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The Effect of External Monitoring Mechanisms and Inquiry Letter Supervision on Real Earnings Management: Evidence from China

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ABSTRACT

This article used the A-share listed companies on the Shanghai and Shenzhen Stock Exchanges from 2016 to 2024 as samples to examine the impact of external monitoring mechanisms on the real earnings management of enterprises, and focused on analysing the regulatory role of the inquiry letters. It is found that in the environment of high information asymmetry and weak law enforcement, the increase of institutional investors' shareholding aggravates real earnings management. Further, the increase of media attention also induces this behaviour through the market pressure mechanism. The regulatory role of the inquiry letter mainly includes two aspects. On the one hand, the inquiry letter strengthens the pressure on institutional investors and further stimulates the management to carry out real earnings management. On the other hand, inquiry letters can activate the substantive governance function of high-quality auditors and enhance their inhibiting effect on real earnings management. This study reveals the complex transmission path of external regulatory mechanisms and provides empirical evidence for improving the front-line stock exchanges regulatory.

1. INTRODUCTION

Financial reports are an important means for alleviating the information asymmetry between enterprises and investors, but management often manipulates earnings for opportunistic motives. Compared to accrual

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earnings manipulation, real earnings management (REM) is more concealed and causes greater damage to the long-term value of enterprises (Roychowdhury, 2006). Therefore, how to effectively identify and suppress REM has become a core issue in corporate governance and capital market regulations.

The external monitoring mechanism is an important force to restrain the opportunistic behaviour of management. As an independent third-party professional, auditors assume the responsibility of "gatekeeper" in capital markets, and society has placed increasing expectations on their supervisory role (Zakaria et al., 2022). With their financial strength, professional knowledge, and information processing ability, institutional investors can deeply analyse and interpret the information disclosed by management (Piosik & Genge, 2019; Ismail et al., 2024). Media attention forms an intangible pressure through information exposure and public opinion supervision (Chen & Zhang, 2025). Especially in the context of the rapid development of social media, the efficiency of information dissemination has significantly improved, which helps alleviate the problem of information asymmetry. Moreover, with the continuous deepening of the two-way opening of China's capital market, foreign institutional investors, such as Qualified Foreign Institutional Investors (QFII), with more mature investment concepts and stronger independence, have increasingly received attention for their corporate governance role. The independent director system is an essential part of modern corporate governance mechanisms. Its core function lies in curbing the opportunistic behaviour of management through external supervision (Hsu et al., 2024). Are the effects of these diversified external monitoring forces affected by specific institutional environment and regulatory contexts? These issues still need to be answered through systematic theoretical and empirical research.

With the continuous development of China's capital market, the China Securities Regulatory Commission has proposed the regulatory concept of "relaxing control and strengthening supervision", promoting the shift of the focus of information disclosure regulation from "pre-event review" to "in-process and post-event supervision". As a self-regulatory agency, the Shanghai and Shenzhen Stock Exchanges have begun to implement supervision over listed companies' regular reports through the inquiry system since 2001, but this, as a supplementary regulatory measure, has not been made public. In 2014, the Exchanges officially launched the "Information Disclosure Expressway" system, reducing the cost of information disclosure and supervision and promoting market entities to fulfil their responsibilities, marking the arrival of the era of independent information disclosure by listed companies. Since that year, the public disclosure of annual report inquiry letters has made regulatory inquiries increasingly regular and strict, and the scope of inquiries has continued to expand, while the phenomenon of repeated inquiries has also gradually increased (Wu & Yuan, 2022; Tang & Liu, 2024). In recent years, the Exchanges have maintained a high level of attention to earnings management behaviours, frequently sending inquiry letters regarding issues, such as profit adjustment, which has made inquiry letters gradually become an important signal that reflects the regulatory orientation. When listed companies receive inquiry letters, it often triggers concentrated attention from investors and the media. Theoretically, the inquiry letter system has a direct or indirect impact on their earnings management behaviours. In this context, is the inquiry letter system merely an independent regulatory deterrent, or can it be a regulator or catalyst to strengthen the role of other external supervision mechanisms? Currently, most studies on inquiry letters have focused on their direct governance consequences, such as financial restatement (Zhang et al., 2025) and corporate value (Wei et al., 2024), while the interaction and synergy effects between them and other external supervisors remain an important mechanism that has not been fully explored. So, can all kinds of external supervision mechanisms

effectively inhibit the company's REM? Furthermore, will the release of the exchange inquiry letter significantly enhance the governance effectiveness of these external supervision mechanisms through signal transmission and attention focusing?

This article used A-share listed companies from 2016 to 2024 as the sample, from the perspective of external supervision, to examine the regulatory effect of annual report inquiry letters and its indirect influence on REM. The main contributions of this article are as follows: First, based on the context of China's emerging market, it reveals the impact of independent directors, audit quality, domestic and foreign institutional investors, and media attention on earnings management, enriching the research on external supervision mechanisms. Second, this research breaks away from the traditional perspective of viewing each supervision mechanism independently, introduces the inquiry letter as a moderating variable, and deepens the understanding of how non-punitive supervision can collaborate with market forces to improve corporate governance. Third, it systematically examines the moderating effect of inquiry letters on the "audit-institutional investors and media and independent director" external supervision chain and distinguishes the differentiated reactions of domestic and foreign institutional investors (Aker et al., 2024), providing new empirical evidence for emerging capital markets.

The structure of the remainder of this article is as follows. Section 2 is the literature review and hypothesis development. Section 3 is the research design, which describes sample selection, the definition of main variables, and the empirical model. Section 4 presents the empirical results and analysis. Section 5 provides the conclusion.

