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Auditors' perceptions on impact of mandatory audit firm rotation on auditor independence –Evidence from Bahrain

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The current study examined several issues regarding auditor independence from the perspective of an emerging market such as Bahrain. Factors affecting the ability of auditors to remain independent include long audit tenure, financial dependence on a single audit client, non-audit services provided to audit clients, ex-auditor employment with an audit client and the existence of audit committees. It is therefore timely to examine the importance of auditor independence in the provision of reliable and credible financial information. The current study uses a questionnaire survey to examine auditors' perceptions of the impact of mandatory audit firm rotation on auditor independence. The results of the study revealed that the majority of auditors agreed that MAR could safeguard auditor independence. The results also reveal that there is *a* significant relationship between mandatory audit firm rotation and auditor independence. Analyses of variance (ANOVA) were also conducted to test for the possibility of confounding effects arising from participants' background and experience. None of these variables were found to have a confounding effect on the experimental results. The results also reveal that the adoption of rotation rules wasn't given enough attention among the auditing firms in Bahrain.

Keywords: Mandatory audit firm rotation (MAR), auditor independence, Gulf Cooperation Countries (GCC), European Commission (EC) Government Accounting Office (GAO), Company Accounting Oversight Board (PCAOB).

INTRODUCTION

The concept of mandatory audit rotation (MAR) is not new. There has been considerable interest in MAR as a means of strengthening auditor independence, reducing the incidence of audit failure, improving the quality of audit and protecting investors and other users of financial statements. Mandatory audit firm rotation sets a limit on the number of years a public accounting firm may audit a company's financial statements. After a predetermined period, an accounting firm is no longer eligible to serve as the company's auditor for a set time interval and a

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rotation of firms is required. A mandatory audit rotation rule which sets a limit on the maximum number of years an audit firm can audit a given company's financial statements has been proposed as a means to preserve auditor independence and possibly to increase investors' confidence in financial reports.

In October 2010, the European Commission (EC) issued a Green Paper to address financial market regulatory reform in reaction to the 2008 global financial crisis. The proposed regulations, issued in November 2011, included mandatory rotation of audit firms after six years (with an extension to nine if joint audits are used), with a cooling- off period of four years.

In the United States (US), the Government Accounting Office (GAO), which was delegated by the Securities and Exchange Commission (SEC) to study the issue of MAR, concluded that there is no clear evidence regarding the potential benefits of a MAR rule (GAO, 2008). However The Public Company Accounting Oversight Board (PCAOB) issued a concept release in August 2011 on ways to enhance auditor independence, objectivity and professional skepticism. The concept release included mandatory audit firm rotation on as one alternative for consideration. In discussing that alternative, they did not specify or indicate a specific term (PCAOB, 2011). Horwath (2012) pointed out that 94% of the comment letters received by the PCAOB were against rotation. There are certain G20 jurisdictions have introduced mandatory audit firm rotation including: (IESBA 2012)

1. Brazil- for listed companies excluding banks;
2. China - for state owned entities and financial enterprises;
3. India - for banks, insurance companies, provident trust funds and public sector entities;
4. Indonesia – five- year rotation for the central bank, and six - year rotation for public and private companies;
5. Italy – nine - year rotation for all listed companies;
6. Saudi Arabia – all listed companies excluding banks; and
7. Turkey –eight - year rotation for banks, seven -year rotation for insurance companies, Five – year rotation for energy companies and all listed companies.
8. In Bahrain, it is not mandatory to switch auditing firms. In fact, in 2006, the Central Bank of Bahrain (CBB) took a position against a notion in the parliament to mandate such a requirement on the ground that small markets are distorted by such decisions.

Experience has shown that switching of auditing firms takes place in very rare cases and generally occurs only after an audit failure. The (Central Bank of Bahrain) CBB does require audit partner rotation for financial institutions at least every five years. Auditing firms claim that they follow such a practice for other firms in accordance with their own internal policies. Auditors are not prevented from joining a client firm at any time, even immediately after formulating an audit opinion (CBB).

