Director interlocks and audit pricing: The spillover effects of comment letters

Abstract: We examine whether regulatory comment letters generate spillover effects through interlocking directors. Using data from listed Chinese firms between 2015 and 2023, we find that auditors charge lower fees to focal firms whose interlocking directors also serve on boards of firms that received comment letters. This supports the hypothesis of positive governance spillovers, indicating auditors view the exposure of interlocking directors to regulatory scrutiny as enhancing board oversight and reducing audit risk. Channel analysis confirms that the lower fees stem from reduced perceived audit risk rather than decreased audit effort. Spillover effects intensify when focal firms are state-owned, have higher institutional ownership, or hold frequent board meetings, which are characteristics oftentimes linked to increased governance responsiveness. Directors with greater reputational capital and experience further amplify these spillovers. However, the effect weakens with severe comment letters involving numerous questions or internal control concerns, suggesting a risk contagion mechanism. Finally, we find no evidence of improved disclosure quality among focal firms, indicating auditors primarily react to perceived governance enhancements rather than tangible disclosure improvements. Our results highlight director networks as significant conduits of regulatory influence.

Keywords: Comment letters; Director interlocks; Spillover effect; Audit fees; Financial reporting regulation; Corporate governance

1. INTRODUCTION

Comment letters represent an important regulatory oversight of corporate disclosures (Cassell et al., 2013). These letters are formal communications between regulators and companies, aiming to address concerns related to compliance with applicable financial reporting and disclosure requirements (Cunningham et al., 2022). Rising public interest, along with the substantial costs for both the regulators in reviewing and the companies in responding, has driven a rapid expansion in comment letter literature. Prior studies primarily focus on the Securities and Exchange Commission (SEC) comment letters in the US and identify various economic consequences of receiving a comment letter, including negative stock returns (Dechow et al. 2016), enhanced corporate disclosure (Bozanic et al., 2017), improved financial reporting environment (Johnston and Petacchi, 2017), reduced tax avoidance (Kubick et al., 2016) and a switch from accrual-based earnings management to real activities manipulation (Cunningham et al., 2020). In addition to these direct effects on targeted firms, emerging evidence suggests that regulatory scrutiny may have broader implications beyond the firm level. For instance, comment letters have been shown to exert spillover effects on industry peers (Brown et al., 2018) and audit firms associated with the targeted firms (Cao et al., 2019; Bills et al., 2024). Nevertheless, whether comment letters can generate spillover effects through inter-organizational governance linkages—such as board interlocks—has not been systematically examined.

Board interlocks serve as an important channel for the diffusion of information, knowledge, or resources (Shropshire, 2010; Zona et al., 2018). Prior research finds that firms with common directors share similarities in governance practices, accounting choices and financial behaviors (e.g., Bizjak et al., 2009; Bouwman, 2011; Chiu et al., 2013; Brown and Drake,2014; Cai et al., 2014; Han et al., 2017; Karim et al., 2022). As boards of directors play a key role in ensuring the integrity of financial reporting, interlocking directorships may also generate effects of either reputational contagion or governance spillovers. One line of research suggests that board interlocks can amplify the transmission of regulatory shocks across firms. For instance, when a firm

allegedly engaged in misconduct or fraud, interlocked firms often experience penalties, including negative market reactions (Kang, 2008; Ding et al., 2024), higher audit fees (Li et al., 2023; Ivanova and Prencipe, 2023), and increased cost of debt (Lai et al., 2019). These effects reflect stakeholders' concerns that governance weaknesses—or weak oversight—may extend across interlocked firms, triggering a reassessment of risk exposure through governance networks.

On the other hand, board interlocks may not only transmit risk but also induce preemptive governance improvements (Zhang, 2021). Driven by reputational concerns or regulatory learning, directors serving on multiple boards could proactively enhance disclosure quality or tighten internal control in connected firms to avoid being associated with poor governance practices (Zhong et al., 2017; Cheng et al., 2019). In this way, the diffusion of regulatory scrutiny through interlock networks can thus serve as a self-correcting mechanism. Empirical evidence supports this notion, showing that firms sharing directors with misconduct-accused companies are less likely to engage in similar misconduct (Wang et al., 2022) and face a lower stock price crash risk when they share directors with firms accused of fraud (Wen et al., 2023). These contrasting mechanisms raise important questions about how external stakeholders interpret such inter-firm connections. In particular, it remains unclear whether auditors, who serve as key external monitors, respond to comment letter spillovers through board interlocks by adjusting audit fees in light of perceived risks or governance improvements.

Notably, most prior studies on interlock spillovers focus on severe regulatory events, such as fraud allegations or enforcement actions (e.g., Kang, 2008; Li et al., 2023), which are typically associated with clear governance failures and reputational penalties. In contrast, comment letters represent a less severe but more frequent form of regulatory scrutiny, aimed at helping firms improve disclosure quality of financial reporting in a timely manner (Cunningham et al., 2022; Liao et al., 2023). Given their corrective and informational nature, comment letters may not be viewed solely as red flags but as catalysts for governance improvements within interlocked firms. When

such regulatory interventions occur through board interlock networks, they may lead to either (1) risk contagion, where concerns about reporting quality spread across interlocked firms; or (2) governance spillover, where interlocked directors facilitate improvements in financial oversight. These alternative channels have direct implications for auditors' risk assessments on financial reporting. Understanding whether auditors interpret such comment letter events as red flags or signals of governance improvement is thus essential for unpacking how regulatory pressure travels through inter-organizational ties and influences the pricing of audit services.

To resolve this ambiguity, we examine whether and how auditors adjust audit fees for firms whose interlocked firms have received financial reporting comment letters. As sophisticated assessors of financial reporting risk, auditors' pricing decisions directly reflect their risk perception of financial reporting quality (Ody-Brasier and Sharkey,2023) —precisely the dimension targeted by comment letters. This focus distinguishes our study from prior research in capital markets (e.g., analyst forecasts; Dai et al., 2025), where outcomes often reflect investor sentiment or information asymmetry. In contrast, audit fees are determined by independent professionals based on evaluations of firms' financial reporting. As such, they offer a more objective and direct measure of perceived financial reporting risk compared to market-based measures.

Specifically, we examine two potential mechanisms through which comment letters may affect the pricing of audit services. First, drawing on the notion of risk contagion, we hypothesize that auditors perceive increased risks of financial reporting quality when firms are connected through interlocks with firms receiving comment letters. This perceived risk may lead auditors to increase audit fees as a precautionary measure to mitigate the potential reputational damage associated with their client's reporting quality. Second, we consider the possibility of governance spillover. In this scenario, directors may leverage their positions on multiple boards to foster improvements in financial oversight and reporting practices in interlocked firms. If

auditors perceive these governance improvements as reducing reporting risks, we hypothesize that audit fees could decrease or stabilize as a result of the perceived reduction in financial reporting risk.

To test these hypotheses, we use a dataset of Chinese A-share firms listed on the Shanghai and Shenzhen Stock Exchanges from 2015 to 2023. We focus on the Chinese market for the following reason: First, unlike the U.S. where SEC comment letters are disclosed only after the review process is completed (Bozanic et al., 2017), China provides timely disclosure of comment letters. To alert investors, all comment letters and responses are released for public dissemination immediately. This policy allows auditors to observe regulatory scrutiny in a timely manner, reducing information lags and facilitating the identification of spillover effects. Second, China lacks the institutional mechanisms supporting high-quality disclosure compared to developed markets (Lennox and Wu, 2022). The characteristics of the market function include weak legal protection of minority shareholders, concentrated ownership structure, widespread state ownership (Allen et al., 2005; Cheng et al., 2022; Lu et al., 2023). which may amplify the role and relevance of regulatory oversight (Yang, 2022). Third, while studies in developed markets generally affirm the effectiveness of comment letters (e.g., Johnston and Petacchi, 2017; Bozanic et al., 2017), evidence from developing economies remains limited and mixed (e.g., Duan et al., 2022; Xu et al., 2022; Lu et al., 2023). Studying how comment letters function in China thus offers valuable insights into the global applicability of disclosure regulation and the dynamics of inter-organizational risk transmission in emerging markets.

Through regression analysis, we find that auditors tend to charge firms lower fees when their director-interlocked firms receive comment letters within the previous three years. This finding is more consistent with the governance spillover mechanism, suggesting that auditors interpret the regulatory scrutiny faced by interlocked firms as contributing to improved oversight and financial reporting quality. Consequently, they adjust their risk assessments downward, leading to reduced audit fees. To address potential sample selection bias and endogeneity concerns, we conduct

propensity score matching (PSM) and difference-in-differences (DID) analyses. The main results are also robust to using alternative measures other sensitivity tests.

To further explore the heterogeneity of the governance spillover effect, we conduct a series of cross-sectional analyses based on governance characteristics. First, we find that the reduction in audit fees is more pronounced when focal firms are SOEs. This is consistent with the view that SOEs are more sensitive to regulatory signals due to their political legitimacy concerns (Lin et al., 2020) and tend to respond proactively to mitigate regulatory risks. Second, we find that the reduction in audit fees is more pronounced when focal firms have higher institutional shareholding. Institutional investors are generally large, sophisticated investors who play a monitoring role in enhancing reporting quality (e.g., Ramalingegowda and Yu, 2012). Their involvement can enhance the effectiveness of governance improvements, thereby reducing perceived audit risk and reinforcing the observed reduction in audit fees. Third, we find that this spillover effect is also stronger when focal firms or exhibit better information communication, as evidenced by higher frequency of board meetings. More frequent board meetings provide directors with greater opportunities to exchange regulatory insights, discuss governance improvements, and address potential risks in a timely manner (Adams and Ferreira, 2008; Liu et al., 2016). This enhanced communication strengthens corporate oversight and facilitates the transfer of best practices, thereby reducing perceived audit risk. These heterogeneous effects collectively support the governance spillover hypothesis.

Additionally, we examine how the characteristics of interlocking directors moderate the spillover effect. The results show that the audit fee reduction is more pronounced when the interlocking directors possess greater experience—proxied by older age—and higher reputation, as indicated by the number of concurrent directorships held. These findings suggest that more experienced and reputable directors are better positioned to absorb regulatory insights and transmit governance-enhancing practices across the firms they serve. Their stronger reputational concerns may also motivate them to proactively mitigate perceived governance weaknesses in interlocked firms,

thereby reducing auditors' risk assessments.

Furthermore, our findings reveal that the strength of the effect varies depending on the severity of the comment letters. When the comment letters are more severe, as indicated by a higher number of questions or involve internal control issues in comment letters, the spillover effect on the focal firms' audit fees is less pronounced. This suggests that while moderate regulatory scrutiny may be interpreted as constructive, more severe interventions are still perceived by auditors as indicators of heightened financial reporting risk.

Considering that audit fees are associated with either audit effort or perceived risk by the auditors (Markelevich and Rosner, 2013), we further investigate which of these two factors drives the reduction in audit fees in our context. Our empirical evidence suggests that the decrease in audit fees is not attributable to a reduction in audit effort, but rather to a lower perceived risk.

To assess whether the observed audit fee reductions truly reflect improvements in financial reporting quality, we conduct a series of complementary tests capturing multiple dimensions of the firm's disclosure quality. The results reveal a nuanced picture: First, we find a significant increase in real earnings management among focal firms, consistent with prior research suggesting that firms may shift toward less detectable manipulation techniques under tighter regulatory scrutiny (Cohen et al., 2008; Zang, 2012). This suggests that while firms respond to the governance signal, they may not fundamentally improve reporting quality but rather reallocate manipulation efforts (Cunningham et al., 2020). Second, we do not observe a significant decrease in analyst forecast errors or forecast dispersion. This result indicates that the perceived governance improvements primarily affect internal monitoring or audit readiness, without materially altering the quality of publicly disclosed information that analysts rely upon. Third, we find a decline in stock price synchronicity, suggesting that the market incorporates more firm-specific information following the regulatory experience of interlocked firms. One possible interpretation

is that regulatory events can activate investor attention and reduce synchronicity by encouraging the interpretation of firm-level fundamentals (Piotroski et al. ,2015). The above results reinforce the idea that the spillover effects observed are largely perceptual and signal-driven, rather than rooted in substantive changes to the quality of financial disclosures. This divergence highlights a potential disconnect between relational signals perceived by auditors and actual governance outcomes, especially in emerging markets, where informal relationships and perceived trust often substitute for transparent, verifiable information (Duan et al., 2022).

This study contributes to literature in several ways. First, it adds to the literature on the spillover effects of disclosure regulation (e.g. Cao et al.,2019; Brown et al.,2018; Bill et al., 2024; Ding et al., 2024) by uncovering how comment letters can indirectly shape audit pricing decisions through director interlocks. While recent work has documented comment letter spillovers through director networks in influencing analyst forecasts (e.g., Dai et al., 2025), we extend this literature by showing that auditors—independent and professionally third-party monitors— also adjust their risk assessments based on such indirect regulatory exposure. This focus on audit pricing offers a novel perspective on how governance-related regulatory signals travel through informal ties and are internalized by gatekeepers beyond capital markets. By shifting the focus from market-based outcomes to audit pricing, this paper deepens our understanding of how regulatory information propagates through inter-organizational networks and influences corporate stakeholders' behavior.