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

2.1 Audit quality and earnings management

According to the principal-agent theory and the theory of information asymmetry, the senior management of a company, as the actual operator, has a goal difference and information gap with the owners and other stakeholders. To achieve specific performance targets or meet external expectations, the management may tend to manipulate earnings and embellish the financial reports, thereby covering up the true operating conditions of the company. In this context, high-quality external auditing, as an important external governance mechanism, can effectively identify and restrain the opportunistic behaviour of the management, and enhance the reliability of financial information, thereby alleviating the principal-agent conflict exacerbated by information asymmetry (Krismiaji & Sumayyah, 2022).

Previous studies have mainly explored the impact of audit quality on earnings management from two perspectives: one is from the perspective of the governance environment at the national level. For instance, Hassan et al. (2023) found that in countries with stronger governance mechanisms, high-quality audits have a more significant inhibitory effect on earnings management. Conversely, in emerging markets, due to a relatively weaker institutional environment, the supervisory role of auditing may be limited. For example, Almarayeh et al. (2020), based on research in the Jordanian market, found that the size of the audit committee and audit fees do not significantly inhibit earnings management. Similarly, Yasser and Soliman (2018) in their Egyptian market research, showed that the size of the audit committee and industry expertise also fail to effectively inhibit earnings management. These studies collectively emphasise the decisive role

of the institutional environment in the effectiveness of audit supervision, as well as the differences in audit governance mechanisms between emerging markets and developed countries.

Second, it is from the perspective of the specific attributes of auditors. Some studies have explored how the personal characteristics of auditors affect audit quality and their constraints on earnings management. For instance, Soroushyar (2023), found in a study based on the Iranian market, that both industry expertise and tenure of auditors can enhance the quality of financial reports, supporting the positive impact of auditor characteristics on audit quality. Shang et al. (2022), in a study targeting the Chinese capital market, further pointed out that the busyness of auditors would increase earnings management, but their rich audit report signing experience could alleviate this negative impact. These studies all indicate that high-quality audits, as an effective external governance mechanism, can significantly suppress earnings management behaviours.

To sum up, based on the agency theory, the existing research generally supports the important role of high-quality audit in inhibiting earnings management. Based on this, this article proposes the following hypothesis:

H1: Audit quality has a negative relationship with real earnings management.

2.2 Foreign Ownership and Earnings Management

The QFII are a relatively special type of shareholder. Most of them are well-known international professional investment institutions, typically possessing mature investment concepts, professional research teams, and a relatively long-term value orientation, rather than aiming for short-term speculation. Regarding whether or not foreign shareholders can play an active role in supervising and governing domestic listed companies, the existing literature has not reached a consensus.

Some scholars support that foreign investors can improve corporate governance. For instance, Widianingsih et al. (2024) found that in Indonesian listed companies, there is a significantly negative correlation between the holdings of foreign institutional investors and earnings management, supporting the agency theory, which suggests that foreign institutional investors help alleviate agency conflicts, supervise management, and reduce information asymmetry, thereby effectively curbing earnings management. Lou et al. (2020) also pointed out that in terms of internal governance, foreign institutional investors often play a more active role than local institutional investors.

However, other studies have suggested that due to factors, such as geographical distance and cultural differences, foreign shareholders are at a disadvantage in obtaining information. The cost of information collection required for them to supervise insiders is higher, thereby weakening their governance effectiveness. For instance, Wati and Gultom (2022) pointed out that in the Indonesian market, due to regulatory differences and information asymmetry issues, foreign investors fail to effectively exert their inhibitory effect on earnings management. Mekolle et al. (2025) also found that in markets with weak institutional environments, insufficient investor protection, and lax regulatory enforcement, foreign investors do not significantly suppress earnings management behaviours.

It is worth noting that the above-mentioned research mainly starts from the perspective of accrual earnings management and pays less attention to REM. This article takes the Chinese capital market as the background, and from the perspective of REM, explores the governance effect of qualified foreign institutional investors. Based on the above analysis, this article believes that foreign shareholders have

strong motivation and ability to suppress REM behaviours that harm the future performance and long-term value of enterprises. Accordingly, it is proposed that:

H2: The existence of foreign ownership is associated with a reduction in real earnings management.

2.3 Domestic Institutional Ownership and Earnings Management

As professional third parties, institutional investors possess strong capabilities in information acquisition and financial analysis, which can to some extent alleviate the information asymmetry between the principal and the agent, thereby restricting the behaviours of management that harm the owners' and the company's interests. However, there are two opposing views on whether or not institutional investors can effectively inhibit earnings management and improve the quality of financial reporting of listed companies in existing research, namely the "active supervision hypothesis" and the "myopic pressure hypothesis" (Lemma et al., 2018).

The active supervision hypothesis posits that institutional investors have large funds, prominent market positions, and the ability to gain in-depth understanding of the operating conditions of listed companies through on-site investigations and other means. They possess the motivation and ability to participate in corporate governance. Their supervisory actions help reduce information asymmetry, and enhance the identification as well as restraints of management's opportunistic behaviours, thereby effectively curbing earnings management. Perwitasari et al.'s (2022) study using Indonesian listed companies as a sample, found that in emerging markets, institutional investors play a positive governance role through active supervision and have improved the information environment. Similarly, Din et al. (2022), who researched the Pakistani market, confirmed that institutional investors play an important external governance role in the capital market.