Some countries have repealed mandatory audit firm rotation in its entity, but nine smaller jurisdictions still require rotation, including: Laos, Morocco, Oman, Paraguay, Portugal (comply - or -explain), Qatar, Serbia, Tunisia and Uzbekistan (IESBA 2012).

Lack of auditor independence is believed to be the reason for financial reporting failure. One of the arguments which could impair auditor independence is the long-term relationship between auditor and its clients. For example Anderson had been auditing Enron's financial statements since its inception in 1985. In fact, Anderson was given permanent office space at Enron's headquarter. He also share a similar culture with Enron's colleagues such as wearing the same business attire, sharing office birthdays, having lunch together and joining Enron's trips (Arel et al., 2005). This close relationship may create a conflict of interests for the auditor which can adversely affect his independence.

Accountants have long recognized that auditor independence is critical to the validity of auditors as a profession. The independence of auditors should be the bedrock of the audit environment. Auditor independence is very crucial to public confidence in financial reporting. Arens et al., (1999) as cited by Nur and Meslina, (2009) defined independence as "taking unbiased viewpoint in the performance of audit tests, the evaluations of the results and the issuance of audit reports". Independence includes the qualities of integrity, objectivity and impartiality. An auditor should maintain objectivity and be free from conflict of interest in performing audit engagement. The EC Green Paper states that situations where a company has appointed the same audit firm for decades seem incompatible with desirable standards of independence. Accordingly, the Green Paper recommended that the mandatory rotation of audit firms should be considered.

Mandatory audit rotation has always been proposed as a solution to enhance auditor independence. It is argued that mandatory audit firm rotation will significantly increase auditor independence because the client no longer has a tactical threat of changing auditors in circumstances when they disagree with the auditor's professional judgment (Tackett et al., 2004). The auditor will not be burdened from pleasing the client's management and at the same time will reduce the auditor's concern over losing the client. Mandatory audit firm rotation would require the clients to replace their external auditor at a certain time, usually after a few years. Section 207 © of Sarbenes Oxlay Act (SOA) define the term "mandatory rotation" as the imposition of a limit on the period of years on which a particular registered public accounting firm may be the auditor of record for a particular issuer. SOA's reforms directly related to auditors include the establishment of the Public Company Accounting Oversight Board (PCAOB), increased audit committee responsibilities, and mandatory rotation of lead and reviewing audit partners after five consecutive years on an engagement (Arel, et al., 2005). Breeden (2012) believed that companies should re-propose their audit engagement at least once every five or six years.

Several prior studies have attempted to draw conclusions of MAR in terms of Audit quality. The majority of the published empirical papers are based on settings where mandatory rotation is not in place, with few exceptions which are characterized by some relevant limitations (Ruiz-Barbadillo et al., 2009; Kim and Yi, 2009; Firth et al., 2012). In December 2011, the American Institute of Certified Public Accountants (AICPA) issued a comment letter that the PCAOB refrain from imposing mandatory audit rotation. The AICPA letter supported the PCAOB's goals to enhancing auditor independence, objectivity and professional skepticism.

Whether audit firm rotation should be made mandatory is an issue that has been debated for almost five decades in the US and around the world (Kwon et al., 2010).
Proponents of mandatory Audit firm rotation have argued that a new auditor would bring to bear greater skepticism and a fresh perspective that may be lacking in long-standing auditor-client relationship. The proponents added that when a company has been a client of an audit firm for a number of years, the client can be viewed as a source of a perpetual annuity, potentially comparing the auditor's independence. However; others concluded that mandatory audit firm rotation might not be the most efficient way to strengthen auditor independence (GAO, 2003).

