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Mandatory Audit Rotation and Audit Independence: Survey of Southern Nigeria

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Abstract

The quest for mandatory audit rotation has been a concern to academics, investors, practitioners and the public at large. This study is designed to determine the relationship between mandatory audit rotation and audit independence in Southern Nigeria. The data used were collected through the distribution of questionnaires to investors, lecturers, consultants, accountants and auditors in Southern Nigeria. Percentage analysis was used to analyze the data while the specified model was estimated using binary logistic regression technique with the aid of computer software Eviews 7. One hypothesis was stated and tested. The study revealed that mandatory audit rotation has a positive relationship on auditors' independence. We therefore recommended that though audit rotation will improve auditors' independence, rotation of external auditors should be made voluntary.

Keywords: Mandatory Audit Rotation, Audit independence, Southern Nigeria

1. Introduction

1.1 Background To The Study

Research studies have in the recent past done to investigate the impact of mandatory audit rotation on auditor independence. This became a concern as a result of some worrisome audit failures recorded across the world. For instance, the case of the world celebrated Enron and WorldCom in the United States of America, Northern Rock in the United Kingdom, Metagelshaft in Germany, Parmalat in Italy (Healey & Kim, 2003; NYSE, 2002; Adeyemi & Okpala, 2011, Arel, Brody & Pany 2005, Appah, & Oyadonghan, 2011) have refocused attention on the professional effectiveness in protecting public interest.

Arthur Andersen's role in the Enron scandal of 2001 cast doubt on the independence and quality report of the external auditors. In a quick response to the public outrage caused by the Enron saga, the U.S. government passed the Sarbanes Oxley Act (SOx) in 2002. One of the Act's provisions which seek to address threats to the auditor's independence was the introduction of mandatory partner rotation where the lead audit partner is restricted from auditing a particular client longer than five years (Cameran., Prencipe., & Trombetta, 2008) .

In Nigeria, the recent happenings in the financial institutions and other sectors of the economy have put auditors under scrutiny. This came as a result of the simultaneous collapse of Afribank Plc, Union bank Plc, Bank PHB, Spring Bank Plc, Oceanic bank, Intercontinental bank plc, African Petroleum Plc, Fin Bank Plc, Lever Brothers and Cadbury Plc raising an eye brow on the integrity, independence and qualifications of the external auditors.

Mandatory rotation of external auditors have been suggested as one of the measures to reduce the possibility of fraud, and minimise familiarity threat, meaning that a maximum limit is set for the tenure of an auditor with a firm resolve to preserve auditors independence (Healey & Kim, 2003; Francis, 2004).

1.2 Problem Analysis

Mandatory rotation of audit firms is a topic that has been debated for over six decades around the world. Crusaders for mandatory auditor rotation argue that audit quality is diminished with long audit tenure, that mandatory rotation will reduces familiarity threat, ensures auditors independence and provides a greater scepticism and a fresh perspective that may be lacking in long-standing auditor client relationships (Firth, Rui & Wu, 2010; Hyeeso, 2004; Riuz-Barbadillo & Gomez-Aguilar, 2002). They claim that the longer an audit firm retains a client; the client can be viewed as a source of perpetual income, potentially impairing the auditors' independence (Dopuch, King & Schwartz, 2001).

On other hand, the opponents of mandatory audit argue that longer audit-client relationships improve audit quality because the auditor acquires client specific knowledge over time. This implies that audit quality is lower during the early years of the audit client relationship and audit quality increases with length of audit tenure due to the reduction in information unevenness between the auditor and the client. Also, increasing the frequency of audit changes will raise the frequency with which the start-up costs associated with first-year engagements are incurred and, consequently, increase total audit costs (Johnson, Khurama & Reynolds, 2002; Francis, 2004; Arrunada & Paz Ares 1997; Nagy, 2005; Chung, 2004). These higher costs will be passed on by auditors in order to maintain profitability and consequently result in higher audit fees for clients. Clients would suffer additional increased costs due to the periodic need to devote resources to assist auditors in obtaining an understanding of their operations and information systems. Perhaps more importantly, costs would rise as the result of decreased audit quality.