In contrast, the myopic pressure hypothesis states that although institutional investors are superior to individual investors in information processing and market influence, their core goal is usually to make profits from trading rather than long-term participation in corporate governance; hence, they lack sufficient incentives to promote governance improvement. Perdana (2019), based on the institutional environment in Indonesia, found that institutional investors do not effectively restrain earnings management behaviour. In fact, the higher their shareholding ratio, the more severe the earnings management is in the company. This study points out that many institutions are short-term-oriented investors, focusing more on stock price fluctuations and short-term gains rather than the long-term development of listed companies. Thus, they have neither the willingness to bear supervision costs nor are they likely to tacitly allow management to engage in earnings management to maintain the stock price. Especially in market environments with high information asymmetry and weak legal enforcement, the supervision costs increase further, making it even more difficult for institutional investors to exert governance effects. Wilson et al. (2022) pointed out that when the interests of institutional investors and minority shareholders are inconsistent, their supervision intentions may weaken, and even may exacerbate earnings management behaviour. Based on the agency and signalling theories and the above studies, the following hypothesis is proposed:

H3: The shareholdings of institutional ownership increase real earnings management.

2.4 Media Attention and Earnings Management

In modern capital markets, media coverage not only acts as an information intermediary, but is also regarded as an informal corporate governance mechanism (An et al., 2020). The existing literature generally recognises the dual role of the media, and points out that the main paths through which it functions include the supervision mechanism, the reputation mechanism, and the market pressure mechanism. Specifically, in terms of the supervisory effect, as an information intermediary, the media helps to alleviate the information asymmetry between the management of listed companies and investors (Chen et al., 2021).

However, some scholars hold different views and believe that the impact of media coverage on earnings management comes more from market pressure than external supervision. For instance, Wang et al. (2022) discovered a significantly positive correlation between media coverage and earnings management, supporting the "market pressure hypothesis". They further pointed out that the media, by triggering abnormal attention from investors, creates public opinion pressure that forces management to engage in more earnings management. Similarly, Dai et al. (2021) indicated that the rapid dissemination of information exacerbates the short-term performance pressure faced by management, compelling them to use earnings management to meet market expectations. Thus, regarding the direction of the impact of media attention on earnings management, existing studies have not reached a consensus. Whether the "effective supervision hypothesis" holds the dominant position or the "market pressure hypothesis" is more explanatory, remains highly controversial. Based on this, this article proposes the following research hypothesis:

H4: The attention of media significantly promotes real earnings management.

2.5 Independent Directors and Earnings Management

According to the principal-agent theory, independent directors, as external supervisors, can alleviate the information asymmetry between shareholders and management and restrain the self-interested behaviour of management. Musa et al. (2023) used Nigeria's non-financial listed companies as samples and found that independent directors could significantly inhibit REM and enable the chief executive officer to better utilize their financial expertise. However, the governance effect of independent directors is influenced by various contextual factors. For example, Fitrasari (2023) found that in an appropriately sized board of directors, independent directors can effectively play the role of inhibiting earnings management, but with the expansion of board size, information asymmetry and communication costs will rise, and their supervisory function will fail or even promote earnings management. Similarly, Asad et al. (2024) found that the information acquisition ability of independent directors determines the effectiveness of their supervision, and their tenure has a nonlinear relationship with the effect of inhibiting REM. In the Chinese institutional context, it is still undetermined whether the establishment of independent directors is for substantive participation in supervision or merely to meet regulatory requirements. Based on this, this article proposes the following research hypothesis:

H5: The independent directors reduce real earnings management.

2.6 The Moderating Effect of Inquiry Letter Supervision

The financial report inquiry letters issued by Stock Exchanges are an important form of front-line supervision, possessing professionalism and authority (Wei et al., 2024; Zhang et al., 2025). According to

the signalling theory, when a listed company receives an inquiry letter, it indicates that the disclosed financial information may not have met the regulatory standards, thereby sending a negative signal to the market (Li & Wen, 2023). Based on this, this article regards the inquiry letter supervision as a contextual moderating variable, and explores its moderating effect on the external governance mechanisms, including audit quality, institutional investors, media attention, and independent directors.

When a listed company receives a financial report inquiry letter from the regulatory authorities, it is equivalent to the regulatory body sending a risk signal to the market indicating that the company has financial discrepancies. This will significantly increase the litigation risk and reputation cost faced by the auditors. According to the deterrence theory, after weighing the benefits and penalties, auditors will maintain a higher level of professional scepticism and implement more rigorous audit procedures, thereby enhancing the sensitivity of high-quality audits to earnings management. Especially in cases where the inquiry letter directly names the auditor and requests the auditor to issue a verification opinion, or questions the auditor's professional process, this regulatory effect becomes more prominent. Therefore, under the regulatory pressure of inquiry letters, the inhibitory effect of high-quality audits on earnings management will be strengthened.

As professional market participants, institutional investors possess information advantages. The additional information provided in the inquiry letters can significantly highlight the problems existing in the company and have a good predictive effect on financial fraud. Therefore, on the one hand, when a company receives an inquiry letter, the exposure of negative information will affect the emotions and perceptions of investors, intensify the risk-averse sentiment of institutional investors, and prompt investors to "vote with their feet" by selling or reducing holdings of the company's stocks, thereby putting pressure on the company's internal personnel. On the other hand, it encourages them to more actively intervene in the company's governance and put pressure on the management to improve the quality of financial information.

