

EFFECT OF AUDIT QUALITY ON FINANCIAL PERFORMANCE: EVIDENCE FROM A DEVELOPING CAPITAL MARKET

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Abstract: The rise in corporate failure and the subsequent erosion of investors' confidence has necessitated research attention on ways to improve the reliability of financial information published in the financial statements without compromising performance. Previous research has reported that the reliability of financial statement information depends on the quality of external audit. Existing evidence further reveals audit quality can be measured using a number of factors including audit firm rotation and audit fees. This study examined the effect of audit quality on financial performance of industrial goods companies in Nigeria. The researchers utilized audit firm rotation (AFR) and audit fees (AUF) as proxies for audit quality while financial performance was measured using return on asset (ROA). We adopted a descriptive and Ex-post facto research designs while the scope of the study covered 2012-2018. The population and sample of study consists of twenty four industrial goods companies listed on Nigerian Stock Exchange as at 4th September 2019. Our results show audit firm rotation and audit fees both have significant positive effect on return on asset. On this premise, we concluded that Audit quality has significant positive effect on financial performance. It is therefore recommended that corporate organizations should endeavour to rotate audit firms periodically so as to benefit from their varied experiences and expertise in improving their accounting methods and policies, thus, improve their financial performances, while shareholders should emphasize on audit quality in appointment of auditors with less attention paid to cost considerations.

Keywords: Audit rotation, Audit fee, Return on Asset.

1. INTRODUCTION

The segregation of business ownership from management necessitates the need for periodic financial statements for stewardship reporting. The lack of trust between the business owners and management gave rise to questions regarding the reliability of the financial statements as reported by management (the Stewards). Even potential investors in the past have suffered financial losses due to their reliance on published accounts which further questions the reliability of the accounts. In a bid to curb these circumstances and restore stakeholders' confidence in the accounts, came the need for an External Auditor. Ordinarily, the main purpose of an audit is to provide an independent assurance that management has presented a true and fair view of the company's performance and position in the financial statements. This is quite different from the internal audit function which the firm introduces as an internal control measure. Achieving quality

financial reporting depends on the role that the external audit plays in supporting the quality of financial reporting (Farouk & Hassan, 2014). Owing to cases of audit failure globally, recently, there has been questions as to whether auditing actually play any significant role towards the attainment of accountability and credibility (Iliemena & Okoye, 2019). Audit quality has therefore become a major issue of discussion in terms of the reliability of the financial reports. There have been concerns about audit quality in the present environment, where severe failures have come to light, for example; Enron scandal of 2001; Parmalat in 2003; Cadbury Nigeria Plc in 2006 and Afribank Nigeria Plc in 2009 (Ajani, 2012; Miettinen, 2011). Stakeholders are now more interested in the quality of audited financial information than on the presentation. As noted by Internal Audits Board (2011), sound audits can help reinforce strong corporate governance, risk management and internal control at firms, thus contributing to financial performance.

Quality audit is further reported to lower risks of misstatements, increase confidence in capital markets, which in turn lowers the cost of capital for firms (Heil, 2012). The reliability of financial statements attracts more capital and investment to a firm which culminates to increased financial performance. The reliability of the financial statement depends on the audit quality which implies an indirect relationship between audit quality and financial performance. Shareholders and potential shareholders make investment or disinvestment decisions based on information published in annual financial reports. Lack of accuracy in financial reporting will lead shareholders and prospective investors to make wrong judgment about the organization (Farouk & Hassan, 2014). The relationship and effect of audit quality on financial performance has received research attention over the years. However most of the existing evidence seems to emanate from well developed capital markets while there is little evidence emanating from under-developed markets. The purpose of this study therefore is to determine the impact of audit quality on the financial performance of quoted firms in developing capital markets, using the case of Nigeria.

