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Mandatory Rotation of Auditors on Audit Quality, Costs and Independence in South-South, Nigeria

Appah Ebimobowei and Oyadonghan James Keretu
Department of Accounting, Bayelsa State College of Education,
P.M.B. 74 Okpoama Brass Island, Yenagoa Bayelsa State Nigeria, West Africa

Abstract: The aim of this study is to examine, the role of mandatory rotation of auditors on the quality, costs and independence of an audit in South-South, Nigeria. The data for this study were collected through primary and secondary sources. The primary data were generated from the randomly administered questionnaire to 172 respondents drawn from auditors and users who have substantial knowledge of accounting and auditing and were analysed using Spearman rank order correlation coefficient. The findings of the study show that there is statistical significant relationship between mandatory rotation of auditors and the quality of audit reports, independence of auditors and the costs of audit. The study concludes that mandatory rotation of auditors improves the quality of services, creates an effective peer review, allow fresh approach, reduce failure, restore investors and public confidence and independence. Thus, the rotation may result to increase in the cost of audit services.

Key words: Mandatory rotation, audit quality, audit independence, audit cost, South-south, Nigeria

INTORDUCTION

Auditors typically have long-term professional relationships with their clients. Some have suggested that such relationships may be perceived to threaten the auditors objectivity, independence and quality of financial reporting because of the closeness of the auditor with the client.

Mandatory rotation of external auditors have been suggested by some practitioners (ICAEW, 2002; Healey and Kim, 2003; ICC, 2005) and academics (Dopuch *et al*., 2001; Myers *et al*., 2003) on a response to this concern because it would not permit auditors to build familiarity over time with their clients. Auditors and others who opposed mandatory rotation of auditors believe it reduces audit quality, increases cost of audits and eliminate the choice of audit committee.

This debate has been intensified by financial scandals in Nigeria and other parts of the world (e.g., Enron, WorldCom, Parmalat, African Petroleum Plc, Cadbury Nigeria Plc), culminating in a number of institutions decision to impose changes in accountability on both the firm's issuing financial reports and their auditors in other to reduce the incidence of frauds in organizations (Cameran *et al*., 2008). One of the suggested means to reduce the possibility of fraud is mandatory rotation of external auditors. According to Li and Wang (2005), the massive audit cases occurred in the different stock markets in recent years have shown that the reason of audit failure is not merely the technical failure but a quite important factor is that auditors have lost independence. So, the rotation regularly of auditor is advantageaus, not only to maintain the auditor independence but also to provide the chance for the latter auditor to find the problem that the former auditor had not discovered.

According to Hoyle in Zawawi (2007), the concept of mandatory auditor rotation was introduced because of highly published corporate collapses that resulted litigation. Asein (2007) note 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.

The view is that if employees of the audit firm get very acquainted or too familiar with the staff of client companies, many transactions may be taken for granted and not properly verified and this would likely negatively impact the quality of audit. For example if an audit staff obtains a loan from his client he cannot be expected to exercise appropriate sense of judgement if he finds transactions that are less than ethical during the process of the audit. He further noted the proponents of this line of thinking believe that audit firms should be rotated every 3 years such that employees of both entities would

Corresponding Author: Appah Ebimobowei, Department of Accounting, Bayelsa State College of Education, P.M.B. 74 Okpoama Brass Island, Yenagoa Bayelsa State Nigeria, West Africa

not get too acquainted, objectivity would be maintained and the audit exercise would be thorough as to be able to add credibility to the stewardship report of directors. It is argued that mandatory rotation of external auditors will put auditors in a stronger position to resist management pressure.

Requiring audit firms to periodically relinquish their clients is one of the suggested means of enhancing auditor independence and objectivity. On the other hand, several studies have proven that the rotation of external auditors will not actually improve the quality of financial reporting but in fact will increase the transactions costs (Johnson *et al*., 2002; Shafie *et al*., 2004).

