THE IMPACT OF MANDATORY AUDITOR-FIRM ROTATION ON AUDITOR INDEPENDENCE, AUDIT QUALITY AND AUDIT COST

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ABSTRACT
The purpose of this study is to examine the Audit Firm Rotation and Audit Quality Evidence from Nigeria Deposit Money Banks. The main objective of the study is to examine the extent audit firm rotation significantly affects audit quality, and to determine the relationship between company size and audit quality and Investigate how audit fees affects audit quality. This study intended to assess the applicability of the mandatory auditor rotation concept in the Nigerian bank sector so as to enhance and improve audit quality, from the findings of both the literature as well as the field survey, it was discovered that audit firm rotation significantly affect audit quality. The research design used for this study is both quantitative and qualitative. The study area is Deposit Money Banks in Nigeria. The population of this research study comprises of all Out of the twenty banks insured by Nigeria Deposit Insurance Corporation as at 2011, fifteen banks were purposively selected for the study. It was concluded that rotation is a good solution to enhance and maintain the auditor independence by decreasing the audit firm’s dependence on the client. Recommendations were made amongst others that the auditor should be remunerated on the basis of work experience, qualification, duration of the audit assignment, and background profile and regulatory bodies e.g. CBN, FIRS should help make laws that will reduce audit firm rotation and help improve audit quality, the Central Bank of Nigeria should think of other ways to address concern about audit quality.

Keywords: Audit Firm Rotation, Audit Quality, Auditor Independence, Central Bank of Nigeria, FIRS
Introduction
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 Fearlay (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) Quality of the working relationship with the audit partner;
iv) Reputation of the firm
V) Technical competence of the audit partner.

**Statement of Problem**

The presence of audit failures in the world has brought a great deal of disappointment to stakeholders and investors, and longevity of audit firm tenure has also been linked with fraudulent financial reporting which reduces the audit firm rotation improves audit quality as auditors may need to be experts in their area and acquire client-specific knowledge overtime (Ghosh & Moon, 2005; Defond & Francis, 2005; Jenkins & Velury, 2008). This means that audit quality is lower during the early years of the auditor-client relationship and increases with length of audit firm rotation due to the reduction in information communication between auditor and client (Azizkhani, Monroe & Shailer, 2006).

Therefore, this study extends and contributes to the body of research using data from Nigerian banks (DMBs) to investigate the likely impact of audit firm rotation on audit quality.

**Research Questions**

The research questions are:
1. To what extent does audit firm rotation significantly affect audit quality?
2. What is the relationship between company size and audit quality?
3. How do audit fees affect audit quality?
4. What is the relationship between board independence and audit quality?

Objectives of the Study
The broad objective of this study is to examine the impact of audit firm rotation on audit quality. The specific objectives of the study are to:
1. Examine the extent audit firm rotation significantly affects audit quality;
2. Determine the relationship between company size and audit quality;
3. Investigate how audit fees affect audit quality;
4. Evaluate the relationship between board independence and audit quality.

Research Hypotheses
The hypotheses stated below are raised in order to actualize the objectives of this study.

Hypothesis One
HO: Audit firm rotation contributes negatively to the quality of audit assignment.
HI: Audit firm rotation contributes positively to the quality of audit assignment.

Hypothesis Two
HO: There is no significant relationship between the firm’s size and audit quality.
HI: There is significant relationship between the firm’s size and audit quality.

Hypothesis Three
HO: There is no significant relationship between board independence and audit quality.
HI: There is significant relationship between board independence and audit quality.

Hypothesis Four
HO: There is no significant relationship between affecting audit quality.
HI: There is significant relationship between affecting audit quality.
Scope of the Study
This study is focused on audit firm rotation and audit quality of Deposit Money banks in Nigeria. Data were collected from financial statements of 15 banks within the period 2005-2011. All the banks used are quoted on the floor of the Nigerian Stock Exchange.