Research Questions

Specifically our study seek to provide answers to the below questions;

1. What is the effect of audit firm rotation on return on asset?
2. How do audit fees affect return on asset?

2. LITERATURE REVIEW

Audit quality and Factors affecting audit quality

An audit is defined as an objective and systematic examination of the financial accounts of an organization by an independent person (the Auditor) in order to express an opinion on the truth and fairness of the financial statement assertions in an accounting period. According to the Code (2018), an external auditor is appointed to provide an independent opinion on the true and fair view of the financial statements of the company in order to give assurance to stakeholders on the reliability of the financial statements. One of the major threats facing investors is the failure of auditors in detecting material misstatements in the financial statement which questions reliability (Iliemena & Okoye, 2019), thus, the need for emphasis on audit quality. Audit quality represents the overall *Quality* of the audit exercise. There are various definitions to the concept of audit quality but this study sees Audit Quality from the point of view of the Stakeholders. Audit quality is therefore defined as the market assessed joint probability that a given auditor will both discover a breach in the client's accounting system and report the breach (De Angelo, 1981). Conceptually, there are varied determinants and factors which affect audit quality. This is revealed to include audit fees, audit firm rotation, audit committee oversight, audit firm size and personal characteristics of the Auditor which include his competence, independence, qualification and experience. These factors seem to be related as the bigger the size of the audit firm is the higher the audit fees, competence, audit plan, independence, qualification and experience, which also increases the quality of the audit and increases the tendency for true and fair view on the financial statements so audited. This is further asserted by Azizi (2010) who states that the bigger the audit firm size is the longer the tenure and the higher the quality of the audit and the lower his or her motivation for manipulating profit to reach personal interests and the higher would be the reliability of financial statements. Onwuchekwa, Erah, and Izedonmi,(2012) examined relationship between audit rotation and audit independence and found that the mandatory audit rotation in Nigeria has positive relationship on independence of auditors. Consequently, this paper focuses on audit firm rotation and audit fees as determinants of audit quality.

Audit firm rotation

Audit firm rotation is defined as the periodic change of the external auditors of a business organization. It is represented by the length of time between the appointment of an audit firm by a client and the appointment of another audit firm by same client, for external audit purposes. Audit firm rotation is implied in the Sarbanes-Oxley (SOX, 2002) Act page 207 as the number of limit on the period of years during which an accounting firm may be the Auditor of record. Where audit firm rotation is practiced either mandatory or voluntary, the audit firm (External Auditors) that conducts the examination of the financial statements of an organization before publication is change at intervals; Example 3years, 2years etc. The audit firm is not necessarily disqualified but in a bid to maintain corporate policy or mandatory requirements. SOX 2002 mandates US companies to rotate their external auditors after five years tenure, European Commission recommended a tenure of seven years while in Nigeria the Nigerian code of Corporate Governance (NCCG, 2018) part A number 20 recommended that external audit rotation should be every five years. The rotation of External Auditors can be a solution to the potential problem of familiarity between the audit company personnel and the client (Asien, 2007). Studies reveal that audit quality and auditor independence may decline over long auditor-client relationships as most of the investigations carried out by earlier studies found positive relationship of audit firm rotation and tenure on audit quality (Myers, Palmrose & Scholz, 2003; Anis, 2014; Chi Huang, Liao & Xie, 2009; Ghosh & Moon, 2005; Kwon, Lim & Simnett, 2014). Some studies but just a few, has reported negative relationship between audit firm rotation and audit quality with the reason that long tenure allows the audit firm to better familiarize themselves with the clients accounting and internal control systems. Deterioration in audit quality in a short tenure audit may be due to either lack of competence or loss of independence, while a loss in quality in a long tenure audit is most likely due to a loss of independence (Knechel & Vanstraelen, 2007). The rotation of audit firm from period to period guarantees the independence of the auditor to an extent as there should be a limit to familiarization to avoid threats. Auditor relationship with company is expected to decrease with audit firm rotation (PWC, 2013). Consequently, the quality of audit is likely to increase in the first year of audit tenure and decrease with audit firm tenure in later years (Brooks, Cheng & Reichelt, 2013). The explanation to this is that the familiarization level of the audit firm with management is low at the earlier tenure, thus independence level is higher, as the tenure of the Auditor with the organization increases, so the familiarization level which causes the independence level to decline and the overall audit quality.

