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Mandatory Audit Firm Rotation and Audit Quality In Nigerian Deposit Money Banks

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ABSTRACT : *Thisstudy investigates how mandatory audit firm rotation rule could affect the audit quality in Nigerian Deposit Money Banks (DMBs). The data for this study were collected through primary and secondary sources. The Binary Logit Model estimation technique was used to analyze the relationship between the mandatory audit firm rotation and audit quality. The study's results show that mandatory audit firm rotation rule does not affect the audit quality. In addition, most banks have complied with the directives of Central Bank of Nigeria with respect to mandatory rotation of audit firm after ten years. We therefore recommended that rotation of external auditors should be made voluntary.*

KEYWORDS:*Mandatory Audit Firm Rotation, Audit Quality, Auditor Independence and Central Bank of Nigeria (CBN).*

I. INTRODUCTION

The concern about tenure arises because if a company and an auditing firm have been in close association for a long time, this may lead to auditors identifying with their client's management consequent detrimental effect on independence, (Gray and Manson,2008). This view has led to suggestions that audit should be rotated with the added benefit that this would: (i) result in automatic checks of the work of the previous auditor; (ii) encourage audit innovation; and (iii) discourage complacency (Gray and Manson,2008)..The idea with mandatory audit firm rotation is not new. Professionals and regulatory bodies have discussed this subject since senator Metcalf in 1976 suggested auditor rotation as a safeguard to prevent auditors to become too familiar with its clients Mandatory audit firm rotation is an extension of audit partner rotation while audit firm is being replaced after a fixed number of years. The replaced audit firm is then not allowed to take on the old client until a fixed period of years has elapsed. Some countries had tried mandatory audit firm rotation through the last two decades but they have later abandoned the idea (Porter, Simon and Hatherly, 2001).

Over the years major organizational collapses have been attributed to poor audit quality associated with a perceived lack of auditor independence. These alleged " audit failures " were deemed to have occurred because auditors failed to either detect or report material errors in the financial statements. Mandatory auditor rotation frequently has been suggested as a means of strengthening independence and reducing the incidence of audit failure. (Catanach Jr. and Walker, 1999).US Congressman Shelby is typical of this view: "how can an auditing firm remain independent… when it has established long term personal and professional relationships with a company by auditing the same company for many years, some 10, 20, 30 years?."

The issue is that auditors might get too close to their clients and can lose professional skepticism and objectivity when the relationship goes on too long. Hayes, Dassen, Schilder and Wallage, (2005) argue that, after a long period, the auditor might lose his professional skepticism if the length of tenure exceeds 10 to 15 years. The European Commission argues that accountants are influenced by their clients and therefore lose their independence if the, audit tenure lasts for many years, the solution they propose is mandatory audit firm rotation. (EC 2010; EC 20110.Recently, the Central Bank of Nigeria has given all deposit money banks (DMBs) up to December 31, 2010 to replace external auditors that have been appointed for more than ten years including years spent with constituent legacy banks (CBN, 2010).This directive is in line with the provisions of the CBN Code of Corporate Governance for banks, which stipulates that "the tenure of the auditors in a given bank shall be for a maximum period of ten years after which the audit firm shall not be re-appointed in the bank until after a period of another ten years.

"For the avoidance of doubt, the maximum period of ten years shall include the period on audit firm which later merged, changed name,first commenced audit assignment in the bank.(CBN, 2010). The motivation of this study comes from the strong interest in examining audit quality partly due to the concern of issues such as corporate collapse, expectation gaps and corporate governance.There is alack of consensus among regulators and audit firms on the issue of mandatory audit firm rotation.

1.1 Objectives of the Study

The broad objective of this study is to investigate the effect of mandatory audit firm rotation on the auditquality in Nigerian Banks.The specific objective of this study are to:

i. identify the pros and cons of mandatory audit firm rotation;
ii. ascertain the level of compliance by all Deposit Money Banks (DMBs) in Nigeria to the CBN directive with respect to mandatory rotation of audit firm; and
iii. examinethe relationship between mandatory audit firm rotation and audit quality in Deposit Money Banks (DMBs) in Nigeria.

1.2 Hypothesis of the Study

The null hypothesis stated below was tested to provide answer to the research question three above.