CONCEPTUAL LITERATURE
Audit Quality
According to DeAngelo (1981), she defines audit quality as “the assessed joint probability that a given auditor will both (a) uncover a fraud in the client’s accounting system and (b) report the fraud.” When stated differently, the quality of an audit is a function of
(1) The ability of the Auditor to discover material omissions or misstatement in the client’s financial statements,
(2) The uncertainty that the auditor will disclose material errors. The diversity in the level of the discovery aspect represents the diversity in the level of competency of the auditor, while the diversity in the incentives to report represents the level of the auditor’s independence. An improvement in either competence or independence would lead to an improvement in audit quality, while the reverse will lead to low audit quality.
Audit quality is the uncertainty that an auditor will discover any material errors, is representation and omissions detected in a client’s accounting system and truthfully report same (De Angelo 1981). According to Hay and Knechel (2010), they said auditing could be placed as a type of credence good and consequently, auditors add credibility to corporate financial reports by saying an opinion about the true and fair representation but only in that the users of financial statements will perceive that the opinion is valuable.
Audit quality is the soul of audit profession. It is related to the vital interest of the public. Audit quality has been considered a multifaceted concept by the International Auditing and Assurance Standard Board (IAASB). Users, auditors, regulators, investors (shareholders), and other stakeholders in the financial reporting process may have divergent views as to what constitute audit quality which will influence the type of indicators one might use to assess audit quality.
The auditor conducting the audit may define high audit quality as satisfactorily completing all tasks that is required by the firm’s audit procedures. The auditor may decide to evaluate high audit quality as one for which the work can be defended against any challenges in an inspection by a court of law. Regulators on their own standpoint may view audit quality as one that is in compliance with professional standard. The public may consider high audit quality to be one that avoids economic problems for a company or the market (Enofe, Mgbame, Adeyemi, Obehioye & Ehi-Ohio, 2013)

**Mandatory Auditor Rotation**

Olowookere and Adebiyi (2013) Mandatory auditor rotation prevents the audit firm from developing a close relationship with the client and also provides an incentives for the audit firm to carry out its work to a high standard because they are aware that the quality of their work will be observable to some extent when a new firm of auditors take over the audit. Dopuch, King, and Schwartz (2001) said that mandatory auditor rotation leads to less biasing Audit reports.

Lu and Sivaramakrishnan (2009) said that mandatory auditor rotation reduces overstatements and increases understatements insinuating increased reporting conservatism.

Catanach and Walker (1999) they 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. When the same client (management) is audited too frequently by a particular auditor, the auditor tends to be too familiar with the client. This over familiarity between the auditor and client 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. As such, the quality of the audit work becomes compromised. The beauty of mandatory auditor rotation is that it will limit the formulation of audit–client relationships that can most times lead to compromising independence.

**Audit Fee Literature**

Previous literature has indicated that higher risk clients will choose higher quality auditors (Datar et al. 1991) and it is reasonable that audit firms will charge higher fees to higher risk clients (Feltham et al. 1991).
Several empirical studies support the relation between higher (lower) client riskiness, more (less) auditor effort and higher (lower) audit fees (O’Keefe et al. 1994; Pratt and Stice 1994; Simunic and Stein 1996; Johnstone and Bedard 2003). As higher risk clients are also more likely to have higher earnings management (abnormal working capital accruals), the above literature supports including an audit fees control variable when modeling earnings management.

Both the audit firm and the company invest significant effort and time (cost) following a change in audit firms. This impact will be even larger for consolidated entities that require statutory audits in many countries.

In a mandatory audit firm rotation environment, these startup costs are more likely to be spread over fewer years, increasing the overall cost of the audit function for both the audit firm and the Audit client.

Extensive research has documented a relation between audit firm change and audit fees (Ettredge and Greenberg 1990; Pearson and Trompeter 1994; Deis and Giroux 1996; Simon and Francis 1988; Cameran et al. 2015; Zain 2013), and a recent paper indicates that the relation between these two variables continues in the post-SOX period (Huang et al. 2009).

Due to the relation between audit fees and audit firm change, the above literature supports including audit fees as a control variable when modeling auditor change and reporting quality to avoid a correlated omitted variable problem.

**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 principal's 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. (Mariand 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.

