restructuring deals can be reverse takeovers, firms have to explicitly state so in the filings and comply with Chinese "IPO Guidelines" in addition to other rules regulating restructurings. "IPO Guidelines" have stringent requirements on the quality of IPO applicants.¹⁶ Target firms of reverse takeovers (i.e. essentially firms seeking to go public) are reluctant to identify the deals as reverse takeovers to avoid complying with "IPO Guidelines." The CSRC aims to stop low quality firms from going public and explicitly bans rejected IPO applicants from involving in restructurings for six months (CSRC, 2018). When the stock exchanges question whether a firm should identify a deal as a reverse takeover (*Comm_RevTkr*), it might indicate the opportunistic incentive of circumventing "IPO Guidelines" and the poor quality of the target. However, the media attention of those issues does not necessarily mean they are more impactful in ending a deal than other comment topics, so the analysis is exploratory.

Table 9 presents the logit models of deal cancellation and content of restructuring letters.

The test variables in column (1) are the indicators for various topics, and two variables are

¹⁶ For example, IPO applicants should 1) have positive net income for the most recent three years and the three-year cumulative net income exceeds 30 million RMB; 2) cumulative operating cash flows exceed 50 million RMB or cumulative sales exceed 300 million RMB over the most recent three years; 3) pre-IPO paid-in-capital exceeds 30 million RMB; 4) intangible assets (except right to use land, right to breed marine lives and mining right etc.) as of the most recent year end are below 20% of net assets; 5) retained earnings are positive as of the most recent year end.

significantly positive—*Comm_RevTkr* and *Comm_Quality*. When the stock exchanges question whether a restructuring deal is a disguised reverse takeover, or cast doubt on the quality of traded assets, the deal is more likely to be cancelled. In column (2), of the variables for the number of times various regulations are referenced by the letters, the only significant variable is *Comm_ConCall*. When the stock exchanges order firms to hold a conference call with the media, the deal is more likely to be abandoned, probably because firms do not like to be questioned in public by the media.

6. Conclusions

Comment letters, through “micro-targeting” individual firms’ financial reporting and disclosure compliance issues, can pressure firms into addressing potentially challenging questions, clarifying existing public information or even providing new, more granular information. For emerging markets with opaque information environments, immature information intermediaries and untimely recognition of economic losses, firm-specific information (negative information in particular) is much needed for investors. Therefore, a SEC-style review system can be useful in emerging markets to supplement marketwide rules and regulations whose enforcements can be ineffective due to other weak institutions. This paper studies Chinese comment letters that are issued by the stock exchanges to recipient firms and investors at the same time, and documents significantly negative short-window abnormal returns surrounding firms’ receipt of comment letters and firms’ delay of responses. The media also take note of firms’ delayed response or non-response (Shanghai Securities News, 2016; Sohu.com, 2018). The magnitude of short-window abnormal returns contrasts sharply with the muted market response to the release of comment letters in the US, possibly due to both the real-time nature of and more material bad news in Chinese comment letters. This paper also shows the

adverse consequences of firms' receiving severe comment letters, including major corporate decisions— firms' canceling planned restructurings.

This paper emphasizes the incentives of the stock exchanges in emerging markets for improving investor protection and financial reporting transparency. Although various institutions in China do not cultivate a high quality information environment, the stock exchanges do strive to be internationally relevant and attract more foreign investors and issuers. The recent Shanghai (Shenzhen)-Hong Kong Stock Connect, the imminent Shanghai-London Stock Connect, and the inclusion of (and later the increased weighting of) Chinese listed firms in the MSCI emerging market index gradually integrate Chinese stock exchanges with global stock markets. To achieve the international recognition, the stock exchanges are motivated to force out opaque, poorly performing, and scandal-ridden issuers to establish more orderly markets. This paper demonstrates the detailed financial analyses, the stock price impact, the sophisticated “micro-targeting,” and the efficacy of comment letters by the stock exchanges in China. The implication is that comment letters, as long as issued by parties that are incentivized to improve investor protection, can be a powerful regulatory tool for emerging markets.

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Appendix 1 Variable definitions