Media attention, as an external supervisory mechanism, can reduce information asymmetry and force management to restrain their earnings management behaviours through information mining and public opinion pressure. When a company receives an inquiry letter, the spotlight effect of the media will amplify the dissemination scope of negative events, triggering broader market attention (Zhao, 2022). Under the influence of the reputation mechanism and market pressure, management may standardise financial disclosures, thereby strengthening the impact of media attention on earnings management.

Similarly, the information disclosed in the inquiry letter and its response letter can provide additional sources of information for independent directors, which will be helpful towards identifying potential REM behaviours. In addition, when a listed company receives an inquiry letter, independent directors, in order to avoid joint liability, will be more proactive in collecting relevant information and questioning the management, thereby more effectively performing their supervisory functions. Based on these, the following hypotheses are proposed:

H6a: Inquiry letter supervision moderates audit quality and real earnings management.

H6b: Inquiry letter supervision moderates foreign ownership and real earnings management.

H6c: Inquiry letter supervision moderates institutional ownership and real earnings management.

H6d: Inquiry letter supervision moderates media attention and real earnings management.

H6e: Inquiry letter supervision moderates independent director and real earnings management.

3. METHODOLOGY

3.1 Data Collection

This article used the data of Chinese Shanghai and Shenzhen A-share listed companies from 2016 to 2024 as the initial sample, and conducted data screening according to the following steps: (1) Eliminate financial companies; (2) exclude ST listed companies; and (3) Exclude listed companies with missing relevant data. Given that the Stock Exchanges began to publicly disclose financial inquiry letters in 2016, 2016 was set as the starting point. The media report data comes from the China Research Data Service Platform (CNRDS), and all other data are from the China Stock Market and Accounting Research Database (CSMAR Database). In this article, all continuous variables were winsorized at the upper and lower 1% levels, and the standard errors of all regressions were adjusted by cluster at the company level.

3.2 Measurements Of Variables

The dependent variable (DV) is REM. This article referred to the methodologies of previous scholars, such as Hsu and Yang (2022) and Jim-Suleiman et al. (2021), which are grounded in the comprehensive model of REM developed by Roychowdhury (2006).

Specifically, the multiple linear regression method was used to perform regression on equations (1) to (3), respectively, according to different industries and years. The residuals after regression of the three formulae represent abnormal production costs (EM_PROD), abnormal discretionary expenses (EM_DISX) and abnormal cash flow from operating activities (EM_CFO).

$$\frac{PROD_t}{TA_{t-1}} = \alpha_0 + \alpha_1 \frac{1}{TA_{t-1}} + \alpha_2 \frac{Sales_t}{TA_{t-1}} + \alpha_3 \frac{\Delta Sales_t}{TA_{t-1}} + \alpha_4 \frac{\Delta Sales_{t-1}}{TA_{t-1}} + \varepsilon \quad (1)$$

$$\frac{DISX_t}{TA_{t-1}} = \alpha_0 + \alpha_1 \frac{1}{TA_{t-1}} + \alpha_2 \frac{Sales_t}{TA_{t-1}} + \varepsilon \quad (2)$$

$$\frac{CFO_t}{TA_{t-1}} = \alpha_0 + \alpha_1 \frac{1}{TA_{t-1}} + \alpha_2 \frac{Sales_t}{TA_{t-1}} + \alpha_3 \frac{\Delta Sales_t}{TA_{t-1}} + \varepsilon \quad (3)$$

Among them, PROD represents production cost, which is the sum of sales cost and change in inventory; CFO stands for operating cash flow; DISX is discretionary expense, equal to sales expense plus administrative expense; Sales is sales revenue; TA is total assets.

REM is equal to abnormal production costs (EM_PROD) minus abnormal discretionary expenses (EM_DISX) minus abnormal cash flows from operating activities (EM_CFO).

Independent variables are audit quality (AUDQ), foreign ownership (FOROWN), institutional ownership (INSTIOWN), media attention (MEDIA) and board independent directors (INDEP). The moderating variable is whether or not the listed company received an inquiry letter (IL) regarding the

financial report of the previous year in the current year. The measurements of all independent variables, moderating variable, and control variables are listed in Table 1.

Table 1. The explanation of variables

Types	Variables	Explanation	References
Dependent variable	REM	Real earnings management as measured by Roychowdhury (2006)	Hsu & Yang (2022); Jim-Suleiman et al. (2021); Liu et al. (2025)
Independent variables	AUDQ	The natural logarithm of audit fees	Rhee et al. (2021)
	FOROWN	The ownership proportion of a firm's equity held by foreign investors	Pham & Hoang (2025); Widianingsih et al. (2024)
	INSTIOWN	The ownership proportion of a firm's equity held by domestic institutional investors	Wilson et al. (2022)
	MEDIA	The natural logarithm of the number of media coverage+1	Wang (2024)
	INDEP	The proportion of independent directors	Wu & Zhang (2023)
Moderating variable	IL	An indicator equals 1 if the firm receives inquiry letters, and 0 otherwise	Qian et al. (2024)
Control variables	SIZE	The natural logarithm of total assets	Qian et al. (2024)
	Growth	Sales growth rate	Qian et al. (2024)
	EAGE	The natural logarithm of the number of years the company has been established+1	Yu & Lee (2022)
	LEV	The ratio of total liability to total assets	Qian et al. (2024)
	ROE	The ratio of net profit to the net assets	Rashid (2020); Qian et al. (2024)
	Ind	Controlling industry fixed-effects	Wang (2024)
	Year	Controlling year fixed-effects	Wang (2024)

Source: CSMAR Database (2024 Edition)