Second, this study offers new insights into the audit pricing literature by uncovering a network-based, regulatory-driven determinant of audit fees. While prior research has examined how firm-specific risk, governance attributes, or client characteristics influence audit pricing (e.g., Simunic, 1980; Hogan and Wilkins, 2008; Francis and Yu, 2009), we show that auditors also incorporate signals from regulatory events affecting peer firms connected through shared directors—even when the focal firm is not directly targeted. Importantly, this response appears to be driven by auditors' reliance on relational signals embedded in director networks—reflecting trust in the

regulatory learning and governance enhancement that may diffuse through these ties. This enriches the audit fee literature by introducing director network signals as a distinct channel influencing auditors' risk assessments and pricing decisions—highlighting the role of relational governance in weakly institutionalized settings (Allen et al., 2005).

Third, this study enriches the literature on director interlocks by shifting the focus from interlocks' impact on internal firm outcomes (e.g., Bizjak et al., 2009; Bouwman, 2011; Chiu et al., 2013; Brown and Drake,2014; Cai et al., 2014; Han et al., 2017) to their role in transmitting regulatory spillovers that shape external evaluations. While prior research has documented how interlocks transmit reputational risks arising from punitive regulatory events—such as fraud or financial misconduct (Kang, 2008; Li et al. ,2023; Ivanova and Prencipe, 2023; Ding et al.,2024), we highlight a different dimension: interlocks also transmit non-punitive regulatory scrutiny, such as comment letters, which influence external assessments. Unlike reputational contagion that increases audit fees, we find that such scrutiny leads to fee reductions, suggesting that auditors perceive this regulatory intervention as indicative of improved governance.

Finally, by focusing on the Chinese market, this study contributes to a broader understanding of how "soft" regulatory instruments operate within emerging economies. China's institutional environment—characterized by concentrated ownership, state influence, and weaker formal investor protections—provides a unique context where informal mechanisms such as director networks and external perception play an outsized role. Our findings suggest that, in such environments, auditors may rely more heavily on relational signals (e.g., interlocked directors' regulatory experiences) to form their judgments, even when substantive improvements in reporting quality are not observable. This distinction between perceived governance and actual disclosure change offers critical insights for regulators and standard-setters in developing economies aiming to strengthen market-based monitoring.

The remainder of this paper proceeds as follows. Section 2 provides the institutional background and reviews the literature. Section 3 develops our hypotheses. Section 4 discusses research design and main empirical results. Section 5 presents the results of the robustness tests, and Section 6 concludes.

2. INSTITUTIONAL BACKGROUND AND LITERATURE REVIEW

2.1 Institutional background of comment letters

After the Enron scandal, financial regulators worldwide strengthened oversight to detect and prevent financial fraud more promptly, leading to the widespread use of comment letters (Hong and Yao, 2024). Originated from the U.S. SEC, comment letters aim to enhance investor protection by identifying potential non-compliance with disclosure and accounting standards through review of company filings (SEC 2021). Under the Sarbanes-Oxley Act of 2002, the SEC is required to review public companies' periodic filings at least once every three years. When deficiencies are identified, the SEC issues a comment letter requesting clarification, additional disclosures, or amendments to current or future filings (SEC 2019). A comment letter may address multiple concerns, and firms are expected to respond within 10 business days or to request an extension. The process typically necessitates several rounds of correspondence until all issues are resolved, with an average of approximately 3 rounds, ranging from 2 to 14 (Cassell et al., 2013). Following the completion of the review, the SEC posts all correspondence to EDGAR no earlier than 20 days. However, there is a notable time lag in the public availability of comment letters; Cunningham et al. (2022) report an average of 297 days between the initial filing date and the public release of the comment letter correspondence.

Since their introduction, comment letters have been proven to be effective instruments for improving the information environment of companies in the US (e.g., Bens et al., 2016; Bozanic et al., 2017; Johnston and Petacchi, 2017). Drawing on the successful experience, less developed markets have sought to adopt similar regulatory mechanisms, in efforts to expedite a move toward well-functioning markets (Duan et

al., 2022). The Chinese Securities Regulatory Commission (CSRC) introduced the comment letter supervision system in 2014, synchronous with the market-oriented reform of the information disclosure system (CSRC 2014). Following this initiative, the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE) began promoting the 'information disclosure through-train' scheme and transformed their approach to front-line supervision from pre-supervision to post-supervision. Listed company announcements are no longer subject to prior approval by the exchanges; instead, they are disclosed directly to investors and reviewed afterward(Jiang and Kim, 2020). As a result, the comment letter has become a key instrument of ex-post supervision in regulating firms' information disclosure practices.

In China's regulatory framework, comment letters are issued by two exchange stocks, SZSE and SSE, leveraging their frontline supervisory role and information advantages (Yao et al., 2024). The Division of Corporate Management of the stock exchanges conducts the review process. Taking annual report reviews as an example, the process initiates when a listed company files its prior-year (t-1) financial statements in year t (T1). For firms with disclosure deficiencies, the Division issues comment letters and require them to provide a written response within the stipulated period. The comment letter is typically issued within 5 to 20 trading days after the annual report disclosure (T2). The issues addressed in these letters often include unusual financial data, related-party transactions, asset impairments, changes in accounting policies, significant risk disclosures, and other non-financial information. All the comment letters are immediately disclosed on the exchanges' official websites under the 'Regulatory Inquiry' section, as well as on the CSRC's designated information disclosure platform (www.cninfo.com.cn). To enhance public awareness, the CSRC also authorizes major financial media (e.g., China Securities Journal, Shanghai Securities News, Securities Times) to disseminate comment letter information. The listed company is required to respond within 5 trading days, although many companies apply for extensions. The company's response is also made publicly available (T3). If the response is deemed insufficient, the exchange may issue follow-up inquiries, extending the process until

all issues are resolved (T4). In contrast to the SEC's multiple rounds of correspondence, China's regulatory framework emphasizes a more Single-round penetrating regulatory approach[1]. Therefore, comment letters typically involve only one round (Duan et al., 2022).

2.2 Literature review

2.2.1 Comment letters

Extent literature has documented the determinants of receiving comment letters and the subsequent economic consequences. For instance, research shows that firms with low profitability, small audit firms, weak corporate governance (Cassell et al., 2013), low accounting quality (Hribar et al., 2014) and political connections (Heese et al., 2017; Chen et al., 2020) are more likely to receive comment letters. Following the receipt of comment letters, firms often experience short-term negative stock price (Dechow et al.,2016; Yang, 2021; Duan et al., 2022). In some cases, companies may face higher audit fees (Gietzmann and Pettinicchio, 2014), increased debt costs (Zhu et al., 2023), and potential reputational damage (Liao et al., 2023). Beyond these economic impacts, firms often make behavioral changes in response to comment letters. Companies may enhance their disclosure (Bozanic et al., 2017), thus improving the financial reporting environment (Johnston and Petacchi, 2017; Xu et al., 2022; Lu and Qiu, 2023). Additionally, firms may engage in more conservative financial reporting (Cao et al., 2021), less tax avoidance (Kubick et al., 2016), and shift from accrual-based earnings management to real activities manipulation due to tightened regulatory scrutiny from the SEC (Cunningham et al., 2020).

Moreover, changes to future disclosures or reporting practices are not limited to companies receiving comment letters; spillover can occur across audit firms or industry peers. Brown et al. (2018) find that a firm that did not receive any comment

[1] This is largely attributable to the design of the comment letter, which typically includes 15–20 questions structured in a "problem tree" format, with each main question accompanied by 3–5 layers of follow-up sub-questions. The responsibility of intermediary institutions (e.g., auditors, lawyers) is also emphasized, as most responses are required to be accompanied by verification opinions from these third parties. Additionally, market discipline acts as an effective deterrent: firms receiving comment letters often experience significant cumulative negative abnormal returns following the public disclosure of the letters (e.g., Duan et al., 2022; Yang, 2022).

letter tends to modify its subsequent year's risk disclosure to a larger degree if the SEC has commented on the risk disclosure of its industry leader, a close rival, or numerous industry peers. Cao et al. (2021) find firms receiving RRGL comment letters subsequently engage in more conservative financial reporting practices, and spilling over this behavior to other clients of the same auditor. Additionally, Bills et al. (2024) find a greater likelihood of goodwill impairment when the audit firm serving the client is exposed to more goodwill-related comments received by other clients, suggesting that auditor facilitates spillover effects of comment letter. More recently, Dai et al. (2025) find that regulatory inquiries can also propagate through director networks: the receipt of comment letters by director-interlocked firms has been shown to reduce analyst forecast errors and dispersion for non-inquired firms.

Studies also find that comment letters can bring changes in the behavior of other stakeholders. From an audit perspective, auditors tend to adjust audit fees upwards in the period in which the comment letter is received (Gietzmann and Pettinicchio, 2014), and are more likely to issue modified or conservative audit opinions to the recipients of comment letters (Hu et al., 2022b). These adjustments are consistent with auditors reassessing the reputation and litigation risk of the client based on the issuance of a comment Letter. The pressure from comment letters can significantly decrease the probability of internal control opinion shopping at both audit firm level and signing partner level (Yao and Xue, 2019). Although auditor switching increases after receipt of an accounting-related comment letter, auditor involvement in the response reduces the likelihood of an auditor change in the following period (Mueller, 2024). Additionally, following the receipt of comment letters, firms experience a decrease in excess cash holdings (Yao and Hong, 2023), excess perks (Hong and Yao, 2024), excess CEO compensation (Wang et al., 2022), a higher likelihood of CFO turnover (Gietzmann et al., 2016) and increased earnings volatility (Yao et al., 2024). Moreover, creditors tend to charge a significantly higher cost of debt financing to recipients of comment letters (Zhu et al., 2023). Private security litigants also appear to benefit from the public dissemination of comment letters (Hutton et al., 2022).

2.2.2 Board interlocks

Board interlock occurs when a director serves on the boards of multiple corporations, creating a special type of social network (Mizruchi, 1996). This practice is widespread among listed firms. Prior studies provide evidence that information, knowledge, and experiences travel across director networks, allowing firms with well-connected directors to experience better firm performance (Larcker et al., 2013), greater firm value (Omer et al., 2014), and higher financial reporting quality (Omer et al. 2020). Furthermore, this information flow between connected firms also positively impacts capital markets by influencing the likelihood of private equity transactions (Stuart and Yim, 2010), sophisticated investor trading behavior (Akbas et al., 2016), and mergers and acquisitions (Cai and Sevilir, 2012). Director interlock can also serve as a conduit for spreading corporate behaviors. Prior research has demonstrated that corporate practices propagate across the interlocked firms, such as governance practices (Bouwman, 2011), stock option backdating (Bizjak et al., 2009), earnings management (Chiu et al., 2013), tax avoidance (Brown and Drake,2014), other accounting applications or choices (Kang and Tan, 2008; Han et al., 2017; Karim et al., 2022) and corporate disclosure policies (Cai et al., 2014).

Since interlocked directors can act as conduits of information and practices between the firms they serve; this raises the possibility that adverse events experienced by one firm spill over to interlocked firms. Fich and Shivdasani (2007) report that, if a firm is subject to a class action lawsuit for financial misrepresentation, connected firms experience negative abnormal market reactions. Similarly, Kang (2008) argues that the negative reputation effect following the announcement of SEC investigation spills over to interlocked firms in the form of negative stock market reactions. Focusing on the debtholder side, Lai et al. (2019) document higher cost of debt and stricter loan covenants arising from corporate fraud by director-interlocked firms. Moreover, Li et al. (2023) and Ivanova and Prencipe (2023) find that auditors charge higher fees for firms whose director-interlocked firms engage in financial misconduct or fraud.

Other studies find positive spillover effects of regulatory enforcement on the interlocked firms. For instance, Zhong et al. (2017) show that a director experiencing regulatory sanction at another firm is more likely to attend the board meetings, shedding light on the positive role of director interlocks in spreading monitoring efforts. Wang et al. (2022) demonstrate that enforcement for violations in interlocked firms inhibits misconduct in focal firms due to two key factors: on the one hand, information transmission by interlocked directors plays a crucial role in the inhibitive learning process; on the other hand, directors in focal firms respond to governance failures in interlocked firms with higher diligence in their duties. Ding et al. (2024) find penalties for information disclosure violations can encourage independent directors to express dissent on board proposals that are raised by director-interlocked firms. Wen et al. (2023) find that interlocked firms experience a lower risk of stock price crashes following frauds, and the spillover effect is mainly motivated by the experiences that interlocked directors learned during frauds. Zhang et al. (2021) find that the disciplinary effects of proxy contests spill over to companies that share board members with target firms. These interlocked firms reduce excess cash holdings, increase shareholder payouts, cut CEO compensation, and engage in less earnings management.

