

The Impact of SAS No. 82 on an Auditor's Tolerance of Earnings Management

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Over the last thirty years, the auditing profession has been under increased pressure to improve its ability to detect earnings management. In response to these criticisms, the Auditing Standards Board issued SAS No. 99 in 2002. One of the primary motivations for the issues examined in SAS No. 99 was the five academic studies commissioned by the AICPA that examined the impact of SAS No. 82 on an auditor's assessment of risk and audit procedures. These studies fail to examine the impact of SAS No. 82 on an auditor's tolerance toward a client's attempt to manage earnings. Investors, regulators, and the public are more concerned with management's ability to manage earnings rather than an auditor's assessment of risk and audit procedures. After controlling for leverage, operating cash flows, size, equity offerings, type of audit report, and audit quality, it is found that SAS No. 82 has not decreased an auditor's tolerance toward a client's attempts to manage earnings. In fact, the results suggest that auditors have become more tolerant of management's attempts to manage earnings over the time period that SAS No. 82 has been in effect. In light of these findings, the Auditing Standards Board may want to consider whether the findings of this study would have impacted the issues examined in SAS No. 99.

Accounting practitioners and academics have long recognized that managers have incentives to manipulate earnings to maximize their own wealth and/or the wealth of the firm. Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers [DeChow and Skinner (2000) and Healy and Wahlen (1999)].

Most studies that have examined earnings management focus on detecting whether and when earnings management takes place. These studies focus on management's incentives to manipulate earnings. These incentives include (1) capital market expectations and valuation; (2) contracts written in terms of accounting numbers; and (3) antitrust or other gov-