Objectives of the Study

The main objective of this study is to explore whether mandatory audit firm rotation should be implemented in Bahrain, and the effects of such a requirement on auditor independence. The following research objectives have been developed:

1. To explore current audit appointment practices by listing companies in Bahrain.
2. To look into the opinion of auditing firms in Bahrain on potential effects provided by implementing mandatory audit firm rotation (auditor independence).
3. To investigate their views in implementing mandatory audit firm rotation in Bahrain.

Significance of the study

The motivation of the current study evolved for a number of reasons. First, most of the literature on audit firm rotation focuses on developed countries. The current study, therefore, addresses this issue in developing countries, the case of Bahrain. Second, as far as the current researchers are aware, no such study was carried out with special reference to Bahrain. The results of the study are hoped to increase knowledge about how listed companies and audit firms in Bahrain reflect mandatory audit rotation through their reporting practices. Third, because Bahrain is a member of GCC, they share a number of specific structural economic features. Key common features of GCC are: a high dependency on oil as expressed in the share of oil (and gas) revenues in total fiscal and export revenues; young and rapidly growing national labor forces; and the heavy reliance on expatriate labor in the private sector. In addition, listed companies are subjected to similar reporting requirements. The companies' laws in these countries require all legal entities to submit an annual report which includes a director's report, auditor's report, and financial statements, and to have their accounts prepared in accordance with International Financial Reporting Standards issued by the International Financial reporting Standards. Thus, GCC are expected to benefit from the results of the current study.

It is believed that this study would supplement literature by providing answers to the following research questions:

RQ1: Does mandatory audit firm rotation improve auditor independence?
RQ2: To what extent the auditors' perceptions of the impact of mandatory audit firm rotation on the auditor independence is influenced by demographic characteristics.

The remainder of the study is proceeds as follows: Section 2 provides for the Bahrain auditing environment. Section 3 provides a review of the controversy and literature review about mandatory audit firm rotation and hypotheses development. Section 4 provides for methodology (data collection, population of the study and testing hypotheses). Section 5 presents the statistical analysis and findings of the study. Section 6 highlights the conclusion and recommendations.

The Bahrain auditing environment:

Some important features of the audit market in Bahrain must be understood to perceive the context in which this study was undertaken.

As of the end of February 2008, audit services in Bahrain are provided by 24 accounting firms. Five of these are considered local; four are operating as foreign branches; and the remaining are linked to international firms. The Big Four; i.e., Ernst & Young (E&Y), Deloitte &

Touche (D&T), KPMG, and Price water house Coopers (PWC) have a strong presence in Bahrain. D&T and KPMG operate as a joint venture, whereas the other two operate as branches of international firms. BDO Jawad Habib and E&Y are the only two firms registered with the United States (US)

The Central Bank of Bahrain (CBB) requires financial institutions to be audited by one of the big audit firms. Audit services are regulated by the Amiri Decree Number 26 of 1996, which requires auditors to obtain a license to practice and set the minimum requirements for a license. In effect, audit firms got two licenses, one to practice auditing and the second specifically to offer auditing services to financial institutions.

Appointments of auditors, as per article (205) paragraph (e) of the Bahrain Commercial Companies Law Number 21 of 2001, should be made on a yearly basis at firm's annual stockholder meetings. However in practice, boards of directors are empowered by annual meetings to appoint auditors and to determine their remuneration. This practice is subject to criticism on the grounds that an auditor's role is to mitigate agency problems that might exist between the board and the shareholders.

The CBB's authority is based on article, (61) paragraph (a), of The Central Bank of Bahrain and Financial Institutions Law Number 64 of 2006, which states: "Every Licensee shall appoint one or more qualified and experienced external auditors for its accounts for every financial year. Prior written approval by the Central Bank will be required before appointing an auditor." This approval is needed annually. In cases where in a decision has been taken to replace the external auditors before the end of the year, the respective financial institutions are also required to inform the CBB about the reasons for this decision.

Auditors and Accounting Standards Module was first issued in October 2010 under otherwise excepted by the Central Bank of Bahrain (CBB). Specialized licensees must ensure that the audit partner responsible further audit does not undertake that function more than 5 years in succession. Specialized licensees must notify by CBB of any change in audit partner.