3 HYPOTHESES DEVELOPMENT

Boards of directors are key players in corporate governance (Adams et al., 2010). They not only influence decision-making and risk management within a single firm but also play a significant role across multiple firms through their external directorships (Mizruchi, 1996). Studies find that interlocking directorates—where a director holds board positions in two or more firms—serve as channels for information transmission, governance practices, and strategic influence (Bouwman, 2011; Cai et al., 2014; Han et al. ,2017; Cheng et al., 2019; Karim et al. ,2022). Despite the widely recognized positive role of board interlocks (e.g., Horton et al., 2012; Larcker et al., 2013), interlocking directors may also facilitate the diffusion of questionable accounting practices. Prior studies show that directors involved in earnings manipulations in one firm may

propagate similar practices to other firms where they serve (Chiu et al., 2013), thereby weakening financial reporting integrity across the network.

When a firm is subjected to regulatory scrutiny—such as being investigated for accounting fraud—directors sitting on its board may be perceived as ineffective monitors who failed to provide adequate oversight and prevent financial misreporting (Fich and Shivdasani, 2007). This negative perception can extend to other firms where these directors hold board seats, raising concerns among external stakeholders about the potential spread of governance deficiencies and financial risks (Kang, 2008; Lai et al., 2019; Li et al., 2023).

Comment letters, issued by regulatory bodies, serve as formal inquiries into firms' financial disclosures. Although less severe than enforcement actions that result in penalties, comment letters still publicly signal heightened regulatory concerns and raise red flags regarding financial reporting quality (Bozanic et al., 2017). They act as an early warning mechanism that alerts the market and stakeholders to possible risks (Duan et al., 2022). Given the reputation-sensitive nature of auditing and auditors' reliance on perceived client risk when setting fees (Simunic, 1980; Bell et al., 2001), auditors may view firms interlocked with comment-letter recipients as riskier clients. The perceived governance deficiencies associated with interlocked directors may prompt auditors to enhance audit effort and demand a risk premium to compensate for the higher probability of financial misstatements or litigation exposure.

Thus, we propose the following hypothesis:

H1a: Auditors charge higher audit fees for firms whose director-interlocked firms receive a comment letter.

Alternatively, director interlocks may serve as conduits for positive governance spillovers (Zhang,2021; Dai et al., 2025). Firstly, Interlocking directors value their reputation in the director labor market, where past governance failures or regulatory scrutiny may negatively impact their directorship opportunities (Fama and Jensen, 1983; Ferris et al., 2003). When a firm with interlocking directors receives a comment

letter, these directors may face potential reputational risks, as stakeholders may question their governance effectiveness or inadequate oversight across all the firms they serve (Fich and Shivdasani, 2007; Kang, 2008). To mitigate reputational damage, interlocking directors have strong incentives to reinforce their monitoring role and enhance governance practices in all firms (Zhong et al.,2017; Zhang,2021), preemptively reducing the likelihood of similar scrutiny and alleviating external doubts about their governance effectiveness.

Secondly, comment letters function as important regulatory signals. Exposure to regulatory scrutiny allows interlocking directors to gain firsthand experience in handling regulatory concerns and improving financial reporting practices (Fich and Shivdasani, 2007). When a firm receives a comment letter, its board usually engages in reviewing and addressing the concerns raised by regulators. Through this direct engagement, interlocking directors accumulate regulatory knowledge and develop a deeper understanding of how to mitigate financial reporting risks and respond to heightened regulatory oversight (Chiu et al., 2013). As interlocking directors accumulate regulatory insights, they are likely to transfer these governance improvements to the other firms on whose boards they serve (Zhong et al., 2017). This regulatory learning effect can help mitigate financial reporting risks and improve firms' overall compliance postures (Wang et al., 2022; Dai et al., 2025).

Third, the deterrent effect further reinforces governance improvements. The regulatory scrutiny associated with comment letters often imposes compliance costs on the targeted firms, including expenses for disclosure revisions, control enhancements, and ongoing monitoring (Cunningham et al.,2022; Kwon et al., 2024)). Witnessing these costs firsthand, interlocking directors may proactively strengthen oversight and disclosure practices at other firms to avoid similar regulatory interventions and their associated costs. Moreover, under heightened regulatory pressure, focal firms may voluntarily adopt more conservative reporting practices and risk management strategies, fostering a more disciplined governance environment (Cao et al., 2021; Wang et al., 2022).

From an auditor's perspective, governance spillovers from board interlocks directly affect audit risk assessments. When interlocking directors transmit enhanced monitoring, stricter internal controls, and improved disclosures—triggered by their exposure to comment letters—auditors perceive lower risks of misstatements and regulatory penalties. Given audit fees' sensitivity to risk evaluations (Simunic, 1980; Bell et al., 2001; DeFond and Zhang, 2014), these perceived governance improvements allow auditors to reduce risk premiums. Consequently, firms with director interlocks to comment letter recipients are likely to receive lower audit fees due to recalibrated risk perceptions.

Thus, we propose an alternative hypothesis:

H1b: Auditors charge lower audit fees for firms whose director-interlocked firms receive a comment letter.

4 RESEARCH DESIGN AND MAIN RESULTS

4.1 Sample selection

Our initial sample includes all A-share listed firms on the Shanghai and Shenzhen stock exchanges from **2015 to 2023**. We exclude firm-year observations that are not interlocked with other firms by common independent directors. We also exclude observations of firms which received comment letters in the current year and the preceding two years to assure that the observed audit fees change is due to regulatory scrutiny on their interlocked firms rather than those on focal firms themselves(Wang et al., 2022; Ivanova and Prencipe, 2023; Ding et al.,2024; Dai et al., 2025) .Consistent with prior research, we remove observations from the financial industries because of their unique regulatory and institutional structures. We also exclude observations that are flagged ST (special treatment) or *ST (delisting risk warning) due to their irregularities in financial reporting or severe operating risk (Liao et al., 2023; Li et al., 2024). Lastly, we delete observations that do not have the information for calculating the required variables. Our final sample includes 18,250 firm-year observations. Table 1 summarizes the sample selection procedure. Except for listed firms' comment letter

data, which are from the China Research Data Services (CNRDS) Database, other data used in this study are from the China Stock Market & Accounting Research (CSMAR) Database.

[Table 1]

4.2 Research design

To investigate whether focal firms are charged a higher (or lower) price by auditors when their interlocked firms receive comment letters, we estimate the following model:

$$Audit\ Fee_{it} = \beta_0 + \beta_1 CL\_Director\_Ratio_{it} + \beta_2 Controls_{it} + \delta_{it} + \theta_{it} + \varepsilon_{it}$$

Consistent with prior research on audit fees, the dependent variable is $Audit\ Fee$, measured as the natural logarithm of audit fees (e.g., Carcello et al., 2002; Hay et al., 2006; Goncharov et al., 2014; Li et al., 2022). The main independent variable is $CL\_Director\_Ratio$, defined as the ratio of the number of commented directors to the total number of interlocked directors in the focal firm during the current year. A director is classified as a "commented director" if they have served at a firm that received a comment letter on its annual reports within the past three years[2].

$CL\_Director\_Ratio$ is chosen as the primary independent variable because it more accurately captures the intensity of regulatory spillover effects and reflects how regulatory influence propagates through interlocking directors as a transmission channel. For robustness checks, we employ several alternative measures, including a dummy variable indicating the presence of commented directors (*CL_Director_Dum*), the number of commented directors (*Num_CL_Director*), the number of commented firms (*Num_CL_Firm*), and the ratio of commented directors to the total number of board members (*CL_Director_BoardRatio*).

Following prior studies, we also include a set of control variables that have been documented to affect audit fees. First, firm size is widely recognized as a key

[2] Comment letters received in year t, t-1, t-2 for annual reports of year t-1, t-2, t-3.

determinant of audit fees, as larger firms tend to have more complex operations and greater audit risk, leading to higher audit costs (Simunic, 1980). Therefore, we control for firm size (*Size*). Audit fees are generally expected to increase with financial distress and operational uncertainty (e.g., Hay et al., 2006). Accordingly, we control for a firm's financial condition by including profitability (*ROA*), leverage (*LEV*), cash flow volatility (*CF Volatility*), current ratio (*Current Ratio*), operating loss (*Loss*), and bankruptcy risk (*Z_Score*). A number of researchers have suggested that audit fees are positively associated with inherent risk in an engagement because certain parts of the audit may have a higher risk of error and require specialized audit procedures (Simunic 1980; Stice 1991). Additionally, we include tangibility (*Tangibility*) and inventory and accounts receivable (*INV_REC*) to control a firm's inherent risk (Simunic, 1980; Hay et al., 2006; Li et al., 2022). In addition, internal control is expected to affect audit fees because auditors perform additional substantive testing and risk assessment procedures when internal controls are weak (e.g., Hogan and Wilkins, 2008; Bae et al., 2021). Thus, we control for the presence of material weakness (*Material Weakness*) in the firm's internal controls over financial reporting. Moreover, we include audit firm turnover (*Turnover*) to control for the influence of low-balling (Butterworth and Houghton, 1995; Hay et al., 2006). Given that board governance may influence audit fees by affecting the level of oversight and agency risks, we control for several board characteristics, including the number of directors (*BoardSize*), the number of board interlocks (*Num_Interlocks*), and the proportion of independent directors (*IndDirectorRatio*) (e.g., Carcello et al., 2002).

Finally, to better isolate the spillover effect of comment letters transmitted through director interlocks, we control potential confounding effects arising from industry and auditor affiliations. Specifically, we include indicators for whether the focal firm and its director-interlocked firms that received comment letters operate within the same industry (*CL_Director_SameInd*) or are audited by the same audit firm (*CL_Director_SameAuditor*).

We further control for industry, year, and audit firm fixed effects to account for

unobservable heterogeneity across industries, time periods, and auditors. Detailed definitions of all variables are provided in the Appendix. All continuous variables are winsorized at the 1st and 99th percentiles to mitigate the influence of outliers. Standard errors are clustered at the firm level in all regressions.

4.3 Descriptive statistics

Table 2 reports the descriptive statistics of main variables in our study. The mean value of *Audit Fee* is 13.990, with a standard deviation of 0.464. The minimum and maximum values range from 12.766 to 16.293, respectively. The mean value of *CL_Director_Ratio* is 0.286, indicating that on average, 28.6% of interlocked directors in a focal firm have served at firms that received comment letters in the past three years. Meanwhile, the mean of *CL_Director_Dum* is 0.526, suggesting that approximately 52.6% of the sample firms have at least one interlocked director linked to comment letter recipients.

Moreover, descriptive statistics reveal that focal firms and their interlocked comment letter recipients infrequently share auditors or industries. Specifically, only 9.6% of cases involve shared auditors (*CL_Director_SameAuditor*), consistent with auditors' independence requirements (Lennox, 2005). In contrast, 17.7% operate in the same industry (*CL_Director_SameInd*), likely reflecting industry specialization in director labor markets. This divergence confirms that our primary variables (*CL_Director_Ratio* and its alternatives) capture regulatory spillovers transmitted through director networks rather than industry or auditor overlaps, a distinction further controlled in regression analyses.

[Table 2]

4.4 Main regression results

Table 3 reports the main regression results, in which we explore whether and how focal firms' audit fees are influenced if their director-interlocked firms receive comment letters. Column (1) presents the baseline results with industry and year fixed

effects, while Column (2) adds control variables. Column (3) adds audit firm fixed effects without control variables, and Column (4) includes both control variables and fixed effects. The coefficients on *CL_Director_Ratio* are consistently negative and statistically significant at the 1% level across all models, indicating that auditors charge lower audit fees for firms whose director-interlocked firms have received comment letters. These findings support hypothesis H1b, suggesting that auditors perceive firms with interlocking directors to comment letter recipients as lower risk due to enhanced governance, resulting in lower audit fees.

The economic magnitude of the effect appears to be meaningful. For instance, in Column (1), the coefficient on *CL_Director_Ratio* is -0.084, implying that for a one-unit increase in the ratio of interlocked directors with commented firms, the audit fee decreases by approximately 8.4%. After controlling for firm-specific and audit firm factors (Column 4), this effect becomes more robust, with the coefficient slightly attenuated to -0.035, but still statistically significant.

Analysis of control variables reveals that *Size* and *ROA* both have significant effects on audit fees. Larger firms and firms with lower profitability tend to face higher audit fees, consistent with prior literature (e.g., Simunic, 1980). Financial distress variables, such as *Loss* and *Z-score*, exhibit positive relationships with audit fees, indicating that firms in financial distress tend to face higher audit costs. *Tangibility* is negatively related to audit fees, suggesting that firms with higher tangible assets incur lower audit fees, likely due to the ease of valuing and auditing these assets. In contrast, *INV_REC* is positively associated with audit fees, indicating that firms with higher levels of inventory and receivables face higher audit fees due to the additional auditing complexity involved. Notably, Material Weakness also shows a positive and significant coefficient, implying that firms with material weaknesses in internal controls face higher audit fees due to increased audit risk. On the other hand, Auditor turnover is negatively associated with audit fees, consistent with low-balling behavior where incoming auditors discount fees to secure new engagements. These results align with prior findings on audit fee adjustments (e.g., Li et al., 2022).