Variable	Definition
CAR_Letter	cumulative market-adjusted returns over [-1,1], 0 being the date on which a firm receives a comment letter
CAR_Delay	cumulative market-adjusted returns over [-1,1], 0 being the date on which a firm announces it has to delay its response to a comment letter
Letter_Ann	indicator variable that equals 1 if the annual report for a firm-year is commented on by the stock exchanges
MediaRpt	number of times a firm clarifies media reports in a year
LnBaidu	logarithm of the average of Baidu search indices for a firm in a year
Big4	indicator variable that equals 1 if a firm's auditor is one of the Big Four auditors (KPMG, Ernst & Young, PwC and Deloitte)
CleanOp	indicator variable that equals 1 if a firm receives a clean audit opinion ("unqualified opinion") and 0 otherwise. Non-clean audit opinions include "unqualified opinion with emphasis of matter paragraph," "unqualified opinion with explanation notes," "qualified opinion," "adverse opinion" and "disclaimer of opinion."
ICWeakness	indicator variable that equals 1 if a firm reports any internal control weakness
BoardSize	number of directors on a firm's board
BoardIdpt	percentage of the number of independent directors to the total number of directors
SpecialT	indicator variable that equals 1 if a firm's stock has "special treatment" in its trading symbol for recent poor accounting performance
LnMktCap	logarithm of market value of equity
AbRet	abnormal annual stock return that is buy-and-hold annual return minus buy-and-hold market return
MB	market value of equity to book value of equity
Lev	total liabilities to total assets
Growth	sales in year t minus sales in year t-1, divided by sales in year t-1
Accruals	net income minus operating cash flows, scaled by total assets
ROA	net income divided by total assets
BadRating	indicator variable that equals 1 if the stock exchange gives a firm a C or D rating for disclosure quality for a specific year, and 0 if the stock exchange gives a A or B rating
Enforcement	indicator variable that equals 1 if a firm-year's financial reporting receives accounting-related enforcement actions
Issues	number of issues raised in a comment letter
AccuseStat	number of accusatory statements in a comment letter, including comments alleging various earnings management tactics (e.g. manipulating timing of revenue recognition, abusing credit policy, taking excessive expenses or "big bath" etc.), expropriation of minority shareholders and demanding testaments on truthfulness of accounting accounts or underlying transactions
Delay	indicator variable that equals 1 if a firm announces that it has to delay its response to a comment letter
Revise	indicator variable that equals 1 if a firm revises its annual report after receiving an annual report letter
NoReply	indicator variable that equals 1 if a firm does not reply to a restructuring letter
Cancellation	indicator variable that equals 1 if a firm cancels its proposed restructuring deal after receiving a restructuring letter
Draft	indicator variable that equals 1 if a commented restructuring filing is a draft, and 0 if the filing is a more advanced proposal or report

LnDealVal	logarithm of a restructuring deal value; for a restructuring with several sub-deals, the values of the sub-deals are summed up. The deal value is the either the transaction price, or the appraisal value of the traded assets if the transaction price is not given by the filing
IssueStk	indicator variable that equals 1 if a restructuring deal involves issuing stocks
AssetPchse	indicator variable that equals 1 if a restructuring deal involves asset purchase
AssetSale	indicator variable that equals 1 if a restructuring deal involves asset sale
AddFunds	indicator variable that equals 1 if a restructuring deal involves additional financing to support the restructuring
RelatedPty	indicator variable that equals 1 if a restructuring deal involves related-party transactions
Comm_RevTkr	indicator variable that equals 1 if a restructuring letter asks why a firm does not classify the restructuring as a reverse takeover
Comm_Quality	indicator variable that equals 1 if a restructuring letter asks about the quality of traded assets
Comm_Pricing	indicator variable that equals 1 if a restructuring letter asks about the pricing of the deal
Comm_Promise	indicator variable that equals 1 if a restructuring letter asks about the arrangement of post-closing contingent payment
Comm_CounterPty	indicator variable that equals 1 if a restructuring letter asks about the counterparty of the deal
Comm_RelatedPty	indicator variable that equals 1 if a restructuring letter comments on the related party transaction or asks whether the deal should be classified as a related party transaction
Comm_Control	indicator variable that equals 1 if a restructuring letter comments on the disputed ownership of traded assets, for example some assets are used as pledge by the seller and might not be completely controlled if a firm purchases these assets
Comm_AddFunds	indicator variable that equals 1 if a restructuring letter asks about the planned additional financing to support the restructuring
Comm_PriorDeal	indicator variable that equals 1 if a restructuring letter asks about a firm's prior restructuring efforts
Comm_Acctg	indicator variable that equals 1 if a restructuring letter comments on accounting issues
Comm_ConCall	number of times a restructuring letter references the stock exchanges' guidelines on firms' holding media conference calls to discuss restructuring deals
Comm_Guidelines	number of times a restructuring letter references "Restructuring Guidelines"
Comm_Rule26	number of times a restructuring letter references "Rule 26"
Comm_Memo6	number of times a restructuring letter references "Memo 6-concerning Asset Appraisal"
Comm_FAQ	number of times a restructuring letter references "FAQs of Listed Companies' Governing Laws and Rules"
Comm_Q&A	number of times a restructuring letter references "Several Q&As concerning Restructurings"
Comm_Govern4	number of times a restructuring letter references "Listed Companies's Governing Guideline Number 4"
Comm_Others	number of times a restructuring letter references rules other than those mentioned above

Appendix 2 Examples of comment letters issued by Chinese stock exchanges (translated from Chinese)

1. An annual report letter

Annual report comment letter concerning DongGuan Winnerway Industrial Zone Co

Corporate Division, Annual Report Letter [2016] Number 132

Board of directors of DongGuan Winnerway Industrial Zone Co:

Our division discovered the following issues amid the annual report review:

1. During the current accounting period, your affiliated company Guizhou Hongxi Mining Co (“Guizhou Hongxi” hereafter) realized zero net income. Please explain Guizhou Hongxi’s industry qualifications in mining, business model, major assets (including but not limited to business description, current sales, net income as a percentage of listed company’s consolidated sales and net income), reasons for zero net income and whether the assets are consolidated into your financial statements and why. Please ask your accountants to express their professional opinions on the matter.
2. On January 27, 2015, your company signed “Asset Consolidation Agreement between Weining County Jieli Mining Co and Kongjiagou Mining Co” with Yi Ying and Jin Ronghui, but Yi Ying and Jin Ronghui did not transfer the ownership of Kongjiagou Mining on time and unilaterally engaged in production, as a result your company sued Yi Ying and Jin Ronghui. Please comment on the effect of the event on your subsidiary Weining County Jieli Mining Co and explain why no contingent liabilities were recorded.
3. During the current accounting period, your company realized net loss of -98,844,800 RMB, sales 310,000,000, a year-on-year 64.43% decrease. Please explain the large decrease in sales according to the industry cycle, competition, business model and changes in major customers; please explain the reason for the loss and future corrective actions according to the changes in major line items of consolidated income statement.
4. During the current accounting period, your inventory turnover was 0.1392, a year-on-year 64.8% decrease and your company did not record provisions for inventory impairment. Please explain the large decrease in inventory turnover, inventory impairment test and the validity for not recording provisions, according to changes in business model, major customers, capacity expansion, and industry average metrics.
5. Your company had positive retained earnings from 2013 to 2015, but you did not distribute dividends. Please explain whether the lack of distribution is consistent with your corporation by-laws and “Three-year payout plan” you disclosed previously.
6. Please provide additional information regarding the top five contributors to accounts receivable, prepaid expenses, payables and unearned revenue, including company names, amounts, and nature of payments, and explain whether these companies are related parties to your company, your board of directors, executive officers, key technology staff, large shareholders with holding of 5% or above or controlling shareholders.

7. During the current accounting period, the top five contributors to prepaid accounts constituted 66.48% of total prepaid accounts. Please explain the reason for the high concentration of the top five suppliers and your plans to counter the risk of relying on only a few suppliers, according to the characteristics of your company and industry.
 8. During the current accounting period, your company wrote off 201,600 RMB loans to Dongguan Development Bank and Hainan Development Bank because the debtors were no more. Please elaborate on the event and explain whether the loans to the outside parties were appropriately approved previously and whether the company fulfilled relevant information disclosure.
 9. During the current accounting period, your company recognized 29,000,000 RMB bad debt provision for the entire amount of receivable resulting from selling the equity stake of Liuxiangyang. Please explain the details of the equity stake sale, the reason for recording provision for the entire amount, and how the event affected your company's operations.
 10. As of the accounting period end, your inventory balance contained capitalized borrowing expenses. Please provide the breakdown of accumulative capitalized interests, capitalized interests of the current period, the percentage of interests being capitalized, and explain whether your company's accounting treatment of capitalizing interests was consistent.
 11. During the current accounting period, your nonoperating expenses included 519,200 RMB of fine overdue. Please explain the events that triggered the fine, the effect on your company and whether your company fulfilled relevant information disclosure.
 12. Please disclose information specific to real estate industry as required by Shenzhen Stock Exchange.
- Please address the issues above in correspondence and provide public disclosure if needed, and send relevant materials to our division by May 12.

Shenzhen Stock Exchange
Corporate Division
May 6, 2016

2. A restructuring letter

Restructuring Comment Letter Concerning Shenzhen Quanxinhao Co

Restructuring Comment Letter [2015] Number 12

Board of directors of Shenzhen Quanxinhao Co:

On September 10, 2015, your company disclosed “Shenzhen Quanxinhao Co’s Major Asset Purchase Agreement (Draft)” (“Restructuring Agreement” hereafter). Our division examined the filing, and here are our opinions:

1. According to “Listed Companies’ Major Restructuring Guidelines” (“Guidelines on Restructurings” hereafter) number 2 and 15, detail how the deal qualifies as major restructuring; ask your independent financial advisor and lawyer to clearly express their opinions.
2. According to “Restructuring Agreement,” the target has not had any operation. Given that number 11 of “Guidelines on Restructurings” dictates “capable of strengthening the listed company’s ability as a going-concern” and number 4.4 of “Q&A regarding Listed Companies’ Major Restructurings”(“Q&A” hereafter) dictates “capable of improving listed companies’ financial condition and profitability, core business and risk management,” please explain whether the proposed deal meets these requirements and why it is necessary and reasonable to carry out the deal; your independent financial advisor should review the deal and clearly express her opinions.
3. According to the your board meeting minutes, your board of directors did not conduct vetting procedure to assess the proposed deal as required by number 4 of “Q&A.” Please ask your board to conduct proper procedure point by point according to requirements of “Q&A;” your independent financial advisor should review and clearly express her opinions.
4. According to “Restructuring Agreement,” target company’s registered capital is 100 million RMB, and paid-in-capital is 0 RMB, please detail the incorporation of the target company, founding shareholders’ plan on injecting capital, timetable of injecting capital, legality of the incorporation, verification of founding shareholders’ impending paid-in-capital, potential risk and illegality of impaired assets used as paid-in-capital; your independent financial advisor and lawyer should review and clearly express their opinions regarding target company’s incorporation.
5. According to your periodic reports and “Restructuring Agreement,” your company is currently financially constrained and the initial payment originates from selling receivables to a factor, please provide additional information regarding the detailed arrangement, counterparty, costs, and warn investors of the risk on factoring; moreover, please detail your plan on future financing, as well as the financing of the seller of the target; whether the financing arrangement affects current business operations, and provide risk disclosure accordingly.
6. According to the target company’s paid-in-capital situation, detail the target’s planned operating activities and whether it acquires qualifications and approvals from relevant government agencies if it involves regulated operations. Along with comment number 2 above, once again assess whether the

proposed deal meets number 4 of “Q&A;” your independent financial advisor should review and express her opinions.

