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Audit tenure and earnings surprise management

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Abstract

Purpose

The purpose of this paper is to examine the relation between audit tenure and how clients manage the annual earnings surprise.

Design/methodology/approach

A sample of 5,029 firm-year observations from 1996 to 2003 were employed to examine whether audit tenure is negatively related to the incidence of accrual-based-upward earnings management to avoid negative earnings surprises; and whether audit tenure is positively related to the incidence of downward forecast guidance to avoid negative earnings surprises.

Findings

Empirical results indicate a substitution of downward forecast guidance for upward earnings management as audit tenure lengthens.

Research limitations/implications

The paper provides evidence that, as the auditor-client relationship lengthens over time, firms turn to downward forecast guidance as a substitute for upward earnings management. One possible limitation of the sample period involves the implementation of the Sarbanes-Oxley Act (SOX) of 2002. Because of the increased financial reporting scrutiny on both management and auditors that accompanies SOX, it is likely that constraints on earnings misstatements increase after SOX. Any decrease in upward earnings management resulting from SOX would thus work against finding a relation between audit tenure and the



This paper supports the notion that audit tenure affects firms' choices among various tactics in their attempts to avoid negative earnings surprises. The results also contribute to the ongoing debate on mandatory audit firm rotation by showing that audit quality increases with audit tenure.

Keywords

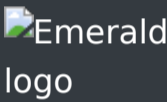
- Auditing
- Financial forecasting
- Organizational earnings

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