3.3 Regression model

To study these relationships using econometric methods, we first estimated them using a static panel data model. Specifically, the Hausman specification test results indicate that the fixed-effects model is superior to the random-effects model. Therefore, this article used the fixed-effects model as the baseline

regression method. The fixed-effects model can effectively eliminate unobserved heterogeneity that does not change over time among different individuals, thereby reducing the estimation bias caused by omitted variables (Saleh et al., 2024). To test the hypotheses of H1 to H5 and the moderating effect of H6, the fixed-effects models are illustrated as follows:

$$REM_{it} = \beta_0 + \beta_1 AUDQ_{it} + \beta_2 FOROWN_{it} + \beta_3 INSTIOWN_{it} + \beta_4 MEDIA_{it} + \beta_5 INDEP_{it} + \beta_6 SIZE_{it} + \beta_7 Growth_{it} + \beta_8 LEV_{it} + \beta_9 ROE_{it} + \beta_{10} EAGE_{it} + \Sigma Ind + \Sigma Year + \varepsilon \quad (4)$$

$$REM_{it} = \beta_0 + \beta_1 AUDQ_{it} + \beta_2 FOROWN_{it} + \beta_3 INSTIOWN_{it} + \beta_4 MEDIA_{it} + \beta_5 INDEP_{it} + \beta_6 IL_{it} + \beta_7 AUDQ_{it} \times IL_{it} + \beta_8 FOROWN_{it} \times IL_{it} + \beta_9 INSTIOWN_{it} \times IL_{it} + \beta_{10} MEDIA_{it} \times IL_{it} + \beta_{11} INDEP_{it} \times IL_{it} + \beta_{12} SIZE_{it} + \beta_{13} Growth_{it} + \beta_{14} LEV_{it} + \beta_{15} ROE_{it} + \beta_{16} EAGE_{it} + \Sigma Ind + \Sigma Year + \varepsilon \quad (5)$$

In addition, Brahma et al. (2021) and Akter et al. (2024) both pointed out that by using a fixed-effects regression model combined with the system generalised method of moments (GMM) estimation, the reliability of the research results can be ensured. In order to further control the potential endogeneity problem and verify the robustness of the conclusion, the one-step systematic GMM method for re-estimation was used.

4. RESULTS AND DISCUSSION

4.1 Descriptive Statistics

Table 2 presents the summary statistics of the research variables, listing the average, median, minimum, maximum, and standard deviation for each variable. The average value of REM is 0.145, and the standard deviation is 0.146. This mean and standard deviation are comparable to those of Liu et al. (2025), who reported a mean of 0.155 and a standard deviation of 0.153 of REM.

The mean value of Audit Quality (AUDQ) is 14.014, and there is a significant gap between its maximum and minimum values, reflecting the heterogeneity of the audit quality of the sample companies. The mean value of Foreign Ownership (FOROWN) is 0.122, and the median is 0.000, indicating that more than half of the sample companies do not have foreign ownership. The mean value of Media Attention (MEDIA) is 5.167, with a minimum value of 0.000 and a maximum value of 8.301, showing that some companies have a high level of media exposure, while a few are in a zero-attention state. The average proportion of institutional investors' holdings is 40.479, and the maximum value is 89.060. This indicates that the proportion of institutional investors' holdings is relatively high. The mean value of the moderating variable (IL) is 0.116, indicating that approximately 11.6% of the samples are in the situation of receiving inquiry letters. This average value is basically consistent with the research result of Zhao (2022), who used the variable of “whether or not a company receives an inquiry letter” as the proxy indicator of IL and reported an average value of 0.132.

Table 2. Summary statistics

Variables	Obs	Mean	Median	SD	Min	Max
REM	26168	0.145	0.102	0.146	0.002	0.800
AUDQ	26168	14.014	13.911	0.637	12.848	16.209
FOROWN	26168	0.122	0.000	0.424	0.000	2.770
INSTIOWN	26168	40.479	41.609	24.108	0.252	89.060
MEDIA	26168	5.167	5.328	1.484	0.000	8.301
INDEP	26168	0.379	0.364	0.054	0.333	0.571
IL	26168	0.116	0.000	0.321	0.000	1.000
SIZE	26168	22.468	22.280	1.278	20.157	26.434
Growth	26168	0.133	0.083	0.354	-0.583	2.002
LEV	26168	0.427	0.420	0.198	0.065	0.907
ROE	26168	0.039	0.061	0.163	-0.998	0.310
EAGE	26168	3.075	3.091	0.275	2.303	3.664

Source: Based on CSMAR database and CNRDS, the calculation was processed using Stata 18.0.

4.2 Correlation analysis

Table 3 presents the Pearson correlation coefficient matrix. In general, a correlation coefficient over 0.80 indicates multicollinearity (Akter et al., 2024). The highest correlation coefficient value among the variables in this Table is 0.742, which is less than 0.80. This suggests that there is no multicollinearity problem between the variables, and thus, there is no threat to the estimated variables. In addition, the variance inflation factor (VIF) test shows that the highest value of all values is 3.04, which is below 10; an upper limit of this value will cause multicollinearity problems (Gujarati and Porter, 2008).