7. Please explain why your company did not hire an accounting firm to audit the financial statements of the target company, and whether the lack of audit satisfies the requirements of “Guidelines on Restructurings” and number 16.6 of “Rule 26;” if the requirements are not met, provide your solution; your independent financial advisor should review and express her opinions.

8. According to number 21 of “Rule 26,” please detail the target company’s main business, including but not limited to the government agencies that regulate the target company’s industry, major laws, rules and regulations, business model, profit driver, accounting system, and the target company’s directors, executives and key technology staff along with their recent changes.

9. According to “Rule 26,” please provide your board of directors’ assessment on the valuation and pricing of the target company, and independent directors should independently assess the fairness of the pricing; your independent financial advisor should review and express her opinions.

10. According to “Restructuring Agreement,” your company realized 94,840,200 RMB from managing real estates and parking lots, and 70,114,200 RMB from housing rentals as revenue between January and June of 2015; however, you reported revenue of 58,415,500 for the first half-year of 2015. Please explain the inconsistency and provide timely disclosure if revision and supplemental notes are needed.

Please address the comments above in correspondence, and send explanatory materials to our division by September 23, 2015, and disclose publicly accordingly.

Shenzhen Stock Exchange

Corporate Division

September 15, 2015

Table 1 Breakdown of topics in annual report letters and breakdown of revised items in revised annual reports filed after the receipt of annual report letters

Panel A: Breakdown of topics in annual report letters

Topic	No
Accounts receivable	268
Quarterly results	263
Inventory impairment	259
Sales	241
Gross margin	236
Accounts receivable impairment	233
Big customers	193
Nonrecurring items	186
Net income	178
Other receivable	177
Inventory	173
Lending, borrowing and guarantee with related parties	146
Selling, general and administrative expenses	144
Mergers and acquisitions	136
Prepaid expense	133
Big suppliers	132
Related party transactions	128
Post-closing contingent payment	127
Costs	125
Operating cash flows	118
Revenue recognition	116
Subsidiary	111
Inconsistency or error	108
Government subsidy	99
Goodwill impairment	94
Other receivable impairment	88
Construction in progress	86
Notes receivable	81
R&D	81
Going concern	76
Lawsuit	74
Solvency risk	74
Fixed asset impairment	73
Contingent debt	68
Liquidity Risk	67
Internal control	61
Accruals	57

Panel B: Breakdown of revised items in revised annual reports filed after the receipt of annual report letters

Revised item	Frequency
Main Quarterly Financials	17
Statement of Cash Flows	10
Income Statement	9
Three-year Main Financials	9
Balance Sheet	7
Statement of Changes in Equity	6
ROE	3
EPS	2

Table 1 Panel A displays the distribution of self-coded topics that appear in at least 50 annual report letters. The topics are not mutually exclusive because one letter can comment on multiple topics. Table 1 Panel B lists the revised items in revised annual reports filed after a firm's receipt of an annual report and is based on 31 annual reports that revise numbers in the previously filed annual reports instead of pure texts. The revised items are not mutually exclusive because one annual report can change multiple items.

Table 2 Comparison of characteristics between annual report letter recipients and non-recipients

Variable	Letter_Ann=1			Letter_Ann=0		
	N	Mean	Median	N	Mean	Median
CAR_Letter	597	-0.014	-0.012			
CAR_Delay	151	-0.009	-0.009			
BadRating	441	0.553	1.000			
Enforcement	694	0.241	0.000			
Issues	694	10.955	10.000			
AccuseStat	694	0.712	0.000			
Delay	694	0.258	0.000			
Revise	694	0.353	0.000			
MediaRpt	754	0.199***	0.000***	7095	0.118	0.000
LnBaidu	754	6.295***	6.251***	7095	6.189	6.116
Big4	754	0.025***	0.000***	7095	0.076	0.000
CleanOp	754	0.812***	1.000***	7095	0.950	1.000
ICWeakness	754	0.549***	1.000***	7095	0.363	0.000
BoardSize	754	8.577**	9.000**	7095	8.723	9.000
BoardIdpt	754	0.375	0.364	7095	0.374	0.333
SpecialT	754	0.101***	0.000***	7095	0.017	0.000
LnMktCap	754	8.993***	8.909***	7095	9.187	9.043
AbRet	754	-0.121	-0.251**	7095	-0.100	-0.210
MB	754	6.899***	3.575***	7095	4.374	3.134
Lev	754	0.549***	0.571***	7095	0.453	0.443
Growth	754	0.312***	0.045***	7095	0.211	0.097
Accruals	754	-0.014	-0.013	7095	-0.008	-0.009
ROA	754	0.002***	0.011***	7095	0.035	0.031