Auditors appointed by specialized licensees must be independent. Auditors who resign or are otherwise removed from office are required to inform the CBB in writing of the reasons for the termination of their appointment.

The appointment of auditors normally take place during the course of the firm's annual general meeting, specialized licensees should notify the CBB of the proposed agenda. The CBB's approval of the proposed auditor does not limit in any way shareholders rights to subsequently reject the board choice. The CBB is considering the proposed (re) appointment of an auditor, takes into account the expertise, resources and reputation of the audit firm, relative to the size and complexity of the licensee. Specialized licensees must notify the CBB as soon as they intended to remove their external auditor. Specialized licenses must ensure that the replacement auditor is appointed (subject to CBB approval), as soon as reasonably practicable after a vacancy occurs, but no later than three months.

The external auditor of specialized licensees must inform the CBB in writing, should it resign or its appointment as auditor be terminated, within 30 calendar days, of the event occurring, setting out the reasons for the resignation or termination. Unless otherwise exempted by the CBB, specialized licensees must ensure that auditor partner responsible for their audit does not undertake that function more than five years in succession. Article 61 (d) of the CBB law imposes conditions for the auditor to be considered as independent. Before a specialized licensee appoints an auditor, it must take responsible steps to ensure that the auditor has the required skills, resources and experience to carry out the audit properly, and is independent of the licensee. For an auditor to be considered independent, it must, among things, comply with the restrictions in Section AA-1.5. In that, specialized licensees must not provide regulated services to their auditor.

Article 217 prohibits an auditor from being a chairman or a member of the board of directors of the licensee he audits; must not hold any managerial position in the licensee he audits and acquiring any shares in the licensee he audits, or selling any such shares he may already own, during the period of his audit. Furthermore, the auditor must not be a relative (up to the second degree) of a person assuming management or accounting duties in the licensee. These arguments may be applied and/or linked to Bahrain. In the light of the increasing focus on the stock exchange market of Bahrain as important avenue for attracting foreign investments and to encourage local residents to invest in shares, Bahraini companies may engage in mandatory audit firm rotation as a mean to enhance the quality of audit. And this will help to enhance the company's ability to raise capital at the lowest cost possible (Healy and Palepu, 1993; Lev, 1992).

In Bahrain, it is not mandatory to switch audit firms. In fact, in 2006, the CBB took a position against a motion in the parliament to mandate such a requirement on the ground that small markets are distorted by such decisions. Experience has shown that switching of audit firms takes place in very rare cases and generally occurs only after an audit failure.

The CBB does require auditors of financial institutions to switch auditing partners at least every five years. Auditing firms claim that they follow such a practice for other firms in accordance with their own internal policies. Auditors are not prevented from joining a client firm at any time, even immediately after formulating an audit opinion.

Literature review and hypotheses development

Many studies have been conducted in the area of mandatory audit firm rotation (Mautz and Sharaft, 1961; Pierre St. and Anderson 1984; Dopuch et al., 2001; Gietzmann and Sen 2001; Davis et al., 2002; Geiger and Raghunandan, 2002; Carcello and Najy, 2004; Kaplan 2004; Arel et al., 2005; Chi et al., 2005; Gavious 2007; and Wibowo and Rosietta, 2009).