Audit fees

There are some arguments for using audit fees as a proxy for audit quality. Some evidence which attest to the relationship between audit fee and audit quality include the works of Carcello, Hermanson, Neal and Riley, 2002; Hoitash, Markelevich and Barragato, 2007; Desender Aguilera, Crespi-Cladera and Garcia-Cestona, 2009; Yassin and Nelson 2012 and Hamid and Abdullah, 2012. The fee which an audit firm is paid is expected to cover the entire cost of the audit, the hours spent on the audit function, the experiences and expertise, and the extent of work to be done in a particular audit. Therefore, there is no static fee for all audit function as it varies with certain considerations and particular circumstance of a particular audit. The task of the External auditor is tedious for public companies, requiring the deployment of a team of workforce. For quality audit to be achieved in an audit exercise, it is expected that the audit fees should be commensurate enough. When the audit is paid lower than necessary he makes due with few numbers of audits staff and strives to maintain the cost of the entire process at a certain limit as no Audit firm would want to incur losses at the end of an audit. Focusing an audit on not exceeding a given cost limit rather than going every necessary extent without cost consideration; compromises the quality of the audit. The risk-based approach of audit planning and subsequent pricing means that clients perceived by the auditor as risky are typically assigned more efforts, which in turn results in higher audit fees (Bell, Doogar & Solomon, 2008). The extent of audit planning depends, on the audit fee, thus, the quality of an audit depends on extent of planning which is assumed to be a function of audit fee. This assumption is in line with previous research (Hoitash, Markelevich & Barragato, 2007; Desender Aguilera, Crespi-Cladera & Garcia-Cestona, 2009; Yassin & Nelson 2012; Hamid & Abdullah, 2012; Martinez & De Jesus, 2014)

Relationship of Audit Quality with Firm Performance

Sometimes we wonder if the achievement of quality audit has any relationship with the corporate goal of wealth maximization. The job which the auditor does on the financial statement has been revealed by previous studies to have a relationship with corporate performance generally (Brown & Caylor, 2004; Internal Audit Board, 2011; Heil, 2012;

Farouk & Hassan, 2014). The auditor in the course of his work offers management advice which may improve the reliability of the internal control system and reduce the tendencies for errors and fraud which erode corporate profits as according to Iliemena and Okoye (2019), the accumulated effect of fraud is detrimental to the firm. The more experienced the auditor, is the better the package he can offer the firm on ways to improve its financial performance. The independence of the Auditor is a part element of quality audit. The independence of the audit firm therefore minimizes the tendency for the manipulation of accounts and financial performance. Audit Quality is therefore an unrecognized additional asset to the reporting organization. Brown and Caylor (2004) suggested that company has a formal policy on auditor rotation is positively related to firm performance. As noted by Asghar and Azizi (2010), the bigger the size of the audit firm and the longer the tenure, the higher the quality of the audit, and the higher the quality of an audit the higher the extent of its influence on management discretions in choice of accounting procedures and the lower their motivation for manipulating of financial performance to reach personal interests and the higher would be the reliability of financial statements. Even indirectly, audit quality has a lot to do with financial performance. Example; when a firm has performed badly in a period, quality audit ensures the right information is conveyed to the stakeholders which will awaken concerted effort towards better performance subsequently. When the stakeholders are allowed to go with the wrong impression about the firm when things are not well, it escalates to fingers being pointed at the audit firm on the eventual collapse of the firm.

