

Audit Firm Tenure and Fraudulent Financial Reporting

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The Sarbanes-Oxley Act (2002) required the U.S. Comptroller General to study the potential effects of requiring mandatory audit firm rotation. The General Accounting Office (GAO) concludes in its recently released study of mandatory audit firm rotation that “mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence” (GAO 2003, Highlights). However, the GAO also suggests that mandatory audit firm rotation could be necessary if the Sarbanes-Oxley Act’s requirements do not lead to improved audit quality (GAO 2003, 5).

We examine the relation between audit firm tenure and fraudulent financial reporting. Comparing firms cited for fraudulent reporting from 1990 through 2001 with both a matched set of non-fraud firms and with the available population of non-fraud firms, we find that fraudulent financial reporting is more likely to occur in the first three years of the auditor-client relationship. We fail to find any evidence that fraudulent financial reporting is more likely given long auditor tenure. Our results are consistent with the argument that mandatory audit firm rotation could have adverse effects on audit quality.

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