**Previous empirical studies on mandatory audit firm rotation**

Arrunada and Areziss issued a paper in 1997, in which they concluded that a mandatory audit firm rotation would eventually result in an increase of both the audit costs, meaning those incurred by the audit firms, and the costs which are directly attributable to the companies being audited. The paper explains that this is because of the competition being developed between audit firms and the increase of production costs. Moreover, it is argued that a mandatory audit firm rotation causes problems to the audit quality both in terms of technical competence and auditor’s independence.

Another study that comes along with the opinion that audit tenure does not have positive relationship with audit quality is that of Knechel and Vanstraelen in 2007.

By using a sample of stressed companies in Belgium, they found that the independence of auditors does not decrease over time and that the audit quality seems to be unaffected.

To continue with the papers which have reached a negative result about the usefulness of the rule, Myers et al. (2003) by investigating a sample of 42,302 firms reached to the conclusion that the longer the audit tenure the higher the earnings quality. They also concluded that when the audit tenure is longer, auditors impose greater constrains to managers who want to take aggressive decision on how they report on the financial performance of the company.

Another study by Johnson et al. (2002) indicated that the shorter the tenure of an audit firm the lowest the audit quality it is provided and also that there is no
indication of lower audit quality for those audit firms that conduct audits for many years in a company. Furthermore, in a study conducted in a country where mandatory audit firm rotation exists, South Korea, Kwon et al. 2010 found that both the audit hours and the audit fees increase because of mandatory audit firm rotation, but that audit quality was not affected significantly. To continue with countries where the rule is established, Shafie et al. conducted a research in 2009 in Malaysia, finding a positive relationship between audit firm tenure and reporting quality when the going concern model of logistic regression as a proxy for audit quality is used.

Another study conducted in Italy, where the audit rotation is mandatory, a different aspect of audit rotation was detected. More specifically, Cameren et al. searched in 2012 in a field where mandatory audit firm rotation exists, that of Italy, and found that if the mandatory audit rotation was held for three years with the option to be renewed for another six years, the level of reporting conservatism will be higher for the auditors in the last year of their initial tenure. They have also indicated that the audit quality that firm provide improves in the last periods of audits but they admit that further research on that subject needs to be conducted.

To continue with, Harris and Whisenant (2012) in their study investigated the effects of mandatory audit rotation by splitting the period investigated in pre-adoption and after adoption. Their results indicated that in the period after the adoption of the rule, there was detected less earnings management and more accurate recognition of losses as concerned by the time being reported. However, their study showed less audit quality in both periods when the proxy for audit quality is the level of earnings management.

Some researchers like Jackson et al. (2008) have tried to introduce new concepts of mandatory audit firm rotation. More specifically they tested the implications of the rule on audit quality and the costs to the audit market in the Australian environment taking into consideration client’s financial characteristics. They concluded that when the propensity of a going concern opinion is used as a proxy, the quality of audits improves, whereas when discretionary accruals are used, it remains unaffected. At last, Fitzgerald et
al.(2012) examined the effects of the rule in not-for-profit organizations in the U.S.A finding that audit quality is improved when audit firm tenure exists.

**Empirical literature**

Etimobowei and Oyadonghan (2011), auditors may be engaged in a long term audit-client relationship and there may be different incentives for this. Such long term professional affiliation may signal skepticism with regards to the perception of the auditor’s objectivity, independence and audit quality. The findings of the study show that there is a statistical significant relationship between mandatory rotation of auditors and the quality of audit reports. The study concludes that a policy favoring mandatory rotation of auditors could have positive effects on the quality of audit reports as it would allow for fresh approach and restore public confidence in the audit function.

According to Johnson, Khurana and Reynolds(2002), as the auditor-client relationship lengthens, there is the tendency that auditors may develop a “learned confidence” in the client which may result in the auditor not performing religiously, the required testing of financial reports. This learned confidence results in the auditor making assumptions about outcomes and using less rigorous audit procedures or static audit programs. Potentially, a loop hole for a decline in audit quality has been created.