1.3 Objective Of The Study

The objective of this study is to examine the impact of mandatory audit rotation on auditors' independence in southern Nigeria.

1.4 Research Question

- Does mandatory rotation of auditors affect audit independence in Nigeria?

1.5 Scope Of The Study

The focus of this research work is to examine the impact of mandatory audit rotation on auditors' independence in Southern Nigeria with emphasis on qualified accountants including those in the public sector and private sector. Those in the public sector shall comprise of qualified lecturers in accounting, banking, management and economics department while the private sector shall comprise of selected accredited auditing firms in Abia State, Edo State and Lagos State respectively. A total of five hundred (500) consultants, lectures, accountants and auditors are examined upon which questionnaires are administered.

1.6 Hypothesis Of The Study

For the purpose of our research study, the hypothesis is formulated in null form:

- Mandatory audit rotation has no significant relationship on the independence of auditors in Nigeria.

2. Review Of Relevant Literature

2.1 Concept Of Mandatory Audit Rotation

Mandatory rotation of audit firms is a statutory prescription of the length of time an audit firm stays and renders professional services to its clients. It requires audit firms to be rotated after a specified number of years despite the efficiency, quality, and independence of the audit firm, the willingness of the shareholders and the management to keep the audit firm.

According to Zawawi (2007), the concept of mandatory audit rotation was introduced as a result of the highly publicized corporate failures that resulted in litigations. Asein (2007) further notes that the issue of rotation of external auditors was conceived to be a solution to possible familiarity threat between personnel of the audit firm and the client.

Rotation of external auditors is not an unprecedented policy though, is novel in Nigeria following the pronouncement by the Central Bank of Nigeria mandating banks to rotate her external auditors after ten consecutive years of audit engagement. E.I.U Pont De Nemours and Company, commonly known as DuPont, a United State of America company started rotation of her external auditors in 1910 (Marquita, 2002).

Mandatory rotation of auditors became a national interest and was first introduced during the Mckesson Robbins accounting scandal in the late 1930s ("Question", 1967). Mckesson Robbins was involved in a huge scandal in which the accounting firm Price Waterhouse were unable to detect nineteen million US dollars misstated in the inventory and the receivables. Mckesson Robbins falsified records and Price Water House did not question or verify the validity of their financial statements. What followed after the discovery of this fraud were congressional hearings and debate by lawmakers to reform the accounting profession. ("Question", 1967).

2.3 Mandatory Audit Rotation and Auditors Independence

External auditors play important roles in the capital markets by providing services to protect the interests of the investing public. These public watchdogs' functions require that accounting firms remain independent of the audit client and act on behalf of the shareholders. However, the control over hiring and firing of auditors by client's management, combined with managers strong motivation to attain or exceed stated goals and objectives, imposes a heavy burden upon the auditors to stand firm. Managers may try to actively use auditor-switching to avoid qualified reports, and may also use switch-threat to obtain a more favourable report from an incumbent auditor.

Mautz & Sharaf (1961) developed a concept of independence with two components: practitioner's independence and professional independence. According to them, practitioner's independence, on the one hand, is a state of mind and equates the notion of integrity and objectivity of the individual auditor. Professional independence on the other hand, is apparent independence of auditors, as a professional group, to the public. This implies that an auditor should avoid undue influence. In this regard, an auditor must not be interested in running the affairs of the company covertly or overtly (Izedonmi, 2000). Auditor's independence in its most general form allows external auditors to reduce agency cost between corporate managers and shareholders (Watts & Zimmerman, 1983).

Independence of an auditor is the probability of reporting a discovered breach and joint probability of detecting financial material statement errors (De Angelo, 1981). Brody & Moscove, (1998) asserts that auditor rotation will enhance greater independence and audit quality through a reduction of clients' inadequate influence on auditors. This may come from the risk of losing clients if the auditors do not agree with managers' financial reporting preference.