[Table 3]

4.5 Robustness tests

4.5.1 Alternative measures of independent variable

To ensure the robustness of our findings, we employ alternative measures of the key independent variable (*CL_Director_Ratio*). Specifically, we replace it with: (1) *CL_director_dum,* equals 1 if the focal firm has at least one commented director, 0 otherwise; (2) *Num_CL_Director*, the natural logarithm of one plus the number of commented directors; (3) *Num_CL_Firm*, the natural logarithm of one plus the number of commented interlocked firms (Interlocked firms that received comment letters in the past three years); and (4) *CL_Director_BoardRatio*, the ratio of commented directors to the total number of board members.

Table 4 reports the results based on these alternative specifications. Consistently across all models, the coefficients on the alternative measures remain significantly negative, reinforcing the conclusion that director interlocks with comment-lettered firms are associated with lower audit fees. These results provide strong support for the robustness of our main findings.

[Table 4]

4.5.2 Alternative time windows for comment letters

To further verify the robustness of our findings, we modify the time window used to define commented directors. In the main analysis, a director is classified as a commented director if they have served at a firm whose annual reports received a comment letter within the past three years (years t, t−1, and t−2). As alternative definitions, we first employ a shorter two-year window (years t and t−1), denoted as *CL_Director1*, to examine whether the effect persists over a more recent period. Second, we adopt a lagged three-year window (years t−1, t−2, and t−3), denoted as *CL_Director2*, excluding the current year to mitigate concerns about potential reverse causality. In both alternative specifications, *CL_Director1* and *CL_Director2* are defined

as the ratio of commented directors to the total number of interlocked directors in the focal firm. Table 5 reports the results. Across both alternative definitions, the coefficients remain significantly negative, indicating that our main findings are robust to different time window assumptions.

[Table 5]

4.5.3 Propensity score matching

To mitigate selection bias, we employ propensity score matching (PSM) to construct treatment and control groups, ensuring that any observed differences in audit fees can be attributed to the presence of commented directors rather than underlying firm characteristics. Specifically, we define the treatment group as firms that have commented directors, and the control group as firms without commented directors. We estimate the propensity score as the probability that a firm has commented directors, using all control variables[3] from the baseline regression. The matching is conducted using a one-to-one nearest neighbor matching approach without replacement, with a caliper of 0.01. After matching, we obtain 3,917 treatment firms and 3,917 control firms, forming a well-balanced sample for further analysis.

Table 6 reports the descriptive statistics of firm characteristics before and after matching. Prior to matching, treatment and control firms differ significantly in several characteristics such as Size, LEV, Current Ratio, Z-Score, and Tangibility, suggesting the existence of systematic differences. After matching, these differences become statistically insignificant, indicating that PSM successfully improves the comparability between the two groups.

[Table 6]

Table 7 presents the regression results based on the matched sample, using different caliper widths (0.01 in Column 1, 0.02 in Column 2, and 0.05 in Column 3) to test the robustness of our findings. Across all specifications, the coefficient on

[3] The PSM process excludes CL_Director_SameInd and CL_Director_SameAuditor, since these variables are structurally zero for the control group and directly related to the treatment effect.

CL_Director_Ratio remains significantly negative at the 1% level, reinforcing the evidence that the spillover effect of directors' comment letter exposure leads to lower audit fees. These results confirm that our main findings are not driven by sample selection issues or sensitive to the choice of matching tolerance.

[Table 7]

4.5.4 Difference in difference design

To mitigate this heterogeneity problem and isolate the causal effect of the presence of commented directors on audit pricing, we employ a difference-in-differences (DID) design. The treatment group consists of focal firms whose interlocked firms receive comment letters in any year during the sample period. The control group consists of focal firms whose interlocked firms never receive a comment letter throughout the sample period. Since interlocked firms may receive comment letters in many years during the sample period, we define the event year (t=0) as the first year in which an interlocked firm receives a comment letter. Subsequent years are classified as post-event periods, regardless of whether additional comment letters are received. This approach ensures that our analysis captures the initial regulatory scrutiny's impact on audit pricing while avoiding potential confounding effects from multiple inquiries. Following Ivanova and Prencipe (2023), we use a two-year window and define the pre-event period as [−2, −1] and the post-event period as [1, 2].

To mitigate potential selection bias, we employ propensity score matching (PSM) to construct a comparable control group. Specifically, we estimate propensity scores using a logit model, where the probability of being in the treatment group is determined by firm characteristics, including SIZE, LEV, ROA, industry, and fiscal year fixed effects. We then apply 3-to-1 nearest-neighbor matching with replacement[4], selecting control firms for each treated firm within a caliper of 0.01 to ensure close matching. To maintain a balanced DID framework, we exclude event groups that lack

[4] Given the limited size of the control group, we employ 3-to-1 nearest-neighbor matching with replacement to maximize sample utilization while ensuring comparability.

observations in either the pre-treatment period or the post-treatment period.

After the above construction, we employ the following DID model:

$$Audit\ Fee_{it} = \beta_0 + \beta_1 Treat_i + \beta_2 Post_t + \beta_3 Treat_i \times Post_t + \beta_2 Controls_{it} + \delta_{it} + \theta_{it} + \varepsilon_{it}$$

where the dependent variable $Audit\ Fee_{it}$ is the natural logarithm of audit fees for firm. $Treat_i$ is an indicator variable equal to 1 if firm i is in the treatment group, and 0 otherwise. $Post_t$ is an indicator variable equal to 1 for the post-event period, and 0 otherwise. $Treat_i \times Post_t$ is the interaction term, capturing the DID effect.

Table 8 reports the results of this analysis. Column (1) presents the main specification, Column (2) uses a 2-to-1 matching, and Columns (3) and (4) extend the post-event window to [0, 2], using 3-to-1 and 2-to-1 matching, respectively. Across all specifications, the coefficient on Treat × Post remains negative and significant, supporting the hypothesis that audit fees decrease when interlocked firms receive comment letters. The consistency of results across different matching specifications and time windows strengthens the robustness of our findings.

[Table 8]

5 FURTHER ANALYSES

5.1 Cross-sectional analysis

We next investigate whether the spillover effect of comment letters on audit fees is heterogeneous across governance characteristics, interlocked director characteristics and comment letter severity.

5.1.1 Firm governance characteristics

We first focus on the impact of firm ownership. State-owned enterprises (SOEs) typically face stronger regulatory oversight and political pressure. Since the government is the ultimate owner, SOEs' objectives extend beyond profitability to include policy implementation and social stability (Li et al., 2010; Lin et al., 2020).

Government agencies and regulators impose stricter monitoring on SOEs to ensure compliance, making them more sensitive to regulatory signals. Second, interlocking directors in SOEs often possess higher political and reputational capital. Many SOE directors have backgrounds in government (Cheung et al., 2010; Jiang and Kim, 2020), allowing them privileged access to policy information and a better understanding of regulatory expectations. These collectively may magnify the symbolic impact of regulatory scrutiny and further reinforce auditors' interpretation of such events as positive governance signals. Consequently, we expected that auditors would charge lower fees for SOEs affected by interlocked-director firms' comment letters.

We next examine whether the spillover effect of comment letters on audit fees varies with the strength of alternative governance mechanisms, focusing on institutional ownership. Institutional investors play a crucial role in corporate governance by exerting monitoring pressure on managers and demanding higher financial transparency (Shleifer and Vishny, 1997). Firms with higher institutional ownership tend to have more stringent internal controls and are more likely to respond proactively to regulatory scrutiny (Bushee, 1998). When an interlocked-director firm receives a comment letter, institutionally owned focal firms may respond more strongly by enhancing financial reporting quality to mitigate potential risks. Institutional investors often have a low tolerance for regulatory concerns and may pressure management to improve compliance and disclosure practices to protect firm value (Gillian and Starks, 2003). This heightened governance oversight reduces the likelihood of financial misstatements and lowers perceived audit risk. As a result, auditors are likely to perceive lower engagement risks when auditing firms with higher institutional ownership, leading to reduced audit fees.

We then investigate whether the spillover effect of comment letters on audit fees varies with the internal communication environment within the firm. Board meetings serve as a primary platform for directors to exchange information and oversee corporate governance (Adams and Ferreira, 2008; Chou et al., 2013; Liu et al., 2016). More frequent meetings enable boards to respond swiftly to regulatory scrutiny by

facilitating timely discussions and corrective actions. This improves the board's ability to monitor financial reporting quality, reducing the risk of misstatements and enhancing transparency (Brick and Chidambaran, 2010). Furthermore, frequent meetings foster stronger communication between directors and executives, reinforcing internal monitoring and corporate accountability, which helps mitigate potential regulatory concerns. As a result, auditors may perceive lower engagement risks when auditing firms with more frequent board meetings, leading to reduced audit fees.

To test these arguments, we estimate Eq. (1) in sub-samples. Table 9 presents the regression results. Specifically, we first partition the baseline sample into SOEs and Non-SOEs subgroups. Columns (1) and (2) report results in the SOEs and Non-SOEs subgroups, respectively. In the SOEs subsample, the coefficient on CL_Director_Ratio is negative and significant at the 5% level, while in the subsample with Non-SOEs, the coefficient is not significant. This finding suggests that the spillover effect of regulatory scrutiny on audit fees is more pronounced in SOEs.

Additionally, we examine the moderating role of institutional ownership by splitting the sample at the median level of institutional shareholdings (Inst). Columns (3) and (4) report results in the high and low institutional shareholding subgroups, respectively. The coefficient on CL_Director_Ratio is significantly negative in the high institutional shareholding group, but not significant in the low institutional shareholding group. Our findings suggest that the presence of strong external governance amplifies the regulatory spillover effect, resulting in a more pronounced decline in audit fees.

Last, we assess the role of board meeting frequency by partitioning the sample at the median number of board meetings (Board_Meetings). Columns (5) and (6) report results in the high and low board meetings subgroups, respectively. The coefficient on CL_Director_Ratio is significantly negative in the high board meetings group, but not significant in the low board meetings group. This finding is consistent with our

expectation that more frequent board meetings reinforce the spillover effect of comment letters on audit fees.

[Table 9]

5.1.2 Characteristics of interlocked directors

Prior literature suggests that director characteristics influence both the strength of their monitoring behavior and how external stakeholders interpret their effectiveness (Fich and Shivdasani, 2007; Kang, 2008). We further examine how director-specific characteristics shape the magnitude of audit fee spillovers. Specifically, we focus on two salient attributes: (1) the number of directorships a director holds at other public companies (Directorship), and (2) the age of the interlocked director (Age).

Directors who hold a larger number of board seats are typically seen as possessing greater reputational capital and broader exposure to governance practices (Giannetti et al., 2015; Jiang et al., 2015). These directors are not only better connected within the corporate elite network but also face stronger reputational incentives to uphold high governance standards across all firms in their portfolio (Ferris et al., 2003). Consequently, when such highly visible and experienced directors are exposed to regulatory scrutiny—such as through comment letters in one of their affiliated firms—they are more likely to absorb regulatory expectations and proactively diffuse these insights to their other board appointments. This enhances firm-wide governance quality and reduces perceived audit risk, thereby amplifying the negative spillover effect on audit fees.

Additionally, age serves as a key proxy for accumulated experience and knowledge (Finkelstein and Hambrick,1990; Masulis et al., 2025). Older directors, having spent more time in corporate governance environments, often possess deeper expertise, broader networks, and greater judgment when addressing complex or rare governance challenges. Prior research shows that older directors can provide particularly valuable advice when they have specialized experience or when firms face greater advisory demands (Masulis et al., 2025). These qualities may make them

more effective in internalizing and responding to regulatory scrutiny. Moreover, older professionals often place greater emphasis on legacy building, which heightens their sensitivity to reputational considerations. This motivates them to proactively apply lessons from comment letters to enhance governance practices across all firms they serve. As a result, auditors may perceive focal firms interlocked through older directors as more capable of implementing governance improvements, thereby reinforcing the perceived reduction in audit risk and leading to a lower audit fee.

To test these conjectures, we partition the sample based on the median values of interlocked directors' board directorships and age. Specifically, we divide the sample into high and low groups for each characteristic and re-estimate our baseline regressions within each subgroup. Table 10 reports the results. We find that the coefficient on CL_Director_Ratio is significantly negative in the high directorship and high age subgroups (Columns 1 and 3), but statistically insignificant in the corresponding low groups (Columns 2 and 4). These findings suggest that the spillover effect of regulatory scrutiny on audit fees is more pronounced when interlocked directors hold more board positions or are older, likely due to their greater influence and experience in disseminating regulatory signals and enforcing compliance norms within focal firms.