Adeniyi and Mieseigha (2013) examine the relationship between the tenure of auditor and audit quality in Nigeria.

Findings reveal that there is a negative relationship between auditor tenure and audit quality though the variable was not significant. Carcello and Nagy, (2004) also considered the relationship between audit quality and mandatory rotation of auditor’s tenure which is investigated from the point of view of fraudulent financial reporting. A logistic regression model was used and the results reveal a significant positive relationship between short auditor tenure and audit quality.

Mgbame, Eragnbe and Osazuwa (2012) provide an evidence on the existence or otherwise of a relationship between the tenure of auditor and audit quality in Nigeria. Findings reveal that there is a negative relationship between auditor tenure and audit quality though the variable was not significant. The other explanatory variables (ROA, Board Independence, and Director Ownership and Board size) considered alongside auditor tenure were found
to be inversely related to audit quality aside from Returnson Assets which exhibited a positive effect.

Onwuchekwa, Erah and Izedonmi (2012) examines the relationship between mandatory audit rotation and audit quality. The data used were collected through the distribution of questionnaires to investors, lecturers, consultants, accountants and auditors in southern Nigeria. The data was analyzed using percentage analysis while the specified model was estimated using binary logistic regression technique through computer software Eview 7. One hypothesis was stated and tested. The binary logistic ordered regression shows that there exists a negative relationship between Mandatory Audit Rotation (MAR) and audit quality (AUDQ).

Myers, Myers and Omer (2003) using proxy variables such as discretionary accruals and current accruals, investigate the relationship between audit tenure and audit quality. The univariate results show that when auditor tenure is longer, the negative value of accrual measures was observed to be minimal. Furthermore, the study also employed multivariate analysis in order to examine if the discovered relationship between tenure and accrual is also influenced by other factors. The relationship between auditor tenure and accrual measures was also observed to be consistent in multivariate analysis as in the univariate analysis. On the other hand, the study found that extended auditor tenure had a beneficial effect on the dispersion of accruals. The implication is that there is the tendency for auditors to place greater constraints on both income increasing and income decreasing accruals as the audit client relation lengthens. These results suggest that audit quality does not appear to deteriorate with tenure.

In the light of the positions of various studies as reviewed above, we can argue that the effects of auditor rotation on audit quality are controversial. Moreover, few empirical studies use publicly available secondary data in order to determine whether perceived threats to auditor rotation actually compromise audit quality. Therefore, this study which was motivated by the lack of consensus in the literature on the impact of audit rotation on audit quality will contribute to the debate by examining the relationship between auditor rotation and audit quality in Nigeria.

**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 audit or 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.

**Arguments against 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).

METHODOLOGY
The research design used for this study is both quantitative and qualitative. The study area is Nigeria Deposit Money Banks (DMBs). The population of this research study comprises of all 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. Questionnaire and interview will be used to source data for the purpose of this research. The strata comprise of Deposit Money Banks in Nigeria. The data will be analyzed using analysis of variance (ANOVA)

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Model Specification

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

\[ PAUDQ = B_0 + B_1 \times MATR + E_t \] \hspace{1cm} (1)

Where:
- \( B_0 \) = 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.

Summary of Findings

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 Barbadillo 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) and Carcello 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.

**Recommendations**

In order to make Nigerian Auditing firms more effective in their activities, so that they can continue to play their appropriate roles in the growth and development of deposit money banks and the economy at large, the following measures are recommended for adoption and practice:

- Auditors of deposit money banks in Nigeria should live up to the expectations of their clients, their professional bodies, the laws of the land and the general public. These can be achieved by upholding the ethics of their profession as they observe ethical codes such as integrity, objectivity and confidentiality.
- It is also recommended that the auditor should be remunerated on the basis of work experience, qualification, duration of the audit assignment, and background profile. The payment of the adequate fee will encourage the auditor to do the assurance engagement assignment according to the high degree of standardization expected.
- The professional bodies should always watch governmental actions and raise alarm on policies which could hinder smooth discharge of
Auditors’ responsibility, especially in the audit of deposit money banks in Nigeria.

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