Dopuch, King & Schwartz, (2001) assesses whether mandatory rotation of auditors increases their independence. A multi-period interaction between a manager who invests in a risky asset and an auditor who issues a report about this asset was used. This was analyzed through the willingness of the auditor to issue a report biased in favour of management. The authors draw their conclusions from data collected in an experiment in order to test the relationship between auditor rotation and independence; a setting was created in which the auditor has the incentive to compromise his independence. The experiment was conducted under four regimes: In the first, no mandatory rotation or retention is required. The manager can decide in each period to maintain or retain the auditor; In the second regime, the manager must retain the auditor for a minimum of three years; In the third, the auditor has to be rotated each four period. One hundred and fourty-four (144) subjects participated in the experiment, whose role, as manager or auditor, was assigned randomly. The results support the hypothesis that the auditor compromises his independence most often in the no rotation regimes**.**

In United Kingdom, Hussey & Lan, (2001) analysed the opinions of financial directors about the factors which may affect the roles and responsibilities of the external auditor. Three main topics were identified. One of them was on mandatory rotation. The opinion of United Kingdom Chief Financial Controllers on the rotation of auditors after a certain period of time was collected. Three thousand questionnaires were mailed with a response rate of 25.9%. Seven hundred and seventy six usable replies were obtained. The majority of the respondents agreed that there should be no compulsory rotation of audit firms after a fixed number of years. A multiple regression analysis was further used in order to test the relationship between rotation and the other variables identified. These were the Finance Directors' perception of audit quality, the costs of the audit and the assessment of the nature of the relationship with external auditor. The result shows that the perception of audit independence would be enhanced by prescribing the rotation of auditors.

In Australia, O'Leary, (1996) work aims to analyse the concept of independence and the relative consequences that mandatory rotation may have. For this intention a questionnaire was mailed to three hundred Australian listed companies and to one hundred and eighty audit partners. Three aspects were considered: the actual audit independence, the perceived independence and mandatory rotation. Ninety seven percent (97%) of the auditors and eighty seven percent (87%) of the public listed companies were against compulsory auditor rotation. The respondents consider the cost of rotation to outweigh any benefit. However, when the perception of independence is considered, the results changed. Indeed, sixty seven percent (63%) of public listed companies and thirty seven percent (37%) of auditors consider the introduction of such a proposal as a useful means of improving the perception of independence.

Vanstraelen (2000) work considers the impact of renewable long-term audit engagements on the auditor's reporting behaviour and independence. The empirical analysis was conducted on the basis of two samples taken from the data submitted to the Belgian National Bank over the period 1992-1996. The annual accounts of Belgian companies were considered. The two samples containing the data of large companies were divided in financially stressed and financially non-stressed. A logistic regression was used in which the dependent variable was "unclean" audit reports that occurred in case of qualified opinion, adverse opinion and disclaimer of opinion. The researcher used tenure as the independent variable. The relationships between the identified variables were tested using both univariate and multivariate analyses. The results shows that companies receiving a clean audit report have a significantly longer relationship with the auditors than companies that receive an unclean report. This suggests that auditors are more willing to issue an unclean report in the last year of the official mandate than in previous years. So a long tenure reduces the likelihood that the auditor issues a qualified report. The author states that the implication of this finding is the usefulness of mandatory auditor rotation to maintain the value of an audit to external users.

Healey and Kim (2003) asserts that over the unlimited period of most continuing audits, members of the audit firm will become too familiar with the companies whose records they are meant to review objectively, honestly and accurately. This is similar to the work of Arel, Brody & Pany (2005) believe that with no long-term connection between auditors and clients, the auditors will not face the conflict of interest and can act more freely. Jackson, Moldrich & Roebuck (2008) posit firm rotation may help to prevent large scale corporate collapse. Further if a client seeks a new auditor, auditors will compete with other firms to win the tender and differentiate themselves in terms of service, improving audit quality. From this perspective, a new auditor brings in more objectivity as they are not familiar with the client, potentially improving the quality of the audit.