[Table 10]

5.1.3 The severity of comment letters

Research reports that more severe comment letters are associated with material negative outcomes such as negative market reactions after CL disclosure (Dechow et al. 2016; Ryans 2021; Brownen-Trinh et al., 2015) and costly remediation (Bozanic et al. 2017; Cassell et al. 2013). To examine whether the severity of comment letters influences the spillover effect on audit fees, we construct two measures of comment letter severity based on the textual content of the letters. First, we measure severity by the number of questions raised in the comment letters (Questions) (Cassell et al. 2013; Heese et al. 2017; Brownen-Trinh et al., 2025). Here, the higher the number of

questions highlighted by the regulators, the higher the remediation costs, that is the letter is considered more severe. Second, we classify letters based on whether the raised issues are related to internal control weaknesses (IC-related issues). Prior literature suggests that Prior literature suggests that the effectiveness of internal controls is critical to financial reporting quality, Internal control weakness represents fundamental governance failures (Ashraf ,2022). IC deficiencies are more likely to trigger auditors' additional scrutiny and higher risk premiums (Doyle et al., 2007; Hogan and Wilkins, 2008).

We focus on focal firms that are interlocked with firms receiving comment letters and partition the sample based on the severity of these letters. First, we divide the sample at the median number of questions raised, classifying comment letters into high-question and low-question groups. Columns (1) and (2) of Table 10 report the results, respectively. Second, we categorize comment letters based on whether they involve IC-related issues, classifying them into IC-related and non-IC-related groups, with results presented in Columns (3) and (4) of Table 11.

Interestingly, we find that the audit fee reduction in focal firms is primarily driven by comment letters with lower severity. Specifically, the coefficient on CL_Director_Ratio is significantly negative in the low-issue and non-IC-related groups, but insignificant in the high-questions and IC-related groups. This finding suggests that the positive governance spillover effect is more likely to occur when the regulatory concerns are relatively minor and manageable. However, when the comment letters highlight more severe issues, interlocking directors may instead transmit negative signals about governance quality. The severity of the regulatory scrutiny could heighten auditors' concerns about systemic governance failures across interlocked firms, offsetting any potential positive governance improvements. As a result, auditors may not adjust audit fees downward, reflecting a more cautious risk assessment in the face of heightened regulatory exposure. Overall, these results highlight the nuanced role of regulatory signal strength: mild regulatory scrutiny can trigger constructive governance spillovers and risk reduction, while severe regulatory scrutiny

undermines trust in interlocked directors' effectiveness, neutralizing the benefits of governance improvements.

[Table 11]

5.2 Channel tests: Audit effort or audit risk

To understand whether the observed decrease in audit fees is driven by a reduction in audit effort or a decrease in perceived audit risk, we conduct channel tests using two proxy variables.

Following prior literature (e.g., Li et al., 2022; Wu et al., 2025), we measure audit effort (*Effort*) using audit report lag, defined as the natural logarithm of the number of calendar days between a firm's fiscal year-end and the audit report signing date. A longer lag implies greater audit effort because auditors need additional time to perform more extensive testing, verify complex transactions, and address high-risk areas (Ashton et al., 1987; Bamber et al., 1993).

We measure audit risk as the natural logarithm of the number of Key Audit Matters (KAMs) disclosed in the audit report. KAMs represent areas identified by auditors as requiring significant attention due to their high risk of material misstatement (ISA 701). As such, a higher number of KAMs generally signals increased financial reporting risk and audit complexity. Importantly, auditors may disclose more KAMs as a strategic communication device to flag potential concerns with management's accounting choices or to protect themselves from ex post liability (Zeng et al., 2021). In this sense, KAM disclosure captures not only objective firm-level risk factors but also the auditor's subjective risk assessments and incentives. Therefore, the KAM count serves as a comprehensive proxy for perceived audit risk from the auditor's perspective.

Columns (1) and (2) of Table 12 present regression results where the dependent variable is audit effort, proxied by audit report lag. The coefficient on CL_Director_Ratio is statistically insignificant, suggesting that interlocked comment letters do not significantly influence the time auditors spend conducting audits.

Columns (3) and (4) report results using the number of Key Audit Matters (KAMs) as a proxy for audit risk. Here, we find that CL_Director_Ratio is negatively and significantly associated with KAM disclosure at the 5% and 10% levels, respectively. This implies that auditors perceive lower engagement risk for focal firms interlocked with firms receiving comment letters, and thus disclose fewer critical audit concerns. These results support the interpretation that audit fee reductions are more likely driven by decreased perceived audit risk rather than reduced effort.

[Table 12]

5.3 Further analysis: disclosure quality of focal firms

To further evaluate whether the observed reduction in audit fees reflects substantive improvements in disclosure quality, we conduct a series of complementary tests based from three perspectives: managerial reporting behavior, information intermediaries, and market-based outcome.

First, we examine the extent of earnings management in focal firms. Earnings management, both accrual-based and real activity-based, reflects the degree to which managers manipulate reported financial performance and thus serve as a key proxy for the quality of financial reporting (Dechow et al., 1995; Healy and Wahlen,1999; Roychowdhury, 2006; Kothari et al., 2016). Following the literature (e.g., Zhang, 2021; Wu et al., 2025), we measure accrual-based earnings management using the absolute value of discretionary accruals (DA) estimated based on the modified Jones model (Dechow et al., 1995). Real earnings management (REM) is captured using an aggregate indicator based on Roychowdhury (2006), which combines abnormal cash flows from operations (CFO), production costs, and discretionary expenses.

Columns (1)–(2) in Table 13 reports the regression results, where we find a marginally significant positive association with real earnings management (REM: $\beta=0.011$, $p<0.10$) but no evidence for accrual-based manipulation. This pattern is consistent with prior literature suggesting that under heightened regulatory scrutiny, firms may shift from accrual-based to real activities management, which is more subtle and less detectable

forms of manipulation (Cohen et al., 2008; Zang, 2012). Rather than indicating a fundamental improvement in financial reporting quality, the evidence suggests that firms may reallocate manipulation efforts in response to perceived governance oversight. This interpretation aligns with findings in Cunningham et al. (2020), who document that firms that receive a comment letter tend to switch to higher use of REM.

Second, we examine analyst forecast behavior, which reflects the informativeness and credibility of public disclosures. Following Dai et al. (2025), we use forecast error (absolute deviation between actual and forecasted earnings) and forecast dispersion (standard deviation across analysts' estimates) as proxies. As shown in Columns (3)–(4) of Table 13, we find no significant changes in either measure. This may be because the perceived governance improvements primarily affect internal monitoring or audit readiness, without materially altering the quality of publicly disclosed information that analysts rely upon.

Third, we explore the informativeness of firm-specific disclosures using stock price synchronicity, which measures the extent to which a firm's stock returns move with market- or industry-level returns (Roll, 1988; Jin and Myers, 2006). Lower synchronicity suggests that more firm-specific information is being impounded into stock prices, reflecting enhanced informational efficiency (Dang et al., 2024). Following Qiu et al. (2020), we measure stock price synchronicity using firm-year R^2 from an expanded market model. We then take a logarithmic transformation of the R^2 from this regression as ln(1- R2)/R2 (Dang et al., 2024), and label it as Synch: Higher values imply lower stock price synchronicity and more firm-specific return variations. Column (5) of Table 13 shows a marginal decline in synchronicity. One possible interpretation is that regulatory events can activate investor attention and reduce synchronicity by encouraging the interpretation of firm-level fundamentals (Piotroski et al. ,2015).

The above results reinforce the idea that the spillover effects observed are largely perceptual and signal-driven, rather than rooted in substantive changes to the quality

of financial disclosures. This divergence highlights a potential decoupling between relational signals perceived by auditors and actual governance outcomes, particularly in emerging markets where informal trust may substitute for hard information (Duan et al., 2022).

[Table 13]

6. CONCLUSIONS

In this paper, we examine the regulatory spillover effects through director interlocks from the auditors' perspective. While previous literature has documented that auditors tend to increase audit fees in response to severe regulatory enforcement actions (e.g., fraud investigations or misconduct) faced by interlocked firms (e.g., Li et al., 2023; Ivanova and Prencipe, 2023), it remains unclear how auditors react to comment letters, a more timely and non-punitive form of financial reporting regulation.

Utilizing a dataset consisting of Chinese A-share listed companies from 2015 to 2023, we provide novel evidence that auditors tend to charge lower audit fees for focal firms when interlocked firms have received comment letters. This pattern supports the governance spillover hypothesis, suggesting that auditors interpret regulatory interventions in interlocked firms as signals of improved oversight and reduced audit risk in the focal firms, distinct from the heightened risks typically associated with more severe punitive measures.

Importantly, we show that the reduction in audit fees is not driven by changes in audit effort, but rather by a decrease in auditors' perceived risk. This interpretation is further strengthened by our cross-sectional analyses: the effect is more pronounced when focal firms are SOEs, have higher institutional ownership, or exhibit stronger internal communication (proxied by frequent board meetings). These characteristics likely amplify the transmission and interpretation of governance signals. Moreover, interlocking directors with higher reputational capital and experience magnify the spillover effect, consistent with their greater capacity and incentive to transfer

regulatory knowledge across boards.

However, our findings also reveal important boundary conditions. When the comment letters are more severe—evidenced by a higher number of questions or involve internal control issues—the audit fee reduction is significantly weaker. This implies that excessive regulatory scrutiny may instead raise concerns about financial reporting risk, partially offsetting the governance benefits inferred from the comment letters of interlocked firms.

To prove whether the lower audit fees reflect real improvements in financial reporting, we conduct several tests of disclosure quality. The results paint a mixed picture: we find a rise in real earnings management, no improvement in analyst forecast accuracy or dispersion, and a decline in stock price synchronicity. These results suggest that the spillover effect may be largely perceptual and signal-based, rather than driven by fundamental improvements in reporting quality. In particular, while the market appears to respond to regulatory events via firm-specific pricing, internal governance outcomes may remain unchanged or even involve strategic adjustments in earnings management tactics.

This study advances the understanding of how regulatory signals propagate across firms through board interlocks, shaping auditors' risk perceptions and pricing decisions. By highlighting that such spillover effects are conditional on both firm-level governance features and the characteristics of interlocking directors, we enrich the literature on regulatory externalities and inter-organizational information transfer. Moreover, our identification of a disconnect between perceived governance improvements and actual reporting quality offers a novel insight into how symbolic signals may drive professional judgment in emerging markets. This contributes to the broader discourse on the limits of relational governance and underscores the need to distinguish perception-driven changes from substantive improvements. Practically, the study informs auditors, regulators, and investors about the indirect channels through which regulation affects audit outcomes, and underscores the importance of

distinguishing perception-driven responses from substantive governance improvements, particularly in contexts where informal mechanisms play a prominent role.

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Table 1 The sample selection procedure

Sample selection procedure	Firm-year observations
Initial sample (A-share listed firms, 2015-2023)	35,349
Exclude firms without interlocked independent directors	-2,700
Exclude firms receiving comment letters (t, t-1, t-2)	-5,654
Exclude financial industry firms	-788
Exclude ST/*ST firms	-232
Exclude observations with missing data	-7,725
Final Sample	18,250

Table 2 Summary statistics

	N	Mean	Variance	Min	Median	Max
Audit Fee	18250	13.990	0.464	12.766	13.874	16.293
CL_Director_Ratio	18250	0.286	0.111	0	0.200	1
CL_Director_Dum	18250	0.526	0.249	0	1	1
Num_CL_Director	18250	0.446	0.208	0	0.693	1.386
Num_CL_Firm	18250	0.480	0.252	0	0.693	1.609
CL_Director_BoardRatio	18250	0.089	0.011	0	0.091	0.429
Size	18250	22.519	1.715	20.118	22.315	26.426
LEV	18250	0.427	0.037	0.056	0.422	0.867
ROA	18250	0.038	0.003	-0.185	0.037	0.197
CF Volatility	18250	0.041	0.001	0.003	0.031	0.188
Current Ratio	18250	2.275	4.250	0.352	1.661	16.481
Loss	18250	0.109	0.097	0	0	1
Z_Score	18250	4.986	33.298	0.254	3.148	36.257
Tangibility	18250	0.920	0.009	0.530	0.953	1
INV_REC	18250	0.261	0.025	0.011	0.245	0.697
Material Weakness	18250	0.010	0.010	0	0	1
Auditor turnover	18250	0.089	0.081	0	0	1
BoardSize	18250	2.122	0.038	1.609	2.197	2.639
Num_Interlocks	18250	1.439	0.480	0	1.609	2.639
IndDirectorRatio	18250	0.377	0.003	0.333	0.364	0.571
CL_Director_SameInd	18250	0.177	0.145	0	0	1
CL_Director_SameAuditor	18250	0.096	0.087	0	0	1

Notes: This table reports descriptive statistics for the main variables used in the analysis. Audit Fee is the natural logarithm of audit fees. CL_Director_Ratio is the ratio of the number of commented directors to the total number of interlocked directors. CL_Director_Dum is an indicator variable equal to one if the focal firm has at least one interlocked director from a firm that received a comment letter. Num_CL_Director is the natural logarithm of one plus the number of commented directors. Num_CL_Firm is the natural logarithm of one plus the number of interlocked firms that received comment letters. CL_Director_BoardRatio is the ratio of commented directors to total board members. Control variables are defined in Appendix A. All continuous variables are winsorized at the 1st and 99th percentiles to mitigate the influence of outliers.