Table 3: Correlation coefficients

	REM	AUDQ	FOROWN	INSTIOWN	MEDIA	INDEP	IL	SIZE	Growth	LEV	ROE	EAGE
REM	1											
AUDQ	-0.011*	1										
FOROWN	0.058***	0.037***	1									
INSTIOWN	0.029***	0.356***	0.006	1								
MEDIA	0.093***	0.245***	0.040***	0.146***	1							
INDEP	-0.003	0.012*	0.016***	-0.045***	0.027***	1						
IL	0.007	0.013**	-0.030***	-0.070***	0.012**	0.015**	1					
SIZE	-0.030***	0.742***	0.024***	0.451***	0.328***	-0.007	-0.085***	1				
Growth	0.202***	-0.005	0.023***	0.043***	0.054***	-0.016***	-0.034***	0.039***	1			
LEV	-0.034***	0.386***	-0.019***	0.165***	0.130***	-0.005	0.089***	0.473***	0.033***	1		
ROE	0.105***	-0.006	0.055***	0.134***	0.078***	-0.009	-0.221***	0.118***	0.247***	-0.251***	1	
EAGE	-0.032***	0.133***	0.001	0.071***	-0.050***	-0.030***	0.006	0.170***	-0.108***	0.147***	-0.049***	1

Source: Same as above table. Standard errors in parentheses: * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$;

4.3 Regression results

Table 4 presents the regression results obtained through the fixed-effects analysis method. The regression results show that the adjusted R^2 of the model for the factors influencing REM is 54.07%, which is within an acceptable range. Further multiple regression analysis indicates that INSTIOWN has a positive promoting effect on REM at the 10% significance level (p-value is 0.050), which is consistent with H3. This result supports the "myopic pressure hypothesis", i.e., in a market environment with a high degree of information asymmetry and weak law enforcement, institutional investors are mostly short-term investors, paying more attention to stock price fluctuations and short-term returns, rather than the long-term governance performance of listed companies, thus lacking the willingness to invest in supervision costs (Perdana, 2019). In this context, the increase of institutional ownership does not introduce effective external supervision, but accelerates the REM behaviour of management through the performance pressure transmission mechanism. In order to meet the short-term assessment requirements of institutional investors, management has a strong incentive to choose more covert means of real activity manipulation (Yamen et al., 2022). Therefore, with the increase of the shareholding of institutional investors, the management will further aggravate the REM behaviour of the company due to the performance pressure and financing demand.

On the other hand, the regression results in Table 4 show that MEDIA attention has a significant impact on the REM behaviour of A-share listed companies in Shanghai and Shenzhen of China, with a significance level of 10% and a p-value of 0.080. This finding indicates that an increase in media attention may trigger the REM behaviour of companies. This result supports the market pressure mechanism hypothesis, which states that in a capital market environment where information dissemination is accelerated, extensive media coverage will significantly amplify the short-term performance pressure faced by management. To avoid the decline in stock prices and reputational damage caused by negative public opinion, management is forced to engage in earnings management to meet market expectations, and they tend to choose more covert methods of manipulating actual activities (Dai et al., 2021). This conclusion is also consistent with the research of Wang et al. (2022), that online media reports create public opinion pressure by attracting abnormal attention from investors, prompting management to conduct more earnings management. In addition, Lu et al. (2023) found in the comparison between state-owned and private enterprises in China's capital market, state-owned enterprises are more inclined to adopt REM with stronger concealment when they are highly concerned with the media, so as to avoid regulatory review and reputation risks. To sum up, in the absence of effective governance mechanism, media attention may cause short-term performance anxiety due to market pressure, and then, induce the transmission path of hidden manipulation, aggravating rather than alleviating the REM behaviour of companies.

In addition, the regression results in Table 4 show that the negative relationships between audit quality (AUDQ), foreign institutional holdings (FOROWN), and independent directors (INDEP) and REM are consistent with the theoretical expectations in the previous section. However, these relationships fail to pass the significance test. In terms of audit quality, REM has strong concealment, making it difficult for auditors to make direct adjustments as they do for accrual earnings management. Furthermore, due to the fierce competition in the auditing market, the issue of insufficient auditing independence may also undermine the quality of auditing. This finding is consistent with Areneke et al. (2022) that there may be substantial

oversight deficiencies in emerging market governance mechanisms. For foreign institutional investors, they may face disadvantages in information acquisition, thus making it difficult for them to fully exert their supervisory role. As for the supervision function of independent directors, the finding supports the research conclusion of Asad et al. (2024), that due to the differences in information acquisition ability of independent directors, their inhibitory effect on REM is not a simple linear relationship.

Table 4: Results of regression using FE and GMM models

	(1) FE model REM	(2) GMM model REM
L.REM		0.1229*** (0.0430)
AUDQ	-0.0027 (0.0053)	-0.0519 (0.1254)
FOROWN	-0.0002 (0.0023)	-0.0106 (0.1315)
INSTIOWN	0.0003* (0.0002)	0.0032*** (0.0011)
MEDIA	0.0012* (0.0007)	0.0231*** (0.0069)
INDEP	-0.0165 (0.0248)	0.0290 (0.0466)
SIZE	0.0080* (0.0042)	-0.1326** (0.0584)
Growth	0.0739*** (0.0041)	0.1557* (0.0815)
LEV	0.0488*** (0.0138)	0.5011 (0.4122)
ROE	0.0141* (0.0073)	-0.2921 (0.2709)
EAGE	0.0624* (0.0329)	0.0467** (0.0238)
Constant	-0.2323* (0.1298)	3.2261** (1.6133)
N	25901	21557
r2_a	0.541	
AR(2)p-value		0.215
Hansen(p-value)		0.657
Firms		4052
F	41.45	

Source: Same as above table. Standard errors in parentheses: * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$;

The moderating effect regression results in Table 5 show that there is a significant interaction between institutional investors' shareholdings and the annual report inquiry letter, indicating that the inquiry letter mechanism strengthens the positive impact of institutional investors' shareholdings on REM, thereby supporting Hypothesis H5c. One possible explanation is that management faces stronger regulatory

attention after receiving the inquiry letter. To avoid the external supervision mechanisms, such as auditors detecting the accrual earnings management, they tend to adopt more covert REM methods, thereby amplifying the short-term performance pressure brought on by institutional investors.