Hence, there are two views on the issue of mandatory rotation of external auditors: one derived from the auditing profssion who argue that rotation is unnecessary because it would be costly to clients and may reduce the quality of audits (Asein, 2007) and the second view which is from the regulators who believes on the rotation of external auditors because they believe that it could solve the problems of independence and public protection. Therefore as a result of the, contrary perspectives on rotation of external auditors, led to the objective of this study which is the effect of rotation of external auditors on audit quality, costs and independence in Nigeria.

Theoretical and empirical literature

Mandatory rotation of external auditors: The concept of mandatory auditor rotation was introduced as a result of highly publicized corporate failures that resulted in litigation. The debate resulted in several studies investigating at the arguments for and against mandatory auditor rotation such as studies by Healey and Kim (2003) and Arel *et al*. (2005). These studies have investigated the arguments for and against mandatory rotation of external auditors.

The major argument for mandatory rotation of external auditor is the issue of the gradual decrease in the quality and competence of the auditor's work over time. When the same client is audited year in year out, the auditor tends to be too familiar with the client. This familiarity is likely to restrict the value added service of the auditors. According to the proponents of rotation, competition based on the quality of service would result in the growth for competent auditing firms while those performing poorly would have difficulty in maintaining clients. The rotation is said to create an effective peer review system that encourages aggressive accounting practices while encouraging critical reviews upon each auditor turnover (Healey and Kim, 2003). External auditors would not become stale and they would not view the audit as a simple repetition of earlier engagement but they would be alert to important changes (Arel *et al*., 2005). A new rotation of external auditor may allow a fresh approach being brought into each corporate audit at every rotation.

The issue of independence of external auditors is also an important factor supporting the mandatory rotation of external auditors. Catanach and Walker are of the view that independence can be affected by long standing relationship with clients. This is because the auditor will rely on the client's recommendations to continue the engagement year after year.

Healey and Kim (2003) are of the view that over the extended period of most continuing audits, members of the audit firm will become too friendly with the companies whose records they are meant to review objectively, honestly and accurately. Arel *et al*. (2005) claim 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 *et al*. (2008) sums up the advocates of rotation of external auditors with the following words:

> Advocates of audit firm rotation believe a scheme of compulsory rotation would prevent auditors from becoming too aligned with managers, impacting on their independence. A client may be a significant source of revenue for an auditor and the auditor may be reluctant to jeopardize this revenue stream. 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

The review of arguments against mandatory rotation of external auditors begins by examining the conditions that affect audit quality and independence. The nature of auditing requires that the auditors interact extensively with their client. Zawawi (2007) argued that with the complexity and size of modern business, the auditor will spend more time with the client in order to become acquainted with the firm's systems and internal controls. It is believed that such knowledge is gained through actual audit experience over considerable period of years. As such the mandatory rotation of external auditors will limit the time auditors spends understanding firm's being audited. This is supported by Arel *et al*. (2005) that long term relationship of auditors with clients will lead to personal closeness. However, a close relationship may

not present a problem if the auditor can remain objective during the audit process and provide a reliable opinion on the financial reports.

According to Cameran *et al.* (2005), the introduction of mandatory rotation rule is an expenssive tool whose benefits are not relevant. They argue that there are other factors motivating the auditor to maintain his independence such as the need to preserve reputation and client revenue.

Under mandatory rotation if a client is experiencing conflicts with its auditor over accounting treatments and the auditor is forced to rotate, the market misses out on valuable signals that would have taken place under voluntary rotation.

The largest accounting firms may also increase their market share under mandatory rotation as has been the case in Italy leading to a less-competitive environment (Buck and Michaels, 2005).

Mandatory rotation of external auditors and audit quality: The relationship between a long auditor client relationship and audit quality is not simple because economic, financial and social factors could drive the final result. Most empirical studies define audit quality relative to risk which is the risk that an auditor will fail to modify the opinion on audited financial statements that are materially misstated.

Li (2007) defines audit quality as the market-assessed joint probability that an auditor will discover a breach in a client's accounting system although diverse, reflect the same structure. This probability depends upon the broad concept of an auditor's professional conduct which includes factors such as objectivity due professional care and conflict of interest. According to Cameran *et al.* (2003), the quality of audit work can be evaluated using the following factors:

- Performance determinants which relates to the ability of auditors, intended both as knowledge and experience. Professional conduct, a general concept including ethical constraints and judgement
- Economic incentives
- Audit market structure

The impact of mandatory rotation of auditors on performance determinants, economic incentives and audit market is debated by scholars and regulators on the merits and demerits of rotation.