The close relationship between auditors and clients causes the auditor and the client to have a chance to compromise amounting and reporting method. This decreases the auditor's independence and thus, decreeses the audit quality. It is suggested in the literature review that extended auditor – client relationships can have a detrimental effect on auditor independence because an auditor's objectivity about a client decreases overtime (Mautz and Sharaft, 1961; Dopuch et al., 2001; Kaplan, 2004; Chi et al. 2005; Gavious, 2007). Proponent of audit firm rotation argued that mandatory audit rotation enhances auditor independence because managers cannot directly threaten auditors with their dismissal and cannot promise future income arising from their continued appointment (Kwon et al., 2010). Metcalf Committee indicated that mandatory audit firm rotation is a way to bolster auditor independence (US Senate, 1976). Regulators have suggested a link between auditor tenure and reductions in earnings quality and recommended imposing such a requirement (Commission on Auditors' Responsibilities, 1978; Division for (Certified Public Accountants (CPA) firms, 1992). There are more audit failure and lawsuits in the early years of audit engagement. The major financial reporting failures at Enron and WorldCom, as well as apparent failures at Quest, Tyco, Adelphia, and others, led to the financial reporting reforms contained in Sarbanes-Oxley Act of 2002. Many of the audit failures and legal issues occur in the early years of audit engagement, and thus, the longer the tenure; the audit quality will be better (Pierre St. and Anderson, 1984). Carcello and Nagy (2004) proposed that the probability of fraudulent financial reporting is highest early in the audit firm's tenure and is not substantially higher for instances of long standing audit engagement.

Others argue that even though the auditor rotation costs more, this increases the auditor's independence relatively more than the costs Gietzmann and Sen (2001). Audit rotation causes audit risk, below standard audit implementation, because an auditor has not comprehensively understood his client (Beatty, 1989; Craswell et al., 1995).

However, other views were adopted, in which auditing profession has argued that mandatory audit firm rotation would reduce the auditor incentives to invest in specific industries, destroys the knowledge of client companies that an audit firm usually accumulates over the period of years, distorts the competition in the market and increase the cost of an audit (AICPA, 1992).

GAO's (2003) study concluded that mandatory audit firm rotation may not be the most efficient way to strengthen audit independence and improve audit quality. It appears from the literature that politicians, regulators, analysts and small audit firms favor mandatory audit firm rotation as a solution to the perceived lack of objectivity and independence of auditors, whereas academicians, companies, and large audit firms tend to be against mandatory audit firm rotation because changing auditors is costly (Kwon, et al., 2010).

According to the literature review and based on the above discussion, the arguments in favor of mandatory audit firm rotation can be summarized as follows:

1. If auditors continue to audit the entity for too long, they risk developing too close relationship with the client and compromising independence.
2. Periodically having a new auditor would bring a fresh look to the public company's financial reporting and help the auditor appropriately deal with financial reporting issues because the auditor's tenure would be limited under mandatory audit rotation.
3. Mandatory audit firm rotation would help in the more even development of the auditing profession, helping smaller and medium – size audit firm rotation.

The arguments against mandatory audit firm rotation can be summarized as follows:

1. New auditors may miss problems in the period under review because they lack adequate experience with the client to notice either unusual events or important changes in the client's environment.
2. There are not enough large audit firms to address the audit requirements of large companies, making auditor rotation impracticable at the ground level.
3. The rotation would only prevent auditors from building in-depth institutional knowledge of a client and its business.

Without empirical evidence, it is neither clear whether mandatory rotation would not really ensure audit quality by strengthening auditor independence nor obvious whether the rotation rule would hamper audit quality because of insufficient knowledge of clients. Therefore, any generalization of such findings to a regime with mandatory audit rotation should be implemented with caution, because this study aims to examine the effects of mandatory audit firm rotation and each of auditor independence, the study focuses upon the previous studies about auditor independence.

Mandatory audit rotation and auditor independence

In this part we focus on the relationship between auditor independence and audit firm rotation. The independence of auditors is a key factor in evaluating the reliability of auditor's report. This feature has several implications. The first is for political nature: It is the auditor independence can enhance the credibility of published financial reporting and then add value for several categories of stakeholders. The second implication directly involves the profession: the trait of independence is the best way of demonstrating to the regulator and the public that the auditors are performing their task according to ethical principles, such as objectivity and integrity. (Cameran, et al., 2005).

The auditor who has not comprehensively understood client tends to depend on the estimation and information supplied by client (Gul et al., 2009). The relationship between tenure and independence is negatively hypothesized because the longer the tenure, the relationship between the auditor and the client is closer and thus, the auditors tends to be less critical/less independent (De Angelo, 1981).

