

ABSTRACT

The House of Representatives passed Bill H.R. 1564 on July 8, 2013 that would require the GAO to conduct a cost-benefit analysis on requiring mandatory auditor rotation. To facilitate this analysis, it is important to understand the driver (e.g., engagement risk) and economic consequence (e.g., firm value) for auditor-client retention decisions. Simultaneously modelling the endogenous choice of auditor-client retention, CSR, and firm valuation, I find robust evidence that CSR performance is positively associated with auditor-client retentions, firm value first increases with auditor-client retention and later decreases with auditor-client continuance, and the association between firm value and auditor-client retention is more pronounced for Low CSR conscious firms than for High CSR conscious firms. Further analyses reveal that the normal (abnormal) firm value exhibits an apparent inverted U-shaped pattern (U-shaped pattern) *only* for low CSR conscious firms while no obvious second-order tenure effect exists for high CSR conscious firms, suggesting that the market value auditor-client retention due to improved institutional knowledge gained over time at earlier years but penalizes it at later years due to potential independence concerns for Low CSR conscious firms. This implies that the market distinguishes auditor's incentives from manager's incentives in evaluating auditor-client retention decisions. Moreover, I find that the moderating effect of CSR consciousness on the association between auditor-client retention and firm valuation is fundamentally driven by internal CSR activities rather than external CSR activities and by industry specialist auditors rather than non-industry specialist auditors.

Keywords: Audit Firm Tenure, Firm Value, Corporate Social Responsibility, Governance, Ethics, and Agency Costs.

Data Availability: data used in this study are available from public sources identified in the paper.