The proponents consider rotation as a way to improve audit quality because the familiarity with the client has the effect of reducing the fresh point of view that auditors have in the 1st year of audit. The opponents of mandatory rotation argue that the benefits are largely unproven and that they cannot balance the costs and risks of such a proposal.

Mandatory rotation of external auditors and audit independence: The independence of an auditor is difficult to state. Independence, implies independence of mind and that of appearance. Independence of mind implies that the expressed opinion has not been affected by factors that can compromise integrity, professional skepticism and objectivity of judgement and independence in appearance is what a reasonable and informed 3rd party perceives to be independent after considering all the factors that can threaten the objectivity of the auditor.

The relationship between independence and rotation of external auditors can be interpreted differently. A long term auditor-client relationship is considered by the proponents of rotation as the main element that could impair independence and objectivity. A long term tenure can reduce the incentive for the auditor to carry out his duties with professional independence. In this way, the auditor's and the client's point of view tend to converge, so the auditors results biased.

Opponents of rotation, acknowledge this point of view but they consider the introduction of mandatory rotation of external auditors as an expenssive tool whose advantages are not relevant. They argue that there are other factors motivating independence such as the need to preserve reputation and client revenue (Cameran *et al.*, 2005; Buck and Michaels, 2005).

Mandatory rotation of external auditors and audit costs: The argument that mandatory rotation of external auditors may increase audit costs is an important area that must be considered. These costs involve both the auditors and the clients. From the auditor's point of view, start-up costs can be considered. They are generated by familiarization with clients accounting procedures. This is necessary in order to reach a sufficient knowledge of the audit firm. On the other hand, the client must devote resources to make the 1st audit possible in terms of assistance and material resources. These are the explicit costs that an auditor change involves. Implicit costs include loss of specific assets developed during the past engagement.

Empirical evidences: The following studies bring out the nature of mandatory rotation of external auditors on audit quality, independence and costs. These studies bring out the differences in opinion on mandatory rotation of auditors amongst different scholars. Table 1 shows the methodology, sample and main results of these studies.

Table 1: Empirical studies on mandatory rotation of auditors

References	Methods of analysis and sample	Main results
Carcello and Nagy (2004)	Logistic regression model and a sample of 267 companies between 1990 and 2001	Significant positive relationship between short term auditor tenure and the number of fraudulent financial reports but they do not discover a significant positive relationship between long auditor tenure and fraud
Chung (2004)	Cross sectional modified model and the sample was formed of Korean publicly listed companies for the period 1985-1995	Audit quality is improved when the duration of the auditor client relationship is truncated
Dopuch *et al.* (2001)	Multi-period interaction between managers who invests in a risky asset and an auditor who issues a report about these assets	The likelihood that the auditors bias their reports in favour of the management decreases with the rotation requirement
Geiger and Raghunandan (2002)	Multivariate logistic regression of 117 USA companies that filed for bankruptcy between 1996 and 1998	There are more audit failure in the first years of the auditor client relationship
Ghosh and Moon (2005)	Basic regression framework for the period 1990-2000 and related to public companies included in compustat	The influence of reported earnings on stock ranking becomes larger with extended tenure although the association between debt ratings and reported earnings does not vary with tenure
Hussey and Lan (2001)	Questionnaire and multiple regression	Perceived independence of auditors can be enhanced by mandatory rotation
Jackson *et al.* (2008)	Multiple regression of 772 auditor switches for listed companies in the ASX between 1995 and 2003	Audit quality increases with audit firm tenure when proxied by the propensity to issue a going concern opinion and is unaffected when proxied by the level of discretionary expenses. Given the additional costs associated with switching auditors, it is concluded that there are minimal if any benefits of mandatory audit firm rotation
Johnson *et al.* (2002)	Matched sample statistical regression for the period 1986-1995	Short term firm tenure are associated with a decline in the financial reporting quality
Myers *et al.* (2003)	Univariate and Multivariate analysis of 4, 302 firms annual data from 1998-2000	Longer auditor tenure is associated with less dispersion in the distribution of discretionary accruals
Nashwa (2004)	Logistic regression model and a sample of 90 U.S failed companies for the period 1996-2001	The result indicated that risk increases early in the auditor client relationship and then decreases over time. The researchers concluded that the results do not support that mandatory rotation of auditors improves quality
Ruiz-Barbadillo and Gomez-Agular (2002)	Logistic regression	The auditor show more independence in the 1st year of the contract because the auditor wants to recover the initial investment made in order to understand the business of the client
SDA Bocconi School of Management (2002)	Quantitative analysis of 47 companies from 1980-2001	Mandatory rotation produce positive effects on perceived independence but it generates excessively high social costs. In the 1st year of appointment both the auditee's internal costs and those of the auditor increase which leads to higher market concentration and the probability of collusion among audit firm is increased. Financial markets do not like mandatory rotation because this rule does not give the market tools to punish the company
Vanstraelen (2000)	Univariate and multivariate analysis for the period 1992-1996 from the data submitted to the Belgian National bank	Long term auditor client relationship significantly increase the likelihood of an unqualified opinion
Wu-Chen *et al.* (2001)	Two period game model	Mandatory rotation may have negative effects on auditor independence if the audit fee premium, normal audit profit and the probability of bad states are ignored