Table 2 compares the characteristics of annual report letter recipients (*Letter_Ann=1*) and non-recipients (*Letter_Ann=0*). Firms listed in the main boards of Shanghai Stock Exchanges from 2015 to 2017 and Shenzhen Stock Exchanges from 2014 to 2017 are included. The first eight variables from *CAR_Letter* to *Revise* are only available within annual report letter recipients and the other variables are available for both recipients and non-recipients included in the determinant models. Two-sample t-tests and Wilcoxon tests are conducted to compare the mean and median values of recipients and non-recipients, and ***, ** and * signify two-tail statistical significance. Detailed variable definitions are in Appendix 1.

Table 3 Determinants of the receipt of annual report letters

Panel A: Annual report letters issued by both stock exchanges

Variable	(1) Letter Ann	(2) Letter Ann
MediaRpt	0.021*** [3.483]	
LnBaidu		0.049*** [6.651]
Big4	-0.061*** [-3.567]	-0.058*** [-3.416]
CleanOp	-0.037*** [-3.301]	-0.033*** [-3.045]
ICWeakness	0.035*** [5.628]	0.033*** [5.421]
BoardSize	-0.003 [-1.279]	-0.003* [-1.646]
BoardIdpt	-0.080 [-1.262]	-0.101 [-1.615]
SpecialT	0.069*** [4.786]	0.055*** [4.073]
LnMktCap	-0.007 [-1.488]	-0.022*** [-4.097]
AbRet	-0.002 [-0.522]	0.002 [0.529]
MB	0.002*** [2.994]	0.002*** [3.240]
Lev	0.074*** [3.923]	0.065*** [3.581]
Growth	0.014*** [3.583]	0.014*** [3.812]
Accruals	0.149*** [3.501]	0.138*** [3.303]
ROA	-0.505*** [-7.412]	-0.434*** [-6.485]
Industry FEs	Yes	Yes
Year FEs	Yes	Yes
No. of Obs	7849	7849
pseudo R ²	12.9%	13.8%

Panel B: Annual report letters issued by Shanghai Stock Exchange

Variable	(1) Letter Ann	(2) Letter Ann
MediaRpt	0.030*** [3.023]	
LnBaidu		0.033** [2.081]
Big4	-0.093*** [-3.205]	-0.090*** [-3.083]
CleanOp	-0.036* [-1.708]	-0.036* [-1.720]
ICWeakness	0.003 [0.256]	0.004 [0.327]
BoardSize	-0.012*** [-2.890]	-0.012*** [-2.978]
BoardIdpt	-0.164 [-1.250]	-0.177 [-1.335]
SpecialT	-0.018 [-0.652]	-0.019 [-0.724]
LnMktCap	-0.018** [-2.119]	-0.026** [-2.469]
AbRet	-0.006 [-0.568]	-0.003 [-0.263]
MB	-0.000 [-0.035]	0.000 [0.070]
Lev	0.065* [1.816]	0.061* [1.710]
Growth	0.027*** [3.381]	0.028*** [3.549]
Accruals	0.363*** [4.429]	0.352*** [4.270]
ROA	-0.942*** [-6.869]	-0.889*** [-6.330]
Industry FEs	Yes	Yes
Year FEs	Yes	Yes
No. of Obs	3039	3039
pseudo R ²	9.4%	9.2%

Table 3 reports the logit regressions of the determinant model of firms' receiving annual report letters. Panel A (B) includes annual letters issued by both stock exchanges (Shanghai Stock Exchange). The observations are at the firm-year level. If firm i 's annual report for year t receives a comment letter then $Letter_Ann_{i,t}$ is set to 1, and 0 otherwise. Industry and Year fixed effects are included. Industry classifications are defined by 2012 CSRC industry code. The coefficients are marginal effects at the mean, and z-statistics underneath the coefficients are based on standard errors clustered at the firm level. ***, ** and * signify two-tailed statistical significance at the 1%, 5% and 10% level. Detailed variable definitions are in Appendix 1.

Table 4 Market reactions to the receipt of annual report letters

Variable	(1) CAR Letter	(2) CAR Letter
Issues	-0.000 [-0.293]	
AccuseStat		-0.004** [-2.423]
Big4	-0.007 [-0.822]	-0.006 [-0.712]
CleanOp	0.018** [2.419]	0.016** [2.195]
ICWeakness	0.005 [0.986]	0.005 [1.035]
BoardSize	-0.001 [-0.401]	-0.001 [-0.446]
BoardIdpt	-0.069 [-1.526]	-0.073 [-1.612]
SpecialT	0.009 [1.282]	0.010 [1.396]
LnMktCap	-0.002 [-0.472]	-0.002 [-0.548]
AbRet	-0.000 [-0.033]	0.000 [0.005]
MB	0.000 [0.303]	0.000 [0.209]
Lev	-0.017 [-1.616]	-0.017 [-1.601]
Growth	0.003 [1.215]	0.003 [1.211]
Accruals	-0.039 [-1.350]	-0.034 [-1.202]
ROA	0.001 [0.034]	-0.000 [-0.005]
Industry FEs	Yes	Yes
Year FEs	Yes	Yes
No. of Obs	597	597
Adj R ²	3.5%	4.6%