Opponents of mandatory audit rotation argue that there are other factors motivating the auditor to maintain his independence, such as the need to preserve reputation and client revenue. Ernst & Young (2013) believe that mandatory firm rotation is not an effective way to enhance auditor independence.

We now pointed out some previous studies relating to auditor independence.

O'Leary, 1996 analyzed in his study the concept of independence and the relative consequences that mandatory rotation may have. The respondents to the study consider the cost of rotation to overweigh any benefits. The results of the study (63% of public listed companies and 37% of auditors) consider the introduction of mandatory rotation as a useful means of improving the perception of auditor independence.

Dopuch et al (2001), study aimed to assess whether mandatory rotation and / or retention of auditors increases their independence. The results support the hypothesis that the auditor compromises his independence most often in the no rotation / no retention regimes. On the other hand, the results are consistent with assumption that mandatory rotation coupled with retention increases the auditor's independence. They added that mandatory rotation limits the repeated interaction between manager and auditor that can lead to collusion, so this rule can improve an auditor's independence stand alone or in conjunction with mandatory rotation.

Gietzmann and Sen (2002) studied the tradeoff between the concerns of the auditors to be reappointed by the client and the costs that mandatory rotation rule implies. In other terms, the auditor receiving high fees from the client is interested in a renewal of the engagement and this can impair the auditor's incentive to be independent. The authors concluded that a long standing relationship can induce the auditor to give much more importance to the economic interest in preserving the client than to independence. The authors suggested that in the case of market concentration the proposal for mandatory rotation may be justifiable.

In 2002, and in a 2004 update, the independent academics of SDA Bocconi School of Management studied the impact of mandatory audit rotation in Italy (SDA Bocconi School of Management, 2002) and conducted that the policy seems to lead to additional cost, greater concentration of work among the largest audit firms, negative impact on audit quality (most noticeably in the years immediately after the rotation) and is ignored by the stock market (Cameran et al., 2005). Suriana (2006) carried a study to provide some viewpoints on whether mandatory audit firm rotation should be implemented in Malaysia.

The study examined the value provided by mandatory audit firm rotation from the perspectives of Chief Finance Officer of published companies in Malaysia. The study is based on a survey using questionnaires in order to gather information. The results indicate that mandatory audit firm rotation will enhance auditor independence as perceived by the respondents. However, the respondents believe that the costs overweigh its intended benefits. Kighir A. E. (2013) conducted a study to examine the relationship between audit firm rotation and auditor independence in Nigeria. The study found that there is no statistical significant relationship between audit firm rotation and auditor independence. Table 1 provides a comprehensive overview of research papers addressing the impact of mandatory audit firm rotation on auditor independence.

In summary, so far the extant literature, although very broad, was unable to provide direct and univocal empirical evidence in support or against the introduction of a MAR rule. There is a clear need to research this issue further in settings where the MAR rule is already in place and where the actual incentives of the auditor become more evident. Thus our paper aims at partially filling this gap. For users of financial reports, independence element is very important factor in the audit function; the more the auditor's independence is maintained, the more reliability of the financial statements provided by auditing firms.

Various findings drawn from previous studies, together with what has been discussed above it can be concluded that most prior research was carried out in developed countries.

Hence, there is a need to examine the impact of the MAR on auditor independence in one of the emerging economies; kingdom of Bahrain, In the light of that, and to accomplish the objectives of this research and to answer the research questions, the following hypotheses are formulated:

H01: There is no statistically significant relationship between mandatory audit firm rotation and auditor independence.

Table 1. Finding prior research survey on the impact of mandatory audit firm rotation on auditor independence.