Adapted from various researchers

MATERIALS AND METHODS

The study used survey research design. The primary data for the study were generated through the administration of questionnaire on 250 respondents and 172 were collected for auditors and users who have substantial knowledge of accounting and auditing (credit managers, financial analysts, shareholders) in Bayelsa and Rivers states of Nigeria. The questionnaire has four sections.

The 1st section is related to demographics (age, name of organization, work position, educational background, experience, familiarity with audited financial statements). The 2nd section comprises a list of propositions (six statements) related to mandatory rotation of external auditors and audit independence. The 3rd section is related to mandatory rotation of external auditors and audit quality (seven statements). Finally, the 4th consists of a list of propositions related to audit costs and mandatory rotation of external auditors (six statements). The questionnaire were administered both in hand and soft copies using ten research assistants and networks, most of whom are staff of audit firms and organizations that uses external auditors.

Using a Likert scale of 1-5 (5 = strongly agree, 4 = agree, 3 = undecided, 2 = disagree and 1 = strongly disagree), the respondents were asked to rate the relationship between the mandatory rotation of external auditors on audit quality, independence and costs. The results obtained from the ratings were analysed using Spearman rank order correlation coefficient (r_s) and Z-test to test the hypothesis of the study because the data generated is measured on ordinal scale and the significance of the relationship. Excel software helped us to transform the variables into a format suitable for analysis after which the Statistical Package for Social

Sciences (SPSS) was utilized for data analysis. Spearman rank order correlation (denoted r_s) is given by:

$$r_s = 1 - \frac{6\sum(d1)^2}{n(n^2-1)}$$

Where:

$(d1)^2$ = Sum of the squared differences in the rankings of the subject on the two variables
n = Number of subjects being ranked
r_s = From -1 to+1

Z-test was used to determine the level of significance by using the formula:

$$Z = r_s\sqrt{n-1}$$

Reject H_0 at 99% level of confidence (α-0.01) if the computed value of r_s is greater than the critical value of r_s otherwise accept H_0 at 95% level of confidence.

RESULTS AND DISCUSSION

This study discusses the Spearman rank order correlation coefficient on the effect of mandatory rotation of auditors' on audit quality, costs and independence in South-South, Nigeria. The result obtained from the analysis to test the hypothesis of the study which is stated in the null form as follows:

Hypothesis 1: There is no significant relationship between mandatory rotation of external auditors and audit quality. Table 2, shows the results of Spearman correlation coefficients on the effect of mandatory rotation of external auditors on audit quality in South-South, Nigeria. Table 2 shows the Spearman correlation coefficient for mandatory rotation of auditors' and audit quality to be 0.302 with a p = 0.000, implying that mandatory rotation of external auditors and audit quality is statistically significantly correlated. This result conforms to the studies of Chung (2004), Dopuch *et al.* (2001) and Vanstraelen (2000) that audit quality is improved with mandatory rotation of external auditors.