H_{01} Mandatory audit firm rotation doesnot significantly enhance audit quality in Nigerian Deposit Money Banks (DMBs)

II. LITERATURE REVIEW

Prior research conducted by St. Pierre and Anderson (1984). Stice (1991), Johnson, Khurana and Reynolds 2002; GAO, (2003) and Carcello and Nagy (2004) unanimously agreed that audit tenure is short when the same auditor tenure has audited the financial statements of a company for two or three years. Following this, Johnson, Khurana& Reynolds (2002) and Carcello and Nagy (2004) defined long tenure as being when the same auditor has audited the financial statements of a company for nine years or more. On the basis of the definition of short and long tenure, they defined audit tenure as medium when the same auditor has audited the financial statements from four to eight years.

Myers, Myers and Omer (2003) defined auditor tenure as the number of years an auditor is retained by the firm. A common assumption is that rotation of audit firms increases audit quality. Audit quality is defined as the auditor`s ability to discover a breach in the client`s accounting system combined with the auditor`s willingness to report such a breach (DeAngelo 1981;Watts&Zimmerman, 1981). Whereas the ability to discover a breach relates to the technical competence and expertise of the auditors as well as to the audit procedures and the extent of sampling, the willingness to report as determined by the auditor`s independence, objectivity and professional skepticism The regulatory argument going back to Mautz and Sharaf (1961) is that the longer the tenure of an audit firm with a particular client, the closer the identification of the firm with the client management`s interest and the greater the impairment of auditor independence and its quality.Regulators typically fear a decrease in audit quality with an increase in audit firm tenure. This decrease in quality is supposedly caused by excessive familiarity with the client`s management, and eagerness to please the client and a lack of attention to details due to staleness and redundancy (Arel, Brody and Pany 2005). Mandatory rotation might help to avoid a 'familiarity threat'. Such a familiarity threat could result in financial report assertions not being tested, since results are anticipated instead of being alert to anomalies. This could result in less rigorous audit procedures or an excessive reliance on static audit programs Johnson et al. (2002).

Auditors themselves generally oppose mandatory audit firm rotation for instance; PWC (2007) argued that mandatory audit firm rotation prevents an effective working relationship with management, audit committees and boards of directors.Audit clients have different opinions about mandatory audit firm rotation.A survey in Egypt in 2010 found that the majority of listed companies think a sufficient number of audit firms are able to conduct audits of listed companies (Mohamed, 2010).In addition, management of some companies fear that employees might be very reserved towards new auditors hampering the audit in general and fraud detection in particular (Stringer, 2011). Beattie and Fearnlay (1995) argued that key stakeholders should consider the following five most important factors in audit quality:

i) integrity of the audit firm;
ii) technical competence of the audit firm;
iii) the quality of the working relationship with the audit partner;
iv) the reputation of the firm; and
v) the technical competence of the audit partner.

2.1 Arguments for Mandatory Rotation

The main argument supporting mandatory auditor rotation is the issue of the gradual decrease in the quality and competence of the auditor's work over time. Arguments in favour are that it prevents the audit firm from developing too cosy a relationship with the client and also provides an incentives for the audit firm to carry work to a high standard because they know that the quality of their work will be observable to some extent when a new firm of auditors take over the audit (Gray and Menson, 2008). When the same client is audited year after year, the auditor tends to be too familiar with the client. This familiarity is likely to restrict the value added service of the auditor. For example, the audit programme may become stale as the auditor begins to anticipate the condition of the client's system (Hoyle, 1978).As such, the quality of the audit work falls. This was supported by Catanach and Walker (1999) who mentioned that the said rotation would increase the quality of services provided by the auditor because the audit firm would attempt to differentiate themselves from other firms through the quality of their work.Most of the arguments for mandatory auditor rotation relate to expectations that the regulation will improve the quality of audits (Petty and Cuganesan, 1996).The most predominant argument for audit firm rotation is that it will limit the formulation of audit –client relationships that can sometimes lead to compromising independence.