Table 4 reports the regression results of market reactions to the receipt of annual report letters. *CAR_Letter* is three-day cumulative market-adjusted returns centered on the receipt date of annual report letters. Letters received during trading suspensions do not have *CAR_Letter*. The test variables are the number of issues raised in a letter, *Issues*, and the number of accusatory statements in a letter, *AccuseStat*. Industry and Year fixed effects are included. Industry classifications are defined by 2012 CSRC industry code. t-statistics are based on standard errors clustered at the firm level. ***, ** and * signify two-tailed statistical significance at the 1%, 5% and 10% level. Detailed variable definitions are in Appendix 1.

Table 5 Severity of annual report letters and disclosure quality rating by the stock exchanges

Variable	(1) BadRating	(2) BadRating	(3) BadRating	(4) BadRating
Issues	0.034*** [4.616]			
AccuseStat		0.062*** [2.893]		
Delay			0.209*** [2.893]	
Revise				0.179*** [3.121]
Big4	0.100 [0.435]	0.095 [0.437]	0.090 [0.473]	0.148 [0.769]
CleanOp	-0.410*** [-4.608]	-0.404*** [-4.674]	-0.417*** [-4.857]	-0.440*** [-5.107]
ICWeakness	0.164*** [2.746]	0.155*** [2.635]	0.133** [2.259]	0.144** [2.475]
BoardSize	0.018 [0.863]	0.020 [0.946]	0.014 [0.677]	0.017 [0.839]
BoardIdpt	-1.154 [-1.577]	-0.988 [-1.300]	-1.091 [-1.466]	-0.922 [-1.240]
SpecialT	0.005 [0.060]	0.070 [0.824]	0.106 [1.268]	0.058 [0.662]
LnMktCap	-0.112** [-2.453]	-0.091* [-1.910]	-0.105** [-2.197]	-0.089* [-1.906]
AbRet	0.148** [2.465]	0.105* [1.745]	0.116* [1.893]	0.127** [2.151]
MB	-0.002 [-0.450]	-0.002 [-0.563]	-0.003 [-0.830]	-0.003 [-0.672]
Lev	-0.258* [-1.719]	-0.192 [-1.321]	-0.183 [-1.237]	-0.207 [-1.457]
Growth	0.011 [0.358]	0.007 [0.232]	0.007 [0.254]	0.002 [0.083]
Accruals	0.579 [1.571]	0.722** [1.982]	0.754** [2.087]	0.804** [2.183]
ROA	-0.316 [-0.583]	-0.538 [-1.025]	-0.435 [-0.822]	-0.462 [-0.869]
Industry FEs	Yes	Yes	Yes	Yes
Year FEs	Yes	Yes	Yes	Yes
No. of Obs	441	441	441	441
pseudo R ²	18.4%	15.6%	15.6%	15.8%

Table 5 reports the logit regressions of firms' receiving a bad disclosure quality rating. The observations are at the firm-year level. If firm i 's disclosures for year t receives a C or D rating then $BadRating_{i,t}$ is set to 1, and 0 if the rating is A or B. The test variables are *Issues*, *AccuseStat*, *Delay* and *Revise* that measure the severity of the annual report letters. Industry and Year fixed effects are included. Industry classifications are defined by 2012 CSRC industry code. The coefficients are marginal effects at the mean, and z-statistics underneath the coefficients are based on standard errors clustered at the firm level. ***, ** and * signify two-tailed statistical significance at the 1%, 5% and 10% level. Detailed variable definitions are in Appendix 1.

Table 6 Severity of annual report letters and accounting-related enforcement actions

Variable	(1) Enforcement	(2) Enforcement	(3) Enforcement	(4) Enforcement
Issues	0.010*** [2.731]			
AccuseStat		0.039*** [3.361]		
Delay			0.074* [1.833]	
Revise				0.025 [0.728]
Big4	-0.015 [-0.145]	-0.025 [-0.241]	-0.020 [-0.191]	-0.021 [-0.189]
CleanOp	-0.108** [-2.438]	-0.101** [-2.244]	-0.110** [-2.472]	-0.118*** [-2.616]
ICWeakness	0.126*** [3.021]	0.122*** [2.952]	0.117*** [2.835]	0.128*** [3.108]
BoardSize	-0.002 [-0.134]	-0.001 [-0.046]	-0.002 [-0.181]	-0.003 [-0.204]
BoardIdpt	-0.400 [-0.974]	-0.372 [-0.887]	-0.417 [-1.035]	-0.413 [-1.003]
SpecialT	0.038 [0.710]	0.057 [1.128]	0.065 [1.269]	0.059 [1.164]
LnMktCap	-0.039 [-1.385]	-0.035 [-1.271]	-0.035 [-1.252]	-0.033 [-1.170]
AbRet	0.046 [1.533]	0.042 [1.426]	0.043 [1.489]	0.044 [1.485]
MB	0.002 [0.956]	0.002 [0.808]	0.002 [0.799]	0.002 [0.796]
Lev	-0.074 [-0.806]	-0.049 [-0.551]	-0.044 [-0.487]	-0.044 [-0.490]
Growth	0.030* [1.851]	0.030* [1.908]	0.030* [1.821]	0.031* [1.950]
Accruals	0.206 [0.986]	0.209 [1.000]	0.275 [1.305]	0.277 [1.304]
ROA	-0.311 [-1.046]	-0.356 [-1.191]	-0.392 [-1.328]	-0.393 [-1.317]
Industry FEs	Yes	Yes	Yes	Yes
Year FEs	Yes	Yes	Yes	Yes
No. of Obs	694	694	694	694
pseudo R ²	13.1%	13.4%	12.6%	12.2%

Table 6 reports the logit regressions of firms' receiving accounting-related enforcement actions. The observations are at the firm-year level. If firm i 's financial reporting for year t receives an enforcement action from the stock exchanges or the CSRC then $Enforcement_{i,t}$ is set to 1, and 0 otherwise. The test variables are *Issues*, *AccuseStat*, *Delay* and *Revise* that measure the severity of the annual report letters. Industry and Year fixed effects are included. Industry classifications are defined by 2012 CSRC industry code. The coefficients are marginal effects at the mean, and z-statistics underneath the coefficients are based on standard errors clustered at the firm level. ***, ** and * signify two-tailed statistical significance at the 1%, 5% and 10% level. Detailed variable definitions are in Appendix 1.

Table 7 Comparison of restructuring letter recipients who cancel restructurings and recipients who do not cancel restructurings

Variable	Cancellation=1			Cancellation=0		
	N	Mean	Median	N	Mean	Median
Issues	131	15.344***	14.000***	512	12.697	11.000
NoReply	131	0.206***	0.000***	512	0.041	0.000
Delay	104	0.356*	0.000*	491	0.275	0.000
Draft	131	0.710***	1.000***	512	0.516	1.000
LnDealVal	131	7.332	7.233	512	7.385	7.441
IssueStk	131	0.748***	1.000***	512	0.566	1.000
AssetPchse	131	0.878**	1.000**	512	0.803	1.000
AssetSale	131	0.153	0.000	512	0.207	0.000
AddFunds	131	0.618***	1.000***	512	0.463	0.000
RelatedPty	131	0.802***	1.000***	512	0.668	1.000
Big4	131	0.038	0.000	512	0.066	0.000
CleanOp	131	0.878	1.000	512	0.912	1.000
ICWeakness	131	0.450	0.000	512	0.449	0.000
BoardSize	131	8.618	9.000	512	8.596	9.000
BoardIdpt	131	0.376	0.364	512	0.376	0.364
SpecialT	131	0.084	0.000	512	0.070	0.000
LnMktCap	131	8.885*	8.763	512	9.015	8.891
AbRet	131	0.044	-0.141	512	0.010	-0.162
MB	131	9.349	4.290*	512	7.386	3.605
Lev	131	0.540	0.550	512	0.521	0.527
Growth	131	0.408	0.045	512	0.452	0.039
Accruals	131	-0.023	-0.005	512	-0.016	-0.013
ROA	131	0.011	0.017	512	0.012	0.019

Table 7 compares the characteristics of restructuring letter recipients who cancel restructurings (*Cancellation=1*) and do not cancel restructurings (*Cancellation=0*) upon receiving the letters. The sample only includes letter recipients because almost all planned major restructurings receive restructuring letters. Two-sample t-tests and Wilcoxon tests are conducted to compare the mean and median values of firms who cancel restructurings and firms who do not cancel restructurings, and ***, ** and * signify two-tail statistical significance. Detailed variable definitions are in Appendix 1.

Table 8 Severity of restructuring letters and deal cancellations

Variable	(1) Cancellation	(2) Cancellation	(3) Cancellation
Issues	0.004** [2.175]		
NoReply		0.254*** [5.483]	
Delay			0.059* [1.866]
Draft	0.102*** [3.568]	0.088*** [3.109]	0.070*** [2.753]
LnDealVal	-0.024** [-2.187]	-0.023** [-2.137]	-0.023** [-2.285]
IssueStk	0.087 [1.522]	0.090 [1.569]	0.110** [2.044]
AssetPchse	0.013 [0.166]	0.017 [0.208]	0.036 [0.405]
AssetSale	-0.017 [-0.280]	-0.034 [-0.490]	-0.017 [-0.246]
AddFunds	-0.024 [-0.558]	-0.017 [-0.377]	-0.022 [-0.539]
RelatedPty	0.061 [1.485]	0.050 [1.274]	0.022 [0.581]
Big4	-0.038 [-0.503]	-0.062 [-0.878]	-0.067 [-0.954]
CleanOp	-0.063 [-1.044]	-0.041 [-0.649]	-0.022 [-0.337]
ICWeakness	-0.011 [-0.350]	-0.019 [-0.630]	-0.022 [-0.783]
BoardSize	0.010 [0.881]	0.014 [1.259]	0.012 [1.199]
BoardIdpt	0.286 [0.966]	0.262 [0.890]	0.135 [0.515]
SpecialT	0.003 [0.039]	0.013 [0.197]	-0.017 [-0.270]
LnMktCap	-0.022 [-1.029]	-0.030 [-1.438]	-0.027 [-1.373]
AbRet	-0.003 [-0.127]	0.002 [0.101]	-0.009 [-0.409]
MB	0.000 [0.454]	-0.000 [-0.166]	0.000 [0.012]
Lev	0.060 [0.808]	0.087 [1.222]	0.130** [1.995]
Growth	-0.001 [-0.181]	-0.000 [-0.087]	0.001 [0.146]
Accruals	-0.084 [-0.527]	-0.053 [-0.327]	-0.058 [-0.367]
ROA	0.246 [1.017]	0.210 [0.839]	0.223 [0.969]
Industry FEs	Yes	Yes	Yes
Year FEs	Yes	Yes	Yes
No. of Obs	643	643	595
pseudo R ²	10.9%	15.3%	13.2%

Table 8 reports the logit regressions of firms' cancelling a restructuring deal after receiving a restructuring letter and the severity of the letter. The observations are at the filing level, and the filing can be a preliminary draft (*Draft*=1), or a more advanced proposal or report (*Draft*=0). If a firm

cancels the deal after receiving a restructuring letter *Cancellation* is set to 1, and 0 otherwise. The test variables are *Issues*, *NoReply* and *Delay* that measure the severity of a restructuring letter. The regression with *Delay* as the test variable has fewer observations than the other specifications because only firms that reply to the stock exchanges have *Delay*. Industry and Year fixed effects are included. Industry classifications are defined by 2012 CSRC industry code. The coefficients are marginal effects at the mean, and z-statistics underneath the coefficients are based on standard errors clustered at the firm level. ***, ** and * signify two-tailed statistical significance at the 1%, 5% and 10% level. Detailed variable definitions are in Appendix 1.

Table 9 Topics and referenced regulations in restructuring letters and deal cancellations

Variable	(1) Cancellation	(2) Cancellation
Comm_RevTkr	0.098** [2.323]	
Comm_Quality	0.109*** [2.870]	
Comm_Pricing	-0.048 [-1.328]	
Comm_Promise	0.022 [0.694]	
Comm_CounterPty	-0.032 [-0.871]	
Comm_RelatedPty	-0.006 [-0.173]	
Comm_Control	0.047 [1.499]	
Comm_AddFunds	0.015 [0.338]	
Comm_PriorDeal	0.027 [0.488]	
Comm_Acctg	-0.017 [-0.559]	
Comm_ConCall		0.252*** [4.051]
Comm_Guidelines		0.008 [0.658]
Comm_Rule26		0.008 [1.219]
Comm_Memo6		0.040 [0.923]
Comm_FAQ		0.025 [0.723]
Comm_Q&A		-0.062 [-1.376]
Comm_Govern4		0.007 [0.138]
Comm_Others		0.006 [0.590]
Controls	Yes	Yes
Industry FEs	Yes	Yes
Year FEs	Yes	Yes
No. of Obs	643	643
pseudo R ²	13.1%	14.5%

Table 9 reports the logit regressions of firms' cancelling a restructuring deal after receiving a restructuring letter and the topics or referenced regulations in a letter. The observations are at the filing level, and the filing can be a preliminary draft (*Draft*=1), or a more advanced proposal or report (*Draft*=0). If a firm cancels the deal after receiving a restructuring letter *Cancellation* is set to 1, and 0 otherwise. The test variables *Comm_RevTkr*, *Comm_Quality*, *Comm_Pricing*, *Comm_Promise*, *Comm_CounterPty*, *Comm_RelatedPty*, *Comm_Control*, *Comm_AddFunds*, *Comm_PriorDeal* and *Comm_Acctg* are indicators that equal 1 if a letter comment on reverse takeover, traded asset quality, transaction pricing, post-closing contingent payment, counterparty, related

party transaction, control over traded assets, additional financing, prior restructuring and accounting issues, respectively. The test variables *Comm_ConCall*, *Comm_Guidelines*, *Comm_Rule26*, *Comm_Memo6*, *Comm_FAQ*, *Comm_Q&A*, *Comm_Govern4*, *Comm_Others* are the number of times “guidelines on media conference call regarding restructurings,” “restructuring guidelines,” “Rule 26,” “Memo 6-concerning asset appraisal,” “FAQs of listed companies’ governing laws and rules,” “several Q&As regarding restructurings,” “listed companies’ governing rule 4”, other regulations are referenced, respectively. Industry and Year fixed effects are included. Industry classifications are defined by 2012 CSRC industry code. The coefficients are marginal effects at the mean, and z-statistics underneath the coefficients are based on standard errors clustered at the firm level. ***, ** and * signify two-tailed statistical significance at the 1%, 5% and 10% level. Detailed variable definitions are in Appendix 1.