In terms of audit quality, there is no significant interaction between audit quality and annual report inquiry letters in the fixed-effects model, but in the GMM model, it shows a significant correlation, and the interaction strengthens the inhibitory effect of audit quality on REM. Therefore, hypothesis H5a is supported in the GMM model. In contrast, the interactions between the ownership of foreign investors and the annual report inquiry letters, as well as between media attention and the annual report inquiry letters, are not significant in the GMM model. Thus, hypotheses H5b and H5c are not supported. In the fixed-effects model, however, there are significant correlations between the two groups of variables.

Table 5. Moderating effect of inquiry letter

	IL dummy		IL2 number of letters	
	FE model REM	GMM model REM	FE model REM	GMM model REM
L.REM		0.1234*** (0.0342)		0.1221*** (0.0343)
AUDQ	-0.0028 (0.0053)	0.0927* (0.0538)	-0.0027 (0.0053)	0.0923* (0.0536)
AUDQ_IL	-0.0071 (0.0047)	-0.0212* (0.0112)	-0.0106* (0.0062)	-0.0304** (0.0153)
FOROWN	-0.0006 (0.0023)	0.0124** (0.0055)	-0.0006 (0.0023)	0.0125** (0.0055)
FOROWN_IL	-0.0121* (0.0064)	-0.0146 (0.0112)	-0.0158* (0.0082)	-0.0178 (0.0143)
INSTIOWN	0.0003** (0.0002)	0.0020*** (0.0007)	0.0003** (0.0002)	0.0020*** (0.0007)
INSTIOWN_IL	0.0003** (0.0001)	0.0009** (0.0004)	0.0004** (0.0002)	0.0011** (0.0005)
MEDIA	0.0011 (0.0007)	0.0142*** (0.0050)	0.0011 (0.0007)	0.0142*** (0.0050)
MEDIA_IL	0.0034** (0.0017)	-0.0005 (0.0031)	0.0060** (0.0024)	0.0002 (0.0043)
INDEP	-0.0166 (0.0249)	-0.0251 (0.0522)	-0.0164 (0.0249)	-0.0245 (0.0522)
INDEP_IL	0.0178 (0.0439)	0.0140 (0.0807)	0.0288 (0.0563)	0.0098 (0.1062)
IL	0.0040 (0.0026)	-0.0511** (0.0254)	0.0047 (0.0035)	-0.0683** (0.0337)
SIZE	0.0078* (0.0042)	-0.1669** (0.0669)	0.0077* (0.0042)	-0.1663** (0.0665)
Growth	0.0739*** (0.0041)	0.1597* (0.0821)	0.0739*** (0.0041)	0.1619** (0.0824)
LEV	0.0490*** (0.0138)	1.0127* (0.5681)	0.0493*** (0.0138)	1.0111* (0.5686)

	IL dummy		IL2 number of letters	
	FE model REM	GMM model REM	FE model REM	GMM model REM
ROE	0.0142** (0.0072)	-0.0460 (0.2774)	0.0143** (0.0073)	-0.0519 (0.2787)
EAGE	0.0613* (0.0328)	-0.1633 (0.1909)	0.0617* (0.0328)	-0.1664 (0.1915)
Constant	-0.2226* (0.1296)	2.5085** (1.2278)	-0.2226* (0.1296)	2.5130** (1.2306)
N	25901	21557	25901	21557
r2_a	0.541		0.541	
AR(2)p-value		0.901		0.879
Hansen(p-value)		0.692		0.717
Firms		4052		4052
F	27.33		27.41	

Source: Same as above table. Standard errors in parentheses: * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$;

4.4 Robustness checks

Endogeneity

Considering that earnings management has dynamic characteristics and is prone to endogeneity problems, this article drew on the research of Akter et al. (2024), by using the REM lagged by one period as the instrumental variable, and adopted the one-step systematic GMM model to ensure the robustness of the main results. This is because the model has been widely used to solve the endogeneity problem (Saleh et al.,2024). The test results show that in the direct relationship model (as shown in Table 4), the signs and significance levels of the regression coefficients are consistent with the empirical results in the previous text, indicating that the model constructed in this article and the research conclusions are robust. The relevant results are detailed in Tables 4 and 5.

Alternative measurement of inquiry letter supervision

To further enhance the reliability of the conclusion, this article conducted a robustness test of the measurement of the replacement variables. Specifically, for the moderating variable, inquiry letter mechanism, we replaced its measure by the original dummy variable, i.e., whether or not an inquiry letter was received with the number of inquiries received. The results of the robustness test show that the sign and significance level of the coefficient of the interaction term INSTIOWN $\times$ IL does not change substantially after replacing the measurement method of the moderating inquiry letter mechanism variable. This indicates that the research conclusion of this article on the moderating effect of the inquiry letter mechanism on institutional investors is robust.