2.2 Argumentsagainst Mandatory Rotation

Detractors of the measure argue that if the audit firm were rotated after five years, it would not give sufficient time to become fully acquainted with the audit client. Furthermore, having obtained a good knowledge of the company over several years, the audit firm would be in a better position to offer valuable advice to the client. It is also argued that the auditor would have little incentive to spend much time determining the complexities of the audit client, as they know they will be replaced after a set period of time. Another argument for not endorsing mandatory rotation of auditors is that non-detection of fraudulent financial reporting is more likely when the audit firm is new to the audit and does not have the cumulative audit knowledge that is only obtainable after performing the audit for a lengthy period of time. Mandatory audit firm rotation will also reduce the audit committee's ability to determine which audit firm best meets the company's audit needs. Finally, it is argued that, since there are initially one-off starts up costs involved in audit, the audit function would become more expensive if there were mandatory rotations (Gray and Manson, 2008).

The review of arguments against mandatory audit rotation starts by looking at the conditions that affect the audit quality and audit independence. One of them is the issue of the auditor having a close relationship with client's management. The nature of auditing requires that the auditors interact extensively with their client. Hoyle (1978) argues that with the complexity and size of most modern businesses, the auditor will spend more time with the client in order to become acquainted with the company's system, record keeping and internal controls. It is generally recognized that such knowledge is best gained through actual audit experience over a considerable period of years. As such, mandatory auditor rotation will limit the time the auditor spends understanding the company being audited (Zawawi, 2007).

2.3 Theoretical Framework

The leading credibility theory states that the audited financial statements are used by management to enhance the stakeholders' faith in management's stewardship (Hayes et al 2005). This theory regards the primary function of auditing to be the addition of credibility to the financial statements. Audited financial statements are used by management (agents) in order to increase the principals faith in the functioning of the agent and to reduce the information asymmetry. Audited financial statements are seen to have elements that increase the financial statement users' confidence in the figures presented by the management. The users' are perceived to gain benefits from the increased credibility, these benefits are typically considered to be that the quality of investment decisions improve when they are based on reliable information.

The theory upon which this study rests is Lending Credibility theory. The theory is suitable for the study given that it can explain a manager's incentive to change to a higher quality audit firm. The company's owners' are always seeking the services of "better quality" auditors, so that the monitoring of management's stewardship will be more effective. (Mari and Baldacchino, 2004). It provides the main theoretical underpinning of the study and determines to a great extent the approach to be used in the study. It influences the formulation of the study hypotheses, informs the research methodology and statistical techniques used in the study.

METHODOLOGY

In this study, both primary and secondary data were used. The primary data for analysis were generated through the administration of questionnaire. The secondary data were extracted from the Nigerian Stock Exchange Factbook. Out of the twenty banks insured by Nigeria Deposit Insurance Corporation as at 2011, fifteen banks were purposively selected for the study. 600 copies of questionnaire were administered to regulators, audit firms and investors out of which 530 were returned by respondents residing in Lagos Nigeria. The questionnaire has two sections. Section A contains bio-data of respondents while Section B contains eight statements related to mandatory audit firm rotation and audit quality. Section B is designed in likert form scale ranging from strongly agree to disagree. After sorting and collating the data, respondents appropriate opinion ticked were analyzed using tables in presenting their actual opinions and the percentages. The model specified was estimated using the Binary Logistic Regression technique The relationship between mandatory audit firm rotation and audit quality was analyzed using the Binary Logit Regression. This method of analysis was used based on the inability of OLS regression model to yield reliable coefficients and inference statistics. The data were analyzed using Statistical Package for Social Sciences (SPSS) Version 19.0

3.1 Measurement of Variable

Auditing is a professional service that is intangible. Since the quality of the auditor's work is difficult to observe and measure directly, surrogate measures have been developed to evaluate audit quality in literature. An important variable is the size of the audit firm .DeAngelo (1981) develops a demand and supply rationale for audit quality. She defined audit quality as the joint probability of detecting and reporting material financial statement errors and finds that large accounting firms supply a higher level of audit quality. The argument relies on the assumption that client-specific quasi-rents accrue to the incumbent auditors. Since larger firms have more clients and more client-specific quasi-rents to loose, they have a higher opportunity loss resulting from low quality audits. DeAngelo argues that these quasi-rents serve as ‘' collateral'’ on independence, and thus auditor size is a good surrogate for unobservable audit quality.Moreover, it has often been suggested that Big Four audit firms perform higher audits than non-Big Four firms, because they have a technological edge and because a given client will represent a small amount of their aggregate fee income (Hayes, et al, 2005).For the purpose of this study views of the users of financial statements were adopted as surrogate for audit quality.