Riuz-Barbadillo & Gomez-Aguilar, (2002) considers the relationship between the contract length and the issue of a favourable opinion and find that the variable "tenure" has a negative coefficient and that in the subsequent years of the engagement auditors are less obliging and more independent. On the basis of this evidence, Riuz-Barbadillo & Gomez-Aguilar, (2002) conclude that mandatory rotation is not a suitable mechanism for improving auditor independence in the Spanish context. Summer, (1998) analysis of the hypothesis that mandatory audit rotation can enhance auditor independence find that in the short run, auditors are less independent than in long term engagement and that a mandatory rotation might have negative effects on auditor independence as it might undermine the incentives for building up a reputation for honesty.

3. Methodology

This research is designed to examine the impact of mandatory audit rotation on audit independence, audit quality, cost and shareholders confidence in the southern part of Nigeria. The researchers made use of primary sources for data. Accordingly the data were sourced from three out of the six geo-political zones in Nigeria: South East, South-South and South West collectively referred to as the southern part of Nigeria. Abia State, Edo State and Lagos State were chosen to represent each zone under study. A survey research design was used to gather information from the respondents concerning their opinion on the impact of mandatory audit on auditor independence in southern Nigeria. Five hundred questionnaires were administered to Audit firms, consultants, lecturers and investors out of which four hundred and fourty-two were returned. The questionnaire has two sections, A-B. Section A contains some personal data of the respondent 'that is' sex, age group, academic qualification, name of organisation/institution and length of service, knowledge of financial statements. Section B contains five statements related to mandatory rotation of external auditors and audit independence. Section B is designed in likert form scale ranging from Strongly Disagree to Strongly Agree. After sorting and collating the data, respondents' appropriate option ticked were analyzed using tables in presenting their actual opinion and the percentages. The model specified was estimated using the Binary Logistic Regression technique with the aid of computer software Eviews 7. The hypothesis of the study was tested using Z-test.

3.1 Model Specification

For the purpose of measuring the significant relationship between the dependent and independent variable, an econometric model is hereby specified:

AUDIND = $A_O + A_1MAT + Et$ …………………………………… (1)

Where: Ao = Constant
A1 = Parameter estimate
MAT = Mandatory Audit Tenure
AUDIND = Auditor Independence
Et = Stochastic error term

The model specified above captured auditor independence as the dependent variable while Mandatory audit tenure is the independent variable.

4. Data Presentation And Analysis

4.1 Analysis of results

Here answers provided by the respondents to the questionnaire are analyzed and interpreted. The hypothesis formulated previously is tested in this section. In testing the hypothesis the following decision rules are stated. We accept the hypothesis if the calculated Z-statistic is greater than the Z-critical statistic. The Z-critical statistic is ± 1.96 at 5% significant level (95% confidence) otherwise we reject. The hypothesis is restated in null form.

TEST OF HYPOTHESES 1

- **Hypothesis formulated.** The hypothesis is restated:
  H1Mandatory audit rotation has no significant relationship on the independence of auditors in Nigeria.
- **Test statistics**: the statistic instrument employed in testing this statistic is the Z-test. The Z calculated value is 2.00 (see appendix I).
- **Decision:** Following our decision rule. The regression result shows that Mandatory Audit Tenure (MAT) with a calculated Z-value of 2.00 is greater than the critical Z-value of ± 1.96 at 5% level. Therefore, we reject the null hypothesis.

INSERT TABLE

Table 4.1 highlights respondents' perceptions on issues relating to mandatory audit tenure and audit independence. A total of 117 respondents representing 26.5 percent are of the Disagree view that the length of audit contract affects the possibility that a company may receive a more favourable audit opinion, 67 respondents representing 15.2% are Undecided while 258 respondents representing approximately 58.4% are of the agreed view.

The table also deduced a total number of 90 respondent representing 20.4 percent disagree that auditors tend to be more dependent in the first year of the audit engagement, 91 respondents representing 20.6 percent are Undecided about the statement, 261 respondent representing 59.1 percent are of the agreed opinion.

