

Plain Language Summary: [Do Auditors Tolerate Management's Attempt to Meet Earnings Targets? Evidence from Executive Stock Option Plans in China](#)

What is the study about?

This study examines whether auditors tolerate management's efforts to lower reported earnings before companies announce their first executive stock option (ESO) plans. Using a unique Chinese dataset that captures both pre-audit and post-audit earnings, the researchers analyzed 9,404 firm-year observations from 2006–2012. This allowed them to directly observe audit adjustments and assess whether auditors challenged managers who may have been understating earnings to secure more favorable stock option pricing.

What are the major findings of the study?

The researchers found that firms planning to introduce an ESO plan were significantly less likely to receive upward audit adjustments. Specifically, these firms were about 5.2% less likely to have auditors require earnings increases. The effect was strongest among economically important clients, suggesting auditors may be more willing to accommodate large or valuable clients. The study also found that firms adopting ESOs paid approximately 6% higher audit fees. Among ESO firms, those that did not receive upward audit adjustments paid audit fees that were about 12.4% higher than firms receiving upward adjustments. Additional analyses indicate that managers actively reduced reported earnings before ESO announcements and that auditors often tolerated this behavior.

Why is the study important to accounting professionals?

The findings provide direct evidence that executive compensation incentives can influence financial reporting and potentially affect auditor independence. Auditors, audit committees, regulators, and investors should carefully evaluate earnings declines preceding stock option grants and consider whether audit adjustments adequately address management bias. The study also highlights the importance of maintaining professional skepticism when auditing firms with significant equity-based compensation plans.

What is the impact on professional practice and society at large?

The results raise important corporate governance and investor-protection concerns. By allowing earnings to remain artificially low before option grants, executives may receive stock options at more favorable prices, potentially transferring value from shareholders to management. The findings support stronger oversight, greater transparency around audit adjustments, and closer regulatory scrutiny of firms implementing executive stock option plans. These measures could enhance confidence in financial reporting and strengthen capital market integrity.