Table 3 Main regression results

	(1)	(2)	(3)	(4)
VARIABLES	*Audit Fee*	*Audit Fee*	*Audit Fee*	*Audit Fee*
CL_Director_Ratio	**-0.084*** **	**-0.042*** **	**-0.057*** **	**-0.035*** **
	(-3.77)	**(-2.83)**	**(-2.90)**	**(-2.60)**
Size		0.414***		0.372***
		(48.04)		(48.60)
LEV		-0.041		0.026
		(-0.70)		(0.50)
ROA		-0.555***		-0.613***
		(-4.58)		(-5.53)
CF Volatility		-0.017		0.047
		(-0.11)		(0.33)
Current Ratio		-0.019***		-0.016***
		(-5.14)		(-4.79)
Loss		0.070***		0.063***
		(4.05)		(3.92)
Z_Score		0.006***		0.004***
		(5.12)		(4.05)
Tangibility		-0.527***		-0.513***
		(-6.37)		(-7.11)
INV_REC		0.089*		0.114**
		(1.72)		(2.47)
Material Weakness		0.093***		0.127***
		(2.58)		(3.78)
Auditor turnover		-0.050***		-0.047***
		(-4.43)		(-4.37)
BoardSize		-0.059		-0.042
		(-1.27)		(-0.99)
Num_Interlocks		0.014*		0.009
		(1.69)		(1.23)
IndDirectorRatio		0.036		-0.046
		(0.23)		(-0.32)
CL_Director_SameInd		0.006		0.011
		(0.47)		(0.93)
CL_Director_SameAuditor		-0.005		0.015
		(-0.33)		(1.03)
Constant	14.014***	5.270***	14.006***	6.183***
	(998.18)	(22.86)	(1,178.46)	(29.37)
Year FE	YES	YES	YES	YES
Industry FE	YES	YES	YES	YES
Audit Firm FE	NO	NO	YES	YES
Observations	18,249	18,249	18,244	18,244
Adjusted R-squared	0.101	0.624	0.296	0.681

Notes: This table presents the main regression results, exploring whether and how focal firms' audit fees are influenced by the receipt of comment letters by their director-interlocked firms. The dependent variable is Audit Fee, the natural logarithm of audit fees. The main independent variable is CL_Director_Ratio, which represents the ratio of board members in the focal firm who are interlocked with firms that receive comment letters. Column (1) presents the result that includes industry and year fixed effects but without control variables, while Column (2) includes all control variables. Column (3) adds audit firm fixed effects to control for auditor-specific factors but without control variables, while Column (4) includes all control variables. Continuous variables are winsorized at the 1st and 99th percentiles. Standard errors are clustered at the firm level. *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively.

Table 4 Alternative measures of independent variable

VARIABLES	(1) *Audit Fee*	(2) *Audit Fee*	(3) *Audit Fee*	(4) *Audit Fee*
CL_director_dum	**-0.023****			
	(-2.40)			
Num_CL_director		**-0.031*****		
		(-2.62)		
Num_CL_firm			**-0.027****	
			(-2.41)	
CL_director_BoardRatio				**-0.098***
				(-1.94)
Size	0.372***	0.372***	0.372***	0.372***
	(48.58)	(48.60)	(48.57)	(48.60)
LEV	0.026	0.027	0.027	0.026
	(0.50)	(0.51)	(0.51)	(0.50)
ROA	-0.613***	-0.614***	-0.615***	-0.613***
	(-5.53)	(-5.54)	(-5.54)	(-5.53)
CF Volatility	0.046	0.049	0.047	0.048
	(0.32)	(0.35)	(0.34)	(0.34)
Current Ratio	-0.016***	-0.016***	-0.016***	-0.016***
	(-4.80)	(-4.79)	(-4.80)	(-4.80)
Loss	0.063***	0.062***	0.063***	0.063***
	(3.91)	(3.90)	(3.91)	(3.91)
Z_Score	0.004***	0.005***	0.005***	0.005***
	(4.04)	(4.06)	(4.07)	(4.05)
Tangibility	-0.513***	-0.513***	-0.513***	-0.512***
	(-7.09)	(-7.10)	(-7.10)	(-7.09)
INV_REC	0.114**	0.113**	0.113**	0.113**
	(2.47)	(2.46)	(2.46)	(2.46)
Material Weakness	0.128***	0.127***	0.127***	0.127***
	(3.80)	(3.78)	(3.78)	(3.77)
Auditor turnover	-0.047***	-0.047***	-0.047***	-0.046***
	(-4.38)	(-4.36)	(-4.37)	(-4.35)
BoardSize	-0.040	-0.039	-0.040	-0.048
	(-0.94)	(-0.90)	(-0.92)	(-1.10)
Num_Interlocks	0.013*	0.015*	0.015*	0.013*
	(1.68)	(1.88)	(1.86)	(1.67)
IndDirectorRatio	-0.044	-0.040	-0.042	-0.040
	(-0.31)	(-0.28)	(-0.29)	(-0.28)
CL_Director_SameInd	0.012	0.014	0.014	0.010
	(0.95)	(1.17)	(1.11)	(0.85)
CL_Director_SameAuditor	0.014	0.017	0.017	0.014

	(0.99)	(1.19)	(1.17)	(0.99)
Constant	6.168***	6.161***	6.164***	6.178***
	(29.28)	(29.25)	(29.26)	(29.33)
Year FE	YES	YES	YES	YES
Industry FE	YES	YES	YES	YES
Audit Firm FE	YES	YES	YES	YES
Observations	18,244	18,244	18,244	18,244
Adjusted R-squared	0.681	0.681	0.681	0.681

Notes: This table presents the results of robustness tests using alternative measures of independent variables. The dependent variable is Audit Fee, the natural logarithm of audit fees. The alternative independent variables are defined as follows: CL_Director_Dum is an indicator variable equal to one if the focal firm has at least one interlocked director from a firm that received a comment letter. Num_CL_Director is the natural logarithm of one plus the number of commented directors. Num_CL_Firm is the natural logarithm of one plus the number of interlocked firms that received comment letters. CL_Director_BoardRatio is the ratio of commented directors to total board members. All regressions include firm-level control variables, year fixed effects, industry fixed effects, and audit firm fixed effects. Continuous variables are winsorized at the 1st and 99th percentiles. Standard errors are clustered at the firm level.*, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

Table 5 Alternative time windows for comment letters

	(1)	(2)
VARIABLES	*Audit Fee*	*Audit Fee*
CL_Director1	**-0.031****	
	(-2.32)	
CL_Director2		**-0.042*****
		(-2.91)
Size	0.372***	0.026
	(48.61)	(0.51)
LEV	0.026	-0.612***
	(0.50)	(-5.52)
ROA	-0.611***	0.047
	(-5.51)	(0.33)
CF Volatility	0.045	-0.016***
	(0.32)	(-4.79)
Current Ratio	-0.016***	0.063***
	(-4.78)	(3.93)
Loss	0.063***	0.004***
	(3.93)	(4.05)
Z_Score	0.004***	-0.512***
	(4.03)	(-7.10)
Tangibility	-0.513***	0.113**
	(-7.11)	(2.45)
INV_REC	0.114**	0.127***
	(2.47)	(3.76)
Material Weakness	0.127***	-0.047***
	(3.77)	(-4.38)
Auditor turnover	-0.047***	-0.042
	(-4.38)	(-0.98)
BoardSize	-0.042	0.010
	(-0.98)	(1.40)
Num_Interlocks	0.009	-0.046
	(1.13)	(-0.32)
IndDirectorRatio	-0.047	0.372***
	(-0.33)	(48.60)
CL_Director_SameInd	0.014	0.012
	(1.01)	(0.79)
CL_Director_SameAuditor	0.016	0.007
	(1.34)	(0.53)
Constant	6.180***	6.182***
	(29.35)	(29.36)
Year FE	YES	YES
Industry FE	YES	YES
Audit Firm FE	YES	YES

Observations	18,244	18,244
Adjusted R-squared	0.681	0.681

Notes: This table presents regression results examining the robustness of our findings to alternative definitions of commented directors. CL_Director1 is defined based on a two-year window (years t and t−1), while CL_Director2 is based on a lagged three-year window (years t−1, t−2, and t−3), excluding the current year. In both cases, the main independent variable is constructed as the ratio of commented directors to the total number of interlocked directors in the focal firm. All regressions include firm-level control variables, as well as industry, year, and audit firm fixed effects. Continuous variables are winsorized at the 1st and 99th percentiles. Standard errors are clustered at the firm level. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Table 6 Descriptive statistics of firm characteristics based on PSM

	Before PSM			After PSM		
	Treatment	Control	Difference	Treatment	Control	Difference
Size	22.595	22.436	-0.159***	22.559	22.541	0.018
LEV	0.436	0.417	0.019***	0.429	0.430	-0.001
ROA	0.038	0.039	-0.001	0.039	0.039	0.000
CF Volatility	0.041	0.041	0.000	0.040	0.040	0.000
Current Ratio	2.220	2.336	-0.116***	2.251	2.216	-0.035
Loss	0.108	0.110	-0.002	0.108	0.114	-0.006
Z_Score	4.611	5.402	-0.791***	4.782	4.712	-0.070
Tangibility	0.922	0.917	0.004***	0.918	0.917	0.001
INV_REC	0.261	0.261	0.000	0.260	0.258	0.002
Material Weakness	0.011	0.010	0.001	0.010	0.011	-0.001
Auditor turnover	0.093	0.084	0.010**	0.090	0.093	-0.003
BoardSize	2.133	2.110	0.023***	2.124	2.125	-0.001
Num_Interlocks	1.676	1.177	0.499***	1.490	1.488	0.002
IndDirectorRatio	0.377	0.377	0.000	0.377	0.377	0.000
Observations	9593	8657		3917	3917	

Notes: This table reports the descriptive statistics of firm characteristics for the treatment and control groups before and after propensity score matching (PSM). The treatment group consists of firms with commented directors, while the control group consists of firms without such interlocks. Matching is performed using one-to-one nearest neighbor matching without replacement and a caliper of 0.01. Variables are defined in the Appendix. ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

Table 7 Regression after PSM

	(1)	(2)	(3)
VARIABLES	*Audit Fee*	*Audit Fee*	*Audit Fee*
CL_Director_Ratio	**-0.051*** **	**-0.046*** **	**-0.052*** **
	(-3.12)	**(-2.84)**	**(-3.12)**
Size	0.375***	0.375***	0.376***
	(43.40)	(43.27)	(43.35)
LEV	-0.041	-0.032	-0.047
	(-0.65)	(-0.51)	(-0.73)
ROA	-0.685***	-0.682***	-0.673***
	(-4.60)	(-4.58)	(-4.46)
CF Volatility	0.140	0.131	0.175
	(0.73)	(0.70)	(0.91)
Current Ratio	-0.017***	-0.016***	-0.016***
	(-3.72)	(-3.56)	(-3.50)
Loss	0.049**	0.048**	0.049**
	(2.18)	(2.13)	(2.11)
Z_Score	0.005***	0.005***	0.004***
	(3.13)	(2.89)	(2.67)
Tangibility	-0.560***	-0.570***	-0.556***
	(-6.78)	(-6.79)	(-6.56)
INV_REC	0.135**	0.145***	0.141***
	(2.45)	(2.64)	(2.58)
Material Weakness	0.124***	0.128***	0.125***
	(2.75)	(2.94)	(2.70)
Auditor turnover	-0.035**	-0.040**	-0.037**
	(-2.22)	(-2.51)	(-2.32)
BoardSize	-0.019	-0.025	-0.028
	(-0.37)	(-0.49)	(-0.55)
Num_Interlocks	-0.008	-0.007	-0.010
	(-0.73)	(-0.66)	(-0.95)
IndDirectorRatio	0.011	-0.009	-0.024
	(0.06)	(-0.05)	(-0.14)
Constant	6.138***	6.179***	6.161***
	(24.93)	(25.69)	(24.90)
Year FE	YES	YES	YES
Industry FE	YES	YES	YES
Audit Firm FE	YES	YES	YES
Observations	7,833	7,834	7,833
Adjusted R-squared	0.688	0.687	0.687
caliper	0.01	0.02	0.05