Model Specification

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

$PAUDQ = B_O + B_1MATR + E_t$ …………………………………… (1)

Where:

B_o = Constant

B_1 = Parameter Estimate

MATR = Mandatory Audit Firm Rotation

PAUDQ = Perceived Audit Quality

E_t = Stochastic error term

The model specified above captured perceived audit quality as the dependent variable while mandatory audit firm rotation is independent variable.

Table 3.1 Insured Banks and Their Approved External Auditors In 2011

S/N	Bank Name	Approved Auditors
1	Access Bank Plc	KPMG Professional Services
2	Citibank Nigeria Ltd	Price Waterhouse Coopers
3	Diamond Bank Plc	Price Waterhouse Coopers
4	Ecobank Nig. Plc	Akintola Williams Deloitte
5	Enterprise Bank Nig Ltd	Price Waterhouse Coopers
6	Fidelity Bank Plc	Ernest & Young, PILF Professional Services
7	First Bank of Nigeria Plc	Price Waterhouse Coopers, Pannell Kerr Forster (PKF Professional)
8.	First City Monument Bank Plc	KPMG Professional Services
9.	GTBankPlc	Price Waterhouse Coopers
10.	Keystone Bank Nig Ltd	KPMG Professional Services
11.	Mianstreet Bank Nig Ltd	KPMG Professional Services
12.	SKYE Bank Plc	Akintola Williams Deloitte
13	Stanbic-IBTC Bank Plc	KPMG Professional Services
14	Standard Chartered Bank Nigeria ltd	Akintola Williams Deloitte
15	Sterling Bank Plc	Ernst & Young

16.	Union Bank of Nigeria	KPMG Professional Services
17.	United Bank for Africa	Price Waterhouse Coopers
18.	Unity Bank Plc	Ahmed Zakari& Co.
19.	Wema Bank Plc	Akintola Williams Deloitte
20	Zenith Bank Plc	KPMG Professional Services

Source: NDIC Annual Report and Statement of Account (2011)
As evidence in the Table 3.1 above, there were six firms of chartered Accountants approved to conduct independent audit of the 20 insured DMBs operating inNigeria as at December 31, 2011, KPMG Professional Services, from available statistics, topped the list with 8 banks on their audit list, followed by PriceWaterhouse Coopers with six banks, while Akintola Williams Delioitte had four banks, which were audited either wholly or jointly with another firm during the year 2011

Table 3.2 Analysis of Audit Tenure and Perceived Audit quality

	Statement	***SA***	***A***	***U***	***SD***	***D***
1.	When auditor tenure is more than 15 years, the auditor will not be as independent as he was in the first few years and audit quality will diminish again.	27(5)	106(20)	-	371(70)	(27(5)
3.	A user of annual reports would have higher confidence for the annual reports if audit firm rotation were used.	159(30)	64(12)	-	42(8)	265(50)
4.	The length of an audit contract affects the possibility that a company may receive a more favorable audit opinion.	371(70)	32(6)	-	117(22)	11(2)
6.	Auditor may tend to compromise his quality most often in the no rotation regime.	32(6)	106(20)	-	345(65)	48(9)
7.	The perception of audit quality would be enhanced by prescribing the rotation of auditors.	80(15)	106(20)	37(7)	265(50)	42(8)
8	Familiarity threats as exist are between individuals rather than institutions.	223(42)	85(16)	11(2)	53(10)	159(30)

Source : Field Survey, (2013)

The analyses were based on these five hundred and thirty copies questionnaire retrieved. From Table two, 75% of the respondents disagree thatwhen auditor tenure is more than 15 years, the auditor will not be as independent as he was in the first few years and audit quality will diminish again,while 25% of the respondents disagree with this view.42% of the total respondents disagree with view that a user of annual reports would have higher confidence in the annual reports if audit firm rotation rule was used while 58% of the respondents disagree with this view. 76% of the respondents agree with the statement that the length of an audit contract affects the possibility that a company may receive a more favorable audit opinion while 24% disagree with this statement. 26% of the respondents agree that auditor may tend to compromise his quality most often in the no rotation regime while 74% of the respondents also disagree with this view. 35% of the respondents agree that the perception of audit quality would be enhanced by prescribing the rotation of auditors rule while 58% of the respondents disagree with this statement. Finally 52% of the respondents agree that familiarity threats as exist are between individuals rather than institutions while 40% of the respondents disagree and 11% were undecided respondents.

