Pre and Post-SOX Association between Audit Firm Tenure and Earnings Management Risk

Santanu Mitra
Donald R. Deis
Mahmud Hossain*

Abstract

This study investigates the effect of audit firm tenure on earnings management risk. We perform multivariate regression analyses to examine the empirical relationship between auditor tenure and the probability of earnings manipulation using Beneish’s (1999) framework. The analysis covering a five year time-period surrounding the enactment of SOX produces evidence of a negative relationship between the length of auditor tenure and the probability of earnings manipulation (termed as earnings management risk). Additional analysis reveals that the risk of financial misreporting is more likely to be present in the first three years of auditor tenure in the pre-SOX period. This result is consistent with similar studies prior to SOX (e.g., Carcello and Nagy 2004, Myers et al. 2003, Johnson et al. 2002, Bartov and Cohen 2007, Cohen et al. 2007). Further analyses show that the negative association between audit firm tenure and earnings management risk is substantially moderated in the post-SOX period. We posit that heightened scrutiny over audits (e.g., PCAOB inspections) and the perceived threat of additional regulations to limit auditor tenure explain this finding. Our main results are robust to alternative specifications of earnings management risk and auditor tenure, and in the presence of additional controls for heavily represented industries, mergers and acquisitions, restructuring, issue of new equity and debt securities, change of auditor from Arthur Andersen, and extreme financial performance.

Keywords: Audit firm tenure; Earnings management risk; M-SCORE; M-FACTOR; Sarbanes-Oxley Act; SOX transition period; Pre-SOX; Post-SOX.

Data: Data used in the study is obtained from publicly available sources described in the text.

* The authors are, respectively, Associate Professor of Accounting at Wayne State University-Detroit, Professor of Accounting at Texas A&M University-Corpus Christi, and Assistant Professor of Accountancy at University of Memphis.