Interestingly, the replacement of the inquiry letter measurement method has a significant impact on the interaction term of audit quality. When the dummy variable of whether an inquiry

letter has been received is adopted to measure the inquiry letter mechanism, its interaction term with audit quality is significant at the 10% level under the system GMM model, but insignificant under the fixed-effects model. However, when we adopted number of inquiries to capture continuous changes in regulatory intensity, the interaction term became significantly and negatively correlated at the 5% and 10% levels, respectively. This comparative result reveals the cumulative intensity-dependent characteristic of the regulatory impact of inquiry letters. The inhibitory effect of audit quality on REM is not simply determined by whether a regulatory event occurs, but rather depends on the persistence and cumulative intensity of the regulatory intervention. In other words, the substantive governance role of high-quality audits needs to be activated by continuous external regulatory pressure. When a company only faces one-time occasional inquiries, auditors may still remain at the level of compliance audits. Only when the company encounters multiple rounds of high-intensity continuous inquiries, will the management take the initiative to cooperate with high-quality auditors to initiate more stringent substantive verification procedures to avoid regulatory risks, thus significantly inhibiting REM behaviour. Hence, the H5a hypothesis has been tested, and the results are detailed in Table 5.

5. CONCLUSION

Currently, China is in a critical stage where its economy is transitioning from high-speed growth to high-quality development. Enterprises are the main builders at this juncture, while Stock Exchanges are important supervisors to ensure the standardised operation of enterprises. The inquiry letter system is an innovative information disclosure regulatory mechanism implemented by Exchanges in recent years. This article used the A-share listed companies on the Shanghai and Shenzhen Stock Exchanges from 2016 to 2024 as the research sample, to empirically examine the impact of external supervision mechanisms on the degree of REM of enterprises, and focused on exploring the moderating effect of the annual report inquiry letter system in the above relationship. The results show that in the market environment with high information asymmetry and weak law enforcement, due to myopic and market pressures, the management tends to adopt more hidden REM methods in order to meet the performance appraisal requirements of institutional investors, which leads to the degree of earnings management increasing with the increase of institutional ownership. Further, after the company receives the inquiry letter, the regulatory pressure and the short-term performance pressure of institutional investors strengthen the motivation of management to engage in REM behaviour. Similarly, the increase in media attention intensifies the short-term performance pressure faced by management, forcing them to meet market expectations through earnings management. On the contrary, the inquiry letter mechanism plays a positive stimulating role in the external governance of audit quality, i.e., regulatory pressure can activate the governance function of high-quality auditors and strengthen its inhibitory effect on REM.

5.1 Implications

Based on this finding, this research has theoretical implications and important managerial implications for practitioners and policy makers, as well as important implications for future research on the relationship between external monitoring mechanisms and earnings management in developing countries. Firstly, the study finds that the governance effect of inquiry letters is intensity dependent, and its effect depends on the

accumulation of regulatory pressure. Therefore, regulatory authorities should pay close attention to companies that have received multiple inquiries, and establish a key tracking list. At the same time, the short-sighted behaviour of institutional investors should be restrained by means of long-term assessment and guidance, and they should be encouraged to actively participate in corporate governance from "voting with their feet," so as to truly play the function of external supervision. Secondly, listed companies should view media attention rationally. Finally, auditing institutions should implement stricter quality control over clients who receive inquiry letters, maintain higher professional vigilance under greater regulatory pressure, and ensure that audit opinions truly reflect the earnings management risks of enterprises. Investors should also combine multiple-dimensional information, such as inquiry letters, audit opinions, and media coverages to comprehensively judge the earnings quality of the enterprises.

5.2 Limitations And Future Research

The current research has a few specific limiting factors, which might provide ideas for future academic research. Due to the lack of sufficient data, this survey did not classify institutional ownership as either pressure-resistant or pressure-sensitive, which may have led to fluctuations in institutional ownership. Secondly, this study only examined the phenomenon of REM. Therefore, future researchers may consider exploring the area of accrual earnings management. Moreover, the examination of the inquiry letter's regulatory effect mainly used the inquiry letter quantity as the proxy variable for regulatory intensity, which fails to distinguish the heterogeneous impacts of inquiry letter types, problem severity, and response quality. Future research can conduct text analysis of inquiry letter content, construct more refined inquiry letter regulatory intensity indicators, and deeply explore their heterogeneous regulatory effects in different types of enterprises. Finally, with the comprehensive advancement of the registration system reform in recent years, the regulatory intensity and frequency of inquiry letters have significantly changed. Future research can expand the time window to examine the dynamic evolution characteristics of the inquiry letter governance effect under different regulatory stages.

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7. CONFLICT OF INTEREST STATEMENT

The authors agree that this research was conducted in the absence of any self-benefits, commercial or financial conflicts and declare the absence of conflicting interests with the funders.

8. AUTHORS' CONTRIBUTIONS

Pan Xi: Conceptualisation, methodology, formal analysis, investigation, data curation, writing-original draft, and project administration; **Suhaily Hasnan:** Conceptualisation, methodology, supervision, project administration, and funding acquisition; **Intan Waheedah Othman:** Writing-review and editing, and supervision. All authors have read and approved the final version of the manuscript.

9. DATA AVAILABILITY/SUPPLEMENTARY MATERIALS

The data used in this study were obtained from the China Stock Market and Accounting Research (CSMAR) Database and the China Research Data Service Platform (CNRDS). These proprietary datasets are available from the respective database providers under licence and are not publicly available from the authors. No supplementary materials accompany this article.

10. ETHICS STATEMENT

This research received ethical approval from the Research Ethics Committee (REC), Universiti Teknologi MARA (UiTM) prior to data collection. The study was conducted in accordance with the ethical standards and guidelines of the Committee. The research utilised secondary archival data obtained from the China Stock Market and Accounting Research (CSMAR) Database and the China Research Data Service Platform (CNRDS) and all data were analysed in accordance with the approved research protocol.

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