The table also shows that a total of 72 respondents representing 16.3 percent disagree that long standing relationship can induce an auditor to give much importance on the economic interest in preserving the client than to independence, 59 respondents representing 13.3 percent are Undecided while 311 respondent representing approximately 70.3 percent agree that long standing relationship can induce an auditor to give much importance on the economic interest in preserving the client than to independence.

The table further disclose that a total number of 50 respondents indicating 11.3 percent disagree that auditor may tend to compromise his independence most often in the no rotation/retention regimes, while a total of 93 respondent representing 21 percent are Undecided, 299 respondents indicating 79.5 percent Agree that auditor may tend to compromise his independence most often in the no rotation/retention regimes.

Furthermore, the table tell that 57 respondents representing 12.9 percent disagree that the perception of audit independence would be enhanced by prescribing the rotation of auditors, 34 respondents are Undecided while 351 agree that the perception of audit independence would be enhanced by prescribing the rotation of auditors

4.2 Correlation Analysis

The spearman rank correlation was used to show the relationship between the variable used in the model. The result is shown in table 4.2. The table shows that the co-efficient of correlation of a variable with respect to itself is 1.000. This indicates that there exists a perfect Correlation between a variable with respect to itself.

INSERT TABLE

5. Summary

The study examined empirically, the association between mandatory tenure and auditors' independence. The binary logistic ordered regression shows that there exists a positive relationship between Mandatory Audit Rotation (MAT) and audit Independence (AUDIND) with a value of 0.117 which means the strength of relationship between them is about 12% which shows a weak positive relationship between Mandatory Audit Rotation (MAT) and audit Independence (AUDIND). The result agrees with the works of Brody & Moscove., 1998, Hussey & Lan., 2001, Dopuch & Swchwartz., 2001; Hussey and Lan., 2001; O'Leary., 1996. However, it disagrees with that of Summer, 1998.

5.1 Conclusion

From the literature review, empirical results of scholars and also field results collected one could see that though mandatory audit rotation could encourage auditors' independence but that is not still guaranteed. This suggests that the recent policy of mandatory audit rotation introduced by central bank of Nigeria may not augur well. For auditors' independence to be guaranteed, other factors are involved for example, the size of the audit firm, the experience of the auditor, specialization, goodwill and reputation of the audit firm should also be taken into consideration.

At the beginning of audit engagement, an audit firm takes time to understand the accounting processes, procedures and the system of the new client which may go into years. Therefore implementation of tenure-ship suggest that audit firms would always shop for new client at a higher rate than without rotation and where this is so the audit firm may have to bend some rules in order to win a client and to a great extent this will affect the independence of the auditor and by extension affect the quality of the audit work.

5.3 Recommendations

Based on the result of our research findings we therefore recommend the followings.

- Rotation of external auditors should not be made compulsory. Most of the banks that collapsed employed the services of the big four (PWC, KPMG, Earnest & Young and Akintola Williams) auditing firms in Nigeria. This implies that even if these banks were rotating they would still have collapsed. One would not say that these firms are not independent or were not producing quality audit report. Notwithstanding the independence of our audit firms, experience, size, reputation and goodwill. Unscrupulous management could still hide under these characteristics to perpetrate their selfish aim so mandatory rotation of external auditors cannot guarantee auditors independence.

- To have robust audit report shareholders should have a way of calling for the letter of representation usually written by the auditor to the management and investigate whether the grey areas touched by the auditor where addressed. Joint auditing can also be encouraged to avoid monopoly of audit opinion.

- In the field of medicine we have the dentist, the optometrist, gynaecologist, paediatrics and neurosurgeons. There should be a law mandating our audit firms to specialize in one or two areas and become consultants instead of being jack of all trade and master of none. Using mandatory audit rotation as the solution to produce quality audit and auditors' independence is just like using a hammer to kill a fly. Although Central Bank of Nigeria may succeed but the accompanying damage may be beyond repair.