T-Test

One-Sample Statistics

	N	Mean	Std. Deviation	Std. Error Mean
Sample	26	122.4615	113.84313	22.32647

One-Sample Test

	Test Value = 0					
					95% Confidence Interval of the Difference	
	t	Df	Sig. (2-tailed)	Mean Difference	Lower	Upper
Sample	5.485	25	.000	122.46154	76.4793	168.4438

From the analysis, p-value is less than 0.05 (0.000< 0.05), we will accept the null hypothesis, and reject the alternative hypothesis. We can conclude that mandatory audit firm rotation would not significantly enhance audit quality in Nigeria Banks.

Logistic Regression

Classification Table[a]

Observed			Predicted VAR00002 .00	Predicted VAR00002 1.00	Predicted Percentage Correct
Step 1	VAR00002	.00	0	2	.0
		1.00	0	24	100.0
	Overall Percentage				92.3

a. The cut value is .500

Variables in the Equation

		B	*S.E.*	*Wald*	*df*	*Sig.*	*Exp(B)*
Step 1[a]	VAR00001	.002	.008	.082	1	.774	1.002
	Constant	2.244	1.062	4.464	1	.035	9.432

a. Variable(s) entered on step 1: VAR00001.

Omnibus Tests of Model Coefficients

		Chi-square	***df***	***Sig.***
Step 1	Step	.091	1	.763
	Block	.091	1	.763
	Model	.091	1	.763

Model Summary

Step	-2 Log likelihood	Cox & Snell R Square	Nagelkerke R Square
1	14.011[a]	.003	.008

a. Estimation terminated at iteration number 4 because parameter estimates changed by less than .001.

The parameters of the model was also estimated using the Logit Regression Analysis. The result is shown in the above table.

III. DISCUSSION OF FINDINGS

There is no evidence that mandatory audit firm rotation will improve audit quality in Nigerian Banks.The study findings is in line with Walker, Lewis and Casterella (2001), Knechel and Vanstrael (2007) have also argued that auditor rotation may not necessarily improve audit quality and the effect of tenure does not have either an increasing or decreasing effect on audit quality and at best the effect is weak. However, the study finding is at variance with the conclusions made by Barbadilllo and Aguilar (2000) which found the relationship between the auditor tenure and audit quality to be negative and concluded that the shorter tenure, the more they behave in a dependent fashion . Healy and Kim (2013) andCarcello and Nagy (2004) have also argued that rotation of audit firms is a way of improving audit quality.

CONCLUSION

We find that audit quality is not negatively affected by audit firm tenure. Mandatory audit firm rotation is perceived as an unnecessary procedure without any actual evidence of fulfillment of intended purposes. Mandatory audit firm rotation would have an adverse effect on the quality of audits and on the long term sustainability of the auditing profession. Based on the findings of this study, one can conclude that there is no evidence to support the mandatory audit firm rotation since the disadvantages outweigh the benefit. Moreover, the policy would reduce, not improve audit quality. . The author supports the dialogue to explore other ways to improve audit quality, by enhancing auditor independence, objectivity and professional skepticism.

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Appendix 1

S/N	AUDIT TENURE AND PERCEIVED AUDIT QUALITY	SA	A	U	SD	D
1.	Mandatory audit firm rotation and audit partner rotation does not mean that audit quality will be higher.					
2.	When auditor tenure is more than 15 years, the auditor will not be as independent as he was in the first few years and audit quality will diminish again.					
3.	A user of annual reports, would have higher confidence for the annual reports if audit firm rotation were used.					
4.	The length of an audit contract affects the possibility that a company may receive a more favorable audit opinion.					
5.	Long standing relationship can induce an auditor to give much importance on the economic interest in preserving the client them to quality.					
6.	Auditor may tend to compromise his quality most often in the no rotation regime.					
7.	The perception of audit quality would be enhanced by prescribing the rotation of auditors.					
8	Familiarity threats as exist are between individuals rather than institutions.					