Measuring Financial Performance

Financial performance can be synonymous with how well a corporate organization is doing in achieving its financial targets and shareholders' expectations. Corporate financial performance can be looked at as the level of *performance* of an organization at a point in time. This could be measured in terms of overall profits and losses or asset utilization (Iliemena & Ijeoma, 2019). The measures of financial performance of an organization are as varied as the motive for the measurement. Financial performance measures quantitatively compare the performance of an organization against predetermined standards. Indices of measure include but not limited to return on Equity (ROE) and Return on Assets (ROA). However, our current study adopts ROA to measure financial performance as according to Poddi and Vergalli (2009), ROA is one of the variables that provide a credible measure of financial performance. Return on Assets (ROA) is an indicator of how profitable a company is relative to its total assets. It is calculated by dividing company's total earning by the total asset.

$$\text{ROA} = \frac{\text{Profit before Taxes}}{\text{Total Assets}}$$

Empirical Review of Extant Literature

Adeyemi and Fagbemi (2010) provided evidence on the relationship between corporate governance, audit quality and firm related attributes of Nigerian companies using logistic regression. Results indicate ownership by non-executive director has the possibility of increasing the quality of auditing, and that company size and leverage both have positive effect on audit quality. Moutinho, Cerqueira and Brandao (2012) investigated the relationship between audit fees and firm performance. They used sample of U.S. public companies for the period of 2000 to 2008. This paper use both empirical and theoretical relationship between audit fees and firm performance. The result shows that there is a negative relationship between fees paid to auditors and firm performance. Farouk and Hassan (2014) examined the impact of audit quality on financial performance of four cement companies quoted on Nigerian stock exchange. The descriptive study employed ex-post facto design and data analyzed using multiple regressions. Results show auditor size and auditor independence have significant impacts on financial performance. Martinez and Jesus Moraes (2014) examined the relationship between fees pay to auditors and firm performance of Brazilian listed companies from 2009 to 2010. They argued that higher audit fees companies as a signal to market which companies audited high audit quality that lead to enhance firm value. However, they use Tobin's q as a measure of firm performance and did not examine other measures of firm performance. Their result showed that there is a positive relationship between audit fees and firm value. Gholamreza and Samira (2015) evaluated the relationship between audit quality and profitability of 52 companies on Tehran's securities exchange market. Findings show there is positive and weak relationship between the auditor size (auditor's good fame) and the auditor's tenure period and the profitability ratios. Ayorinde, Babajide and Ademola (2015) investigated the link between audit tenure, rotation and accounting conservatism using empirical data from Nigeria. Secondary data were randomly

gathered by drawing 100 Observations from published financial statements of sample companies operating in financial and non financial sectors. Descriptive statistics, correlation, and multiple regression analysis were used for data analyses. Findings show audit tenure and audit firm rotation both have significant positive influence on accounting conservatism. Ogbodo and Akabuogu (2018) studied the effect of audit quality on corporate performance of selected banks in Nigeria using firm size, audit committee, and committee independence to proxy audit quality. The population and sample of their study was 16 money deposit banks quoted on Nigerian Stock Exchange and data analyzed using regression analyses. Their study found firm size has significant effect on ROE, and committee independence has significant effect on ROE, also audit committee size was found to have significant effect on profit margin. Most recently, Elewa, and El-haddad (2019) examined the effect of audit quality on firm performance of non-financial firms listed as EGX 100 in Canada. The population and sample of study was 30 firms over five-year period ranging from 2007 to 2017 and applied panel data analysis on generated data. Independent variables were auditor experience (measured by Big-4) and Auditor Independence (measured by auditor rotation). Dependent variables were ROA and ROE. The results of the random effect model test reveal Big-4 and rotation both have no significant impact on ROA and ROE.

3. METHODOLOGY

We adopted Descriptive and Ex-post facto research design for the purpose of this study. The population and sample of study consists of twenty four industrial goods companies listed on the floor of the Nigerian Stock Exchange as at 4th September 2019. Data for the study were gathered from the annual reports of these firms for the period 2012 – 2018. For the purpose of empirical analysis, we used linear regression as the underlying statistical technique. Our dependent variable is Financial Performance (FP) while our independent variable is Audit Quality. The regression model utilized to test the effect of audit quality on firm performance is as follows;

$$FP = B_0 + B_1 AFR + B_2 AUF + \epsilon$$

Where;

FP = Financial Performance. The proxy used in measuring financial performance is Return of Assets (ROA). B_0 = Intercept coefficient, B_1 = Coefficient for each proxy of the independent variable, AFR = Audit firm rotation, AUF = Audit Fees, ϵ = Error term.