Author/year	Sample	Method	Results
O'Leary & Radich, 1996	Australia, 300 companies, 180 audit partners	Survey research	63% of public listed companies and 37% of auditors consider mandatory audit firm rotation as a useful means of improving the perception of independence.
Summer, 1998	n/a	Analytical research	Mandatory rotation undermines the incentives for building up a reputation for independence by destroying quasi-rents from an ongoing relation
Vanstraelen, 2000	Belgian, companies submitted to the Belgian National Bank (1992-1996)	Archival research	Long-term auditor-client relationships significantly increase the likelihood of an unqualified opinion or significantly reduce the auditor's willingness to qualify audit reports. Further, auditors are more willing to issue an unqualified audit report in the first two years of their mandate than in the last year of their mandate
Hussey & Lan, 2001	UK, 776 CFOs	Survey research	The perception of audit independence would be enhanced by prescribing the rotation of auditors even if the concerns about audit quality and costs are predominant and overall opinion on the rotation rule is negative
Stefani, 2002	n/a	Analytical research	Positive effects of mandatory audit firm rotation on auditor independence
Gietzmann & Sen, 2002	n/a	Analytical research	Positive effects on independence exceed the costs of mandatory audit firm rotation, when there are only a few but very large audit clients on the audit market.
Iyer & Rama, 2004	USA, 124 CPAs employed as CFO or CEO, controller or treasurer in industry of AICPA	Survey research	Respondents with short audit tenures were more likely to indicate that they could persuade the client's position in case of disagreement.
Cameron *et al.* (2005) referring to SDA Bocconi School of Management, 2002	Italy, managers, internal auditors, auditors and managerial accountants	Survey research	Mandatory auditor rotation results in positive effects on perceived independence
Hatfield, Jackson & Vandervelde, 2006	USA, 155 CPAs	Experimental research	Neither partner rotation nor firm rotation may eliminate the effects of client pressure
Moody, Pany & Reckers, 2006	USA, 49 judges	Experimental research	Mandatory audit firm rotation enhances auditor independence perceptions compared to partner rotation. Further, judges consider auditors less likely to be liable for fraudulently misstated financial statements when firm rotation is involved in a minimally compliant corporate governance environment.
Kaplan & Mauldin, 2008	USA, 163 MBA students as nonprofessional investors	Experimental research	Compared to audit partner rotation, audit firm rotation does not strengthen 'independence in appearance' among nonprofessional investors.

Table 1. cont'd

Ebimobowei & Keretu, 2011	Nigeria, 172 auditors and investors	Survey research	Mandatory audit firm rotation increases the quality of audit reports as well as the independence of auditors, even though also the audit costs increase.
The Canadian Institute of Chartered Accountants 2012		Archival research	Depending upon the length of the rotation period, will eliminate or significantly reduce the institutional familiarity threats since a change in the audit firm must occur.

H02: There is no significant difference between respondents in their perceptions of auditor independence and mandatory audit firm rotation attributed to demographic characteristics variables.

METHODOLOGY

Our study used two sources of data collection: primary and secondary sources. The primary source of data is based on survey methods using questionnaires in order to gather the information related to this study. The benefit of using this method is that the researchers can contact participants who might be inaccessible (Cooper and Schindler, 2003). In addition, the data are collected using primary sources in order to gather the perceptions of the respondents. According to Cooper and Schindler, primary sources are always the most authorative because the information has not been filtered or interpreted by a second party.

Therefore, survey is one of the most appropriate methods used in collection of primary data. Secondary data is information collected come from official journals, articles, newspapers, text books and internet. Analyses of variance (ANOVA) were also conducted to determine whether auditors' perception of the impact of MAR on the auditor independence was influenced by demographic characteristics.

The questionnaire comprises three sections. Section one contains some demographic information and the current audit practices while section two includes questions about potential effects of mandatory audit firm rotation upon audit independence, and section three composes questions about overall opinions on requiring mandatory audit firm rotation. The questionnaire was revised in the light of a feedback from professionals who are working at universities and audit firms. Respondents were asked to express their opinions on the potential effects of mandatory audit firm rotation upon audit independence using a