Hypothesis 2: There is no significant relationship between mandatory rotation of external auditors and audit independence. Table 3 shows the result of Spearman rank order correlation coefficient on the effect of mandatory rotation of external auditors on audit independence in South-South, Nigeria. Table 3 shows the Spearman rank order correlation coefficient for mandatory rotation and audit independence to be 0.296 with p = 0.000, implying a statistically significant correlation. This result is consistent with the findings of Moore *et al*. (2005) which documents that mandatory rotation is an instrument to pursue independence of audit and remove conflicts of interest. Also, Healey and Kim (2003) say mandatory audit rotation increases investors' confidence and auditor independence.

Table 2: Mandatory rotation of auditors and audit quality

Statistical methods	Manrotation	Quality
Spearman's rho manrotation correlation coefficient	1.000	0.302**
Sig. (2-tailed)		0.000
N	172.0	172.0
Quality correlation coefficient	0.302**	1.000
Sig. (2-tailed)	0.000	
N	172.0	172.0

**Correlation is significant at the 0.01 level (2-tailed)

Table 3: Mandatory rotation of auditors and Independence

Statistical methods	Manrotation	Independence
Spearman rho manrotation correlation coefficient	1.000	0.296**
Sig. (2-tailed)		0.000
N	172.0	172.0
Independence correlation coefficient	0.296**	1.000
Sig. (2-tailed)	0.000	
N	172.0	172.0

**Correlation is significant at the 0.01 level (2-tailed)

Table 4: Mandatory rotation of auditors and cost

Statistical methods	Manrotation	Auditcost
Spearman's rho manrotation correlation coefficient	1.000	0.287**
Sig. (2-tailed)		0.000
N	172.0	172.0
Auditcost correlation coefficient	0.287**	1.000
Sig (2-tailed)	0.000	
N	172.0	172.0

**Correlation is significant at the 0.01 level (2-tailed). Generated by the researchers from data collected using SPSS (Version 17.0)

Hypothesis 3: There is no significant relationship between mandatory rotation of external auditors and audit cost. Table 4 shows the results of Spearman rank order correlation of the effect of mandatory rotation of external auditors on audit cost in South-South, Nigeria. Table 4 shows the Spearman rank order correlation coefficient for mandatory rotation of external auditor and audit cost to be 0.287 with p = 0.000, implying statistically significant correlation. This position is confirmed by the study conducted by SDA Bocconi School of Management (2002) and Arunada (2004) who indicates that mandatory rotation of external auditors generates excessively higher social costs in the 1st year of appointment both the auditee's internal costs and those of the auditor increase. The mandatory auditors' rotation debates came from the arguments that long term audit tenure would create cozy relationship between clients and auditors and thus, lead

to audit failure. The concern of the threat to mandatory rotation of external auditors on quality, cost and independence is the subject of concern of both professional accountancy bodies and regulators. Proponents of mandatory rotation of external auditors have alleged that the longer auditor-client relationships impair auditor independence, leading to auditors accepting clients relatively more aggressive. However, opponents claim that there is no evidence of this impaired auditor independence; rather they provide some evidence that shows a positive relationship between mandatory rotation of external auditors and quality, independence and cost.

The objective of this study is to extend prior research by examining the relationship between mandatory rotation of external auditors on independence, costs and quality. The study finds that there is a significant relationship between mandatory rotation of external auditors' on the quality, independence and cost of auditing in Nigeria. What this implies is that mandatory rotation of external auditors affects the independence of auditors, the cost of audit engagement and the quality of financial reports.

CONCLUSION

From this result, the researchers find that rotation would increase the quality of service provided by auditors; create an effective peer reviews upon each auditor allow a fresh approach into corporate audit, reduce audit failure restore investors and public confidence and the independence of auditors in Nigeria.

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