4. ANALYSES AND RESULTS

Hypothesis 1

Ho: There is no significant effect of audit firm rotation on return on asset.

Table 1: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.529 ^a	.280	.208	25.74395

a. Predictor: (Constant) AFR

Table 2: ANOVA^a

Model	Sum of Squares	Df	Mean Square	F	Sig.
1 Regression	2576.757	1	2576.757	3.88	.027 ^b
1 Residual	6627.510	10	662.751		
Total	9204.267	11			

a. Dependent Variable: ROA

b. Predictors: (Constant), AFR

Table 3: Coefficients^a

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
1 (Constant)	11.543	13.289		.869	.405
AFR	.606	.307	.529	1.972	.027

a. Dependent Variable: ROA

In the model summary in table 1, there are two pieces of essential information which are R and R². Coefficient R is the measure of relationship between dependent variable and dependent variable. In this case the R = .529 this shows moderate - to- strong relationship while the R² is 28%percent of variation. ANOVA Table tells if the model is statistically significant or not. The F- ratio found in the ANOVA Table measures the probability of chance from a straight line, we could see that the overall equation to be statistically significant (F=3.888). Finally, in the coefficient of variation table shown above, we are concerned with its association with: Standardized Beta, t- test statistic's level of significance (Sig.) as when P<.05, we find the results statistically significant. The value of β is 0. 606 (Which is positive), T-Value is 1.972 (which is less than standard 2.00) and P-value or significance level is 0 .027 (Which is less than 0.05). Results indicate that audit firm rotation has significant positive effect on return on asset which disputes our hypothesis, hence, the rejection.

Hypothesis 2

Ho: Audit Fee has no significant effect on return on asset.

Table 4: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.637 ^a	.406	.909	28.18361

a. Predictors: (Constant), AUF

Table 5: ANOVA^b

Model	Sum of Squares	Df	Mean Square	F	Sig.
1 Regression	10.681	1	10.681	.013	.010 ^b
Residual	7943.156	10	794.316		
Total	7953.837	11			

a. Dependent Variable: ROA

b. Predictors: (Constant) AUF

Table 6: Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
1 (Constant)	36.985	14.549		2.542	.029
AUF	.039	.337	.637	.116	.010

a. Dependent Variable: ROA

The regression analysis performed for testing the effect of Audit fee on return on asset. The value of β is 0.039 (Which is positive), T-Value is .116 (which is less than standard 2.00) and P-value or significance level is 0. 010 (less than 0.05). Results show that Audit fee has significant positive effect on return on asset. This confirms the R of 63.7% which implies that 64% of changes in ROA can be explained by Audit fee. Hence we reject our null Hypothesis which says Audit fee has no significant effect on return on asset.

5. CONCLUSION

The results of our analyses reveal that the rotation of audit firms and the audit fee both have significant positive effect on Return on asset. This relationship and effect is revealed to be more pronounced with audit fees. This shows that changes in financial performance can be explained by changes in audit quality. We conclude that audit quality has significant positive effect on financial performance. This implies that the higher the audit quality level is the higher the financial performance. This paper therefore, recommends that:

1. Corporate organizations should endeavour to rotate audit firms periodically so as to benefit from their varied experiences and expertise in improving their accounting methods and policies, thus, improve their financial performances. In Nigeria, the Code (2018), recommends that audit firms be rotated after five years, companies should build this into their existing corporate governance structures.
2. The shareholders should shift emphasis from affordability to audit quality in appointment of Auditors, as poor audit quality is indicated to have negative effect on the performance of corporate organizations.

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