Notes: This table presents the regression results examining the association between directors' comment letter exposure and audit fees after propensity score matching (PSM). Column (1) uses a caliper of 0.01, Column (2) uses 0.02, and Column (3) uses 0.05. The dependent variable is the

natural logarithm of audit fees. All regressions include industry, year, and audit firm fixed effects. Continuous variables are winsorized at the 1st and 99th percentiles. Standard errors are clustered at the firm level. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Table 8 Regression using DID

	(1)	(2)	(3)	(4)
VARIABLES	*Audit Fee*	*Audit Fee*	*Audit Fee*	*Audit Fee*
Treat	-0.024	-0.011	-0.023	-0.010
	(-0.47)	(-0.27)	(-0.45)	(-0.25)
Post	0.082**	0.055	0.055*	0.040
	(2.09)	(1.59)	(1.72)	(1.40)
Treat* Post	**-0.094****	**-0.069****	**-0.069****	**-0.056***
	(-2.42)	**(-2.00)**	**(-2.15)**	**(-1.91)**
Size	0.393***	0.386***	0.391***	0.385***
	(33.40)	(35.27)	(33.96)	(35.87)
LEV	0.057	0.105	0.066	0.110
	(0.63)	(1.17)	(0.74)	(1.25)
ROA	-0.881***	-0.913***	-0.778***	-0.818***
	(-4.06)	(-4.39)	(-3.72)	(-4.09)
CF Volatility	0.146	0.137	0.018	0.020
	(0.51)	(0.51)	(0.06)	(0.08)
Current Ratio	-0.004	0.000	-0.004	-0.001
	(-0.60)	(0.03)	(-0.65)	(-0.20)
Loss	0.094***	0.073**	0.098***	0.071**
	(2.90)	(2.26)	(3.22)	(2.34)
Z_Score	0.003	0.003	0.003	0.003*
	(1.20)	(1.37)	(1.25)	(1.70)
Tangibility	-0.563***	-0.549***	-0.556***	-0.538***
	(-4.58)	(-4.55)	(-4.64)	(-4.59)
INV_REC	0.058	0.071	0.051	0.073
	(0.76)	(0.94)	(0.67)	(0.98)
Material Weakness	0.111	0.111	0.056	0.057
	(1.35)	(1.30)	(0.69)	(0.68)
Auditor turnover	-0.086***	-0.082***	-0.084***	-0.079***
	(-3.83)	(-3.68)	(-4.59)	(-4.34)
BoardSize	-0.042	-0.004	-0.050	-0.006
	(-0.58)	(-0.06)	(-0.71)	(-0.08)
Num_Interlocks	0.004	0.006	0.008	0.009
	(0.32)	(0.43)	(0.58)	(0.64)
IndDirectorRatio	-0.204	-0.121	-0.217	-0.136
	(-0.89)	(-0.54)	(-0.96)	(-0.61)
Constant	5.851***	5.835***	5.896***	5.840***
	(17.43)	(18.11)	(17.71)	(18.30)
Year FE	YES	YES	YES	YES
Industry FE	YES	YES	YES	YES
Audit Firm FE	YES	YES	YES	YES
Observations	4,688	4,779	6,087	6,215
Adjusted R-squared	0.727	0.724	0.728	0.726

Notes: This table presents the results of the difference-in-differences (DID) estimation. The dependent variable is the natural logarithm of audit fees (Audit Fee), and the key variable of interest is the interaction term Treat × Post, which captures the DID effect. Treat is an indicator variable equal to 1 if the firm is in the treatment group (i.e., its interlocked firms received a comment letter), and 0 otherwise. Post is an indicator variable equal to 1 for the post-event period, and 0 otherwise. The pre-event window is defined as [−2, −1] and the post-event window is defined as [1, 2]. Column (1) presents the main specification with 3-to-1 nearest-neighbor propensity score matching (PSM) with a caliper of 0.01. Column (2) replicates the analysis using 2-to-1 nearest-neighbor PSM. Columns (3) and (4) extend the post-event window to [0, 2], using 3-to-1 and 2-to-1 nearest-neighbor PSM, respectively. Standard errors are clustered at the firm level. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Table 9 Firm governance characteristics

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)
	Audit Fee		*Audit Fee*		*Audit Fee*	
	SOE	*Non_SOE*	*High_Inst*	*Low_Inst*	*High_BM*	*Low_BM*
CL_Director_Ratio	**-0.075*** **	**-0.014**	**-0.057*** **	**-0.018**	**-0.045*** **	**-0.019**
	(-2.74)	**(-0.95)**	**(-2.60)**	**(-1.12)**	**(-2.60)**	**(-1.10)**
Size	0.420***	0.351***	0.396***	0.332***	0.380***	0.355***
	(32.94)	(38.71)	(37.34)	(34.10)	(42.96)	(37.55)
LEV	-0.021	0.096*	-0.050	0.104*	-0.030	0.070
	(-0.22)	(1.71)	(-0.60)	(1.78)	(-0.49)	(1.06)
ROA	-1.182***	-0.460***	-0.441**	-0.682***	-0.639***	-0.545***
	(-5.00)	(-3.82)	(-2.38)	(-5.53)	(-4.67)	(-3.53)
CF Volatility	-0.420	0.284*	0.050	0.024	-0.075	0.226
	(-1.58)	(1.85)	(0.24)	(0.14)	(-0.44)	(1.19)
Current Ratio	-0.007	-0.020***	-0.001	-0.026***	-0.021***	-0.012***
	(-0.92)	(-5.44)	(-0.17)	(-6.67)	(-4.71)	(-2.93)
Loss	0.025	0.075***	0.070***	0.058***	0.083***	0.044*
	(0.87)	(4.11)	(2.73)	(3.16)	(4.25)	(1.84)
Z_Score	0.008***	0.004***	0.000	0.007***	0.005***	0.004***
	(2.89)	(3.98)	(0.02)	(5.31)	(3.46)	(2.78)
Tangibility	-0.476***	-0.524***	-0.511***	-0.570***	-0.449***	-0.582***
	(-2.90)	(-6.93)	(-4.59)	(-6.95)	(-5.49)	(-5.54)
INV_REC	0.103	0.110**	0.134*	0.091*	0.084	0.179***
	(1.21)	(2.20)	(1.93)	(1.67)	(1.57)	(3.12)
Material Weakness	0.007	0.145***	0.095**	0.144***	0.082*	0.192***
	(0.14)	(3.50)	(2.03)	(3.08)	(1.93)	(3.91)
Auditor turnover	-0.075***	-0.009	-0.069***	-0.023	-0.039***	-0.063***
	(-4.86)	(-0.62)	(-4.38)	(-1.63)	(-2.90)	(-3.55)
BoardSize	0.019	-0.061	-0.075	-0.024	-0.043	-0.038
	(0.27)	(-1.17)	(-1.22)	(-0.45)	(-0.90)	(-0.65)
Num_Interlocks	-0.004	0.017**	0.005	0.017*	0.013	0.003
	(-0.30)	(2.11)	(0.39)	(1.90)	(1.48)	(0.28)
IndDirectorRatio	-0.144	-0.117	-0.050	-0.166	-0.128	0.031
	(-0.61)	(-0.73)	(-0.24)	(-1.04)	(-0.80)	(0.16)
CL_Director_SameInd	0.022	-0.005	0.019	0.006	0.017	0.003
	(0.98)	(-0.40)	(1.03)	(0.43)	(1.07)	(0.20)
CL_Director_SameAuditor	0.040*	0.008	0.023	0.001	0.012	0.022
	(1.65)	(0.45)	(1.13)	(0.07)	(0.69)	(1.21)
Constant	4.984***	6.674***	5.736***	7.066***	6.003***	6.532***
	(13.29)	(28.32)	(19.41)	(26.75)	(25.18)	(23.72)
Year FE	YES	YES	YES	YES	YES	YES
Industry FE	YES	YES	YES	YES	YES	YES
Audit Firm FE	YES	YES	YES	YES	YES	YES

Observations	6,675	11,569	9,118	9,115	10,481	7,759
Adjusted R-squared	0.715	0.632	0.702	0.552	0.684	0.660

Notes: This table presents the results of regressions examining the heterogeneity of the spillover effect of comment letters on audit fees based on firm governance characteristics. Column (1) reports results for state-owned enterprises (SOEs), while Column (2) reports results for non-state-owned enterprises (Non-SOEs). Columns (3) and (4) show results for firms with high and low institutional ownership, respectively, based on the median split. Columns (5) and (6) present results for firms with high and low board meeting frequency, respectively, based on the median split. The dependent variable is the natural logarithm of audit fees. The key independent variable is CL_Director_Ratio, which represents the ratio of board members in the focal firm who are interlocked with firms that received comment letters. Year, industry, and audit firm fixed effects are included in all specifications. Standard errors are clustered at the firm level. T-statistics are reported in parentheses. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Table 10 The effect of interlocked directors' characteristics

	(1)	(2)	(3)	(4)
	Audit Fee		*Audit Fee*	
VARIABLES	High directorship	Low directorship	High Age	Low Age
CL_Director_Ratio	**-0.047*** **	**-0.014**	**-0.046*** **	**-0.009**
	(-2.60)	**(-0.78)**	**(-2.96)**	**(-0.40)**
Size	0.385***	0.356***	0.369***	0.374***
	(39.43)	(36.40)	(40.72)	(38.13)
LEV	0.008	0.023	0.055	-0.002
	(0.12)	(0.37)	(0.86)	(-0.03)
ROA	-0.631***	-0.600***	-0.494***	-0.778***
	(-4.02)	(-4.32)	(-3.81)	(-4.75)
CF Volatility	0.043	0.036	0.079	0.002
	(0.22)	(0.20)	(0.47)	(0.01)
Current Ratio	-0.013***	-0.020***	-0.016***	-0.016***
	(-2.94)	(-4.45)	(-3.69)	(-3.61)
Loss	0.052**	0.073***	0.060***	0.064***
	(2.35)	(3.39)	(2.98)	(2.75)
Z_Score	0.004**	0.005***	0.004***	0.005***
	(2.43)	(3.42)	(3.16)	(3.02)
Tangibility	-0.519***	-0.516***	-0.504***	-0.525***
	(-5.59)	(-5.85)	(-5.87)	(-5.91)
INV_REC	0.156**	0.061	0.156***	0.054
	(2.58)	(1.11)	(2.86)	(0.90)
Material Weakness	0.106*	0.139***	0.088**	0.179***
	(1.93)	(3.46)	(2.07)	(3.34)
Auditor turnover	-0.063***	-0.034**	-0.050***	-0.047***
	(-4.00)	(-2.35)	(-3.40)	(-2.97)
BoardSize	-0.005	-0.069	-0.071	-0.018
	(-0.09)	(-1.26)	(-1.52)	(-0.29)
Num_Interlocks	0.004	0.014	0.022*	0.006
	(0.36)	(1.46)	(1.82)	(0.61)
IndDirectorRatio	-0.001	-0.133	-0.111	0.040
	(-0.01)	(-0.74)	(-0.66)	(0.22)
CL_Director_SameInd	0.003	0.021	0.008	0.006
	(0.23)	(1.27)	(0.54)	(0.35)
CL_Director_SameAuditor	0.037*	-0.013	0.014	0.015
	(1.91)	(-0.69)	(0.79)	(0.71)
Constant	5.793***	6.644***	6.272***	6.094***
	(21.21)	(25.48)	(25.63)	(22.10)
Year FE	YES	YES	YES	YES
Industry FE	YES	YES	YES	YES
Audit Firm FE	YES	YES	YES	YES
Observations	9,242	9,001	10,339	7,905

Adjusted R-squared	0.706	0.651	0.675	0.691

Notes: This table examines the moderating effect of characteristics of interlocked directors on the spillover effect to focal firms' audit fees. The sample is divided based on two director-level attributes. Columns (1) and (2) split the sample by the median number of total directorships held by interlocked directors, defining High directorship and Low directorship groups. Columns (3) and (4) split the sample by the median age of interlocked directors, defining High age and Low age groups. The dependent variable is the natural logarithm of audit fees. The key independent variable is CL_Director_Ratio, which is the ratio of board members in the focal firm who are interlocked with firms that received comment letters. All regressions include year, industry, and audit firm fixed effects. Standard errors are clustered at the firm level. ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