- Auditors' independence can be encouraged through the law. The Companies and Allied Matters Act requires auditors to be appointed by the shareholders but in reality, the appointment of auditors are usually done by the directors of the company and where this happens, the auditor will have to dance to the tune of the directors as they may not want to bite the very hands that fed them even if it means compromising their independence. If the law mandating auditors to be appointed by the shareholders is revisited and monitored that will improve auditors' independence and audit quality.

- The appointment of auditors should be done by the audit committee since they are composed of non executive board members and shareholders. The interest of the shareholders will be protected. This will help to eradicate completely or reduce to the minimum the controversial management auditor romance that could compromise independence.

- The Sarbenes Oxley act of 2002 which most countries are following like Nigeria requires audit lead partners to be rotated after five years but was silent about rotation of the audit firms. If the Central Bank of Nigeria (CBN) wants to follow this US policy we can also begin with the rotation of the lead partners and see how it goes before the introduction of complete audit firm rotation in Nigeria.

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Table 4.1: Mandatory Audit Tenure And Audit Independence

S/N		RESPONSES / PERCENTAGES					
		SD (%)	D (%)	UN (%)	A (%)	SA (%)	TOTAL (%)
6.	The length of an audit contract affects the possibility that a company may receive a more favourable audit opinion	29 (6.6)	88 (19.9)	67 (15.2)	171 (38.7)	87 (19.7)	442 (100)
7.	Auditors tend to be more dependent in the first year of the audit engagement	- (-)	90 (20.4)	91 (20.6)	171 (38.7)	90 (20.4)	442 (100)
8.	Long standing relationship can induce an auditor to give much importance on the economic interest in preserving the client than to independence.	- (-)	72 (16.3)	59 (13.3)	203 (45.9)	108 (24.4)	442 (100)
9.	Auditor may tend to compromise his independence most often in the no rotation/retention regimes.	12 (2.7)	38 (8.6)	93 (21.0)	149 (33.7)	150 (33.9)	442 (100)
10.	The perception of audit independence would be enhanced by prescribing the rotation of auditors.	- (-)	57 (12.9)	34 (7.7)	128 (29.0)	223 (50.5)	442 (100)

SOURCE: Field Survey (2011)

Table 4.2: Spearman Rank Correlation

			MATR	AUDIND
Spearman's rho	MATR	Correlation Coefficient	1.000	.117(*)
		Sig. (2-tailed)	.	.014
		N	442	442
	AUDIND	Correlation Coefficient	.117(*)	1.000
		Sig. (2-tailed)	.014	.
		N	442	442

Source: Field Survey (2011)

4.3 Ordered Probit Logistic Regression Analysis

Table 4.2 : Probit Logistic Regression for Model 1 (AUDIND)

	Coefficient	Std. Error	z-Statistic	Prob.
MATR	0.112276	0.056050	2.003152	0.0452
		Limit Points		
LIMIT_12:C(2)	-0.964845	0.140361	-6.874005	0.0000
LIMIT_14:C(3)	-0.919972	0.139326	-6.603023	0.0000
LIMIT_15:C(4)	-0.714167	0.135765	-5.260315	0.0000
LIMIT_16:C(5)	-0.662125	0.135140	-4.899530	0.0000
LIMIT_17:C(6)	-0.473867	0.133507	-3.549385	0.0004
LIMIT_18:C(7)	-0.320251	0.132967	-2.408496	0.0160
LIMIT_19:C(8)	-0.134575	0.133119	-1.010933	0.3120
LIMIT_20:C(9)	0.114992	0.133994	0.858188	0.3908
LIMIT_21:C(10)	0.299335	0.135055	2.216389	0.0267
LIMIT_22:C(11)	0.848380	0.138795	6.112476	0.0000
LIMIT_23:C(12)	1.202461	0.142133	8.460133	0.0000
Akaike info criterion	4.555989	Schwarz criterion		4.667065
Log likelihood	-994.8735	Hannan-Quinn criter.		4.599800
Restr. log likelihood	-996.8797	Avg. log likelihood		-2.250845
LR statistic (1 df)	4.012342	LR index (Pseudo-R2)		0.002012
Probability(LR stat)	0.045168			

Source: Eviews Output (2011)