Table 11 The severity of comment letters

	(1)	(2)	(3)	(4)
	Audit Fee		*Audit Fee*	
VARIABLES	High_questions	Low_questions	IC-related	Non-IC-related
CL_Director_Ratio	**-0.023**	**-0.062****	**0.004**	**-0.062****
	(-0.82)	**(-2.01)**	**(0.12)**	**(-2.46)**
Size	0.383***	0.359***	0.370***	0.370***
	(37.48)	(32.68)	(30.13)	(39.74)
LEV	0.006	0.090	0.067	0.045
	(0.08)	(1.16)	(0.77)	(0.67)
ROA	-0.584***	-0.456**	-0.316	-0.613***
	(-3.49)	(-2.43)	(-1.57)	(-3.96)
CF Volatility	0.238	-0.102	-0.198	0.183
	(1.08)	(-0.45)	(-0.78)	(0.90)
Current Ratio	-0.012**	-0.019***	-0.010	-0.016***
	(-2.10)	(-3.49)	(-1.60)	(-3.37)
Loss	0.074***	0.083***	0.076**	0.080***
	(2.89)	(2.90)	(2.35)	(3.37)
Z_Score	0.004**	0.006***	0.006**	0.005***
	(2.22)	(2.92)	(2.30)	(2.89)
Tangibility	-0.527***	-0.443***	-0.525***	-0.492***
	(-5.07)	(-3.53)	(-3.87)	(-5.19)
INV_REC	0.151**	0.164**	0.078	0.186***
	(2.36)	(2.54)	(1.06)	(3.19)
Material Weakness	0.194***	0.195***	0.251***	0.165***
	(3.62)	(2.89)	(2.75)	(3.54)
Auditor turnover	-0.044**	-0.041*	-0.073***	-0.033*
	(-2.50)	(-1.71)	(-2.99)	(-1.79)
BoardSize	-0.133**	-0.038	-0.172**	-0.057
	(-2.27)	(-0.65)	(-2.40)	(-1.11)
Num_Interlocks	0.005	0.008	0.029*	-0.002
	(0.33)	(0.53)	(1.70)	(-0.17)
IndDirectorRatio	-0.246	-0.071	-0.405*	-0.037
	(-1.27)	(-0.32)	(-1.76)	(-0.20)
CL_Director_SameInd	0.013	0.004	-0.004	0.013
	(0.81)	(0.24)	(-0.20)	(0.92)
CL_Director_SameAuditor	0.010	0.031	0.017	0.023
	(0.58)	(1.51)	(0.75)	(1.45)
Constant	6.205***	6.399***	6.563***	6.229***
	(22.74)	(20.16)	(19.75)	(23.28)
Year FE	YES	YES	YES	YES
Industry FE	YES	YES	YES	YES
Audit Firm FE	YES	YES	YES	YES
Observations	5,274	4,313	2,806	6,782

Adjusted R-squared	0.672	0.686	0.665	0.685

Notes: This table examines the moderating effect of comment letter severity on the spillover effect to focal firms' audit fees. In Columns (1) and (2), the sample is partitioned based on the median number of issues raised in the comment letters. "High_questions " refers to comment letters with a number of issues above the median, while "Low_questions " refers to those below the median. In Columns (3) and (4), the sample is divided based on whether the comment letter addresses internal control (IC)-related issues. " IC-related " includes letters that cite deficiencies related to internal controls, while "Non-IC-related " refers to letters without such concerns. The dependent variable is the natural logarithm of audit fees. The key independent variable is CL_Director_Ratio, which represents the ratio of board members in the focal firm who are interlocked with firms that received comment letters. Year, industry, and audit firm fixed effects are included in all specifications. Standard errors are clustered at the firm level. T-statistics are reported in parentheses. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Table 12 Audit effort or audit risk

VARIABLES	(1) *Effort*	(2) *Effort*	(3) *KAMs*	(4) *KAMs*
CL_Director	**-0.002**	**0.001**	**-0.016****	**-0.011***
	(-0.42)	**(0.11)**	**(-2.30)**	**(-2.04)**
Size		0.001		0.029***
		(0.49)		(8.60)
LEV		0.022		0.087**
		(1.42)		(3.36)
ROA		-0.283***		-0.435***
		(-6.71)		(-8.02)
CF Volatility		0.002		-0.135*
		(0.04)		(-2.20)
Current Ratio		0.003**		0.005**
		(2.30)		(2.83)
Loss		0.031***		0.011
		(5.44)		(1.47)
Z_Score		-0.001***		-0.002**
		(-2.67)		(-2.61)
Growth		-0.009**		0.013**
		(-2.22)		(2.74)
Tangibility		-0.142***		-0.318***
		(-6.58)		(-8.24)
INV_REC		0.041**		0.147***
		(2.48)		(5.20)
Material Weakness		0.078***		0.025
		(9.04)		(1.15)
Auditor turnover		0.007		0.014**
		(1.47)		(2.58)
BoardSize		-0.016		0.010
		(-1.18)		(0.54)
Num_Interlocks		-0.002		0.006
		(-0.88)		(1.84)
IndDirectorRatio		-0.017		0.013
		(-0.38)		(0.22)
CL_Director_SameInd		-0.005		-0.004
		(-1.05)		(-0.63)
CL_Director_SameAuditor		-0.007		-0.016**
		(-1.33)		(-2.62)
Constant	4.597***	4.740***	1.087***	0.827***
	(1809.75)	(86.14)	(294.14)	(9.56)
Year FE	YES	YES	YES	YES
Industry FE	YES	YES	YES	YES

Audit Firm FE	YES	YES	YES	YES
Observations	18,239	18,239	14,178	14,174
Adjusted R-squared	0.103	0.135	0.092	0.153

Notes: This table examines the potential channels through which comment letters influence audit fees, focusing on audit effort and audit risk. The dependent variable in Columns (1)–(2) is audit effort, measured by the natural logarithm of audit report lag. The dependent variable in Columns (3)–(4) is audit risk, proxied by the natural logarithm of the number of Key Audit Matters (KAMs). CL_Director_Ratio is the ratio of board members in the focal firm who are interlocked with firms that received comment letters. Columns (1) and (3) present baseline regressions without control variables; Columns (2) and (4) include firm-level controls. All regressions include year, industry, and audit firm fixed effects. Robust t-statistics are reported in parentheses. ***, **, and * indicate significance at the 1%, 5%, and 10% levels, respectively.

In December 2016, the Ministry of Finance issued China Auditing Standard No. 1504 – Communication of Key Audit Matters in the Auditor's Report (hereinafter referred to as the Key Audit Matters Standard). This standard requires the inclusion of a Key Audit Matters section in the audit reports of listed entities, disclosing the matters that the certified public accountant considers most significant to the audit of the current financial statements. As a result, our sample starts from 2017, with the sample size reduced to 14,178.

Table 13 Consequences on disclosure quality

	(1)	(2)	(3)	(4)	(5)
VARIABLES	*DA*	*REM*	*Error*	*Dispersion*	*Synch*
CL_Director_Ratio	0.001	**0.011***	0.051	0.020	**0.035***
	(0.89)	**(1.85)**	(1.29)	(0.81)	**(1.66)**
Size	-0.001*	0.022***	-0.065***	-0.023***	-0.132***
	(-1.79)	(8.08)	(-4.54)	(-2.63)	(-15.83)
LEV	0.018***	0.023	-0.152	-0.087	0.432***
	(3.56)	(1.11)	(-1.20)	(-1.08)	(7.51)
ROA	-0.040**	-1.984***	-8.188***	-5.156***	0.840***
	(-2.11)	(-30.29)	(-17.38)	(-17.21)	(4.93)
CF Volatility	0.577***	0.158**	2.076***	1.558***	0.804***
	(27.35)	(2.25)	(4.54)	(5.67)	(4.32)
Current Ratio	-0.001***	0.009***	0.005	-0.010	-0.019***
	(-2.98)	(5.61)	(0.42)	(-1.30)	(-4.10)
Loss	0.023***	-0.147***	0.334***	-0.225***	0.091***
	(9.77)	(-18.14)	(2.89)	(-3.10)	(3.40)
Z_Score	0.001***	-0.003***	0.008**	0.011***	0.011***
	(5.34)	(-3.62)	(2.06)	(4.01)	(6.19)
Tangibility	-0.001	0.127***	-0.034	0.106	-0.298***
	(-0.16)	(4.67)	(-0.25)	(1.27)	(-3.88)
INV_REC	0.007	0.192***	-0.073	-0.222***	-0.029
	(1.54)	(9.46)	(-0.71)	(-3.51)	(-0.54)
Material Weakness	0.019***	0.010	0.569**	-0.087	0.229***
	(2.68)	(0.64)	(2.48)	(-0.68)	(3.94)
Auditor turnover	0.003	0.007	-0.025	-0.004	0.017
	(1.62)	(1.39)	(-0.60)	(-0.16)	(0.85)
BoardSize	-0.007**	-0.015	0.011	0.001	-0.075*
	(-2.24)	(-1.00)	(0.13)	(0.01)	(-1.68)
Num_Interlocks	0.001	-0.007**	-0.027	-0.016	-0.010
	(1.27)	(-2.09)	(-1.39)	(-1.33)	(-1.09)
IndDirectorRatio	-0.010	-0.055	0.645**	0.259	-0.031
	(-0.86)	(-1.10)	(2.23)	(1.54)	(-0.21)
CL_Director_SameInd	-0.004***	-0.003	0.016	0.034	0.018
	(-2.87)	(-0.52)	(0.42)	(1.47)	(1.02)
CL_Director_SameAuditor	0.001	0.004	0.055	0.037	-0.033
	(0.43)	(0.67)	(1.25)	(1.35)	(-1.44)
Constant	0.071***	-0.557***	2.243***	1.014***	3.629***
	(4.91)	(-7.70)	(5.61)	(4.53)	(16.16)
Year FE	YES	YES	YES	YES	YES
Industry FE	YES	YES	YES	YES	YES
Audit Firm FE	YES	YES	YES	YES	YES
Observations	18,185	18,170	12,685	10,797	17,862
Adjusted R-squared	0.191	0.228	0.127	0.105	0.427

Notes: This table investigates the spillover effect of comment letters on the quality of financial disclosures in focal firms. The dependent variables are: (1) DA, the absolute discretionary accruals estimated using the modified Jones model (Dechow et al., 1995); (2) REM, real earnings management based on Roychowdhury (2006); (3) Error, the absolute analyst forecast error, and (4) Dispersion, the standard deviation of analyst forecasts; and (5) Synch, stock price synchronicity, measured following Qiu et al. (2020). CL_Director_Ratio represents the ratio of directors in the focal firm who are interlocked with firms that receive comment letters. All regressions control for firm-level characteristics and include year, industry, and audit firm fixed effects. Robust t-statistics are reported in parentheses. ***, **, and * indicate significance at the 1%, 5%, and 10% levels, respectively.

Appendix

Variables	Definition
Audit Fee	The natural logarithm of audit fees.
CL_Director_Ratio	The ratio of commented directors (directors who served at firms that received comment letters in the past three years) to the total number of interlocked directors.
CL_Director_Dum	Equals 1 if the focal firm has at least one commented director, 0 otherwise.
Num_CL_Director	The natural logarithm of one plus the number of commented directors.
Num_CL_Firm	The natural logarithm of one plus the number of commented interlocked firms (Interlocked firms that received comment letters in the past three years).
CL_Director_BoardRatio	The ratio of the number of commented directors to the total number of board members.
Size	The natural logarithm of total assets.
ROA	The ratio of net income to total assets.
LEV	The ratio of total liabilities to total assets.
CF Volatility	The standard deviation of operating cash flows over the past three years.
Current Ratio	The ratio of current assets to current liabilities.
Loss	Equals 1 if the firm reported negative net income, 0 otherwise.
Z_Score	Altman's Z-score measuring bankruptcy risk
Tangibility	The ratio of PPE to total assets
INV_REC	The ratio of the sum of inventory and accounts receivable to total assets. |
Material Weakness	Equals 1 if the firm reported material weaknesses in internal controls, 0 otherwise.
Turnover	Equals 1 if the firm switched auditors in the current year, 0 otherwise.
BoardSize	The natural logarithm of one plus the total number of directors on the board.
Num_Interlocks	The natural logarithm of one plus the total number of interlocked directors.
IndDirectorRatio	The ratio of the number of independent directors to the total number of directors on the board.
CL_Director_SameInd	Equals 1 if the focal firm and the commented interlocked firm(s) operate in the same industry, 0 otherwise.
CL_Director_SameAuditor	Equals 1 if the focal firm and the commented interlocked firm(s) share the same auditor, 0 otherwise.
SOE	Equals 1 if the firm is state-owned, 0 otherwise.
Inst	The ratio of shares held by institutional investors to total outstanding shares.
Board_Meetings	The natural logarithm of one plus the number of board meetings

	held during the year.
Questions	The natural logarithm of one plus the number of questions raised in the comment letter.
IC-related issues	Equals 1 if the comment letter involves internal control issue, 0 otherwise.
Age	The average age of all interlocked directors.
Directorship	The average number of board seats held by each interlocked director.
Effort	The natural logarithm of the number of calendar days between the fiscal year-end and the audit report issue date.
KAMs	The natural logarithm of one plus the number of key audit matters disclosed in the audit report.
DA	Absolute discretionary accruals measured using the modified Jones model (Dechow et al., 1995).
REM	Aggregate measure of real earnings management (Roychowdhury, 2006), including abnormal CFO, production, and discretionary expenses.
Error	The absolute difference between analysts' consensus earnings forecasts and actual earnings, scaled by absolute value of actual earnings.
Dispersion	Standard deviation of analysts' earnings forecasts, scaled by stock price.
Synch	Stock price synchronicity measured as the R^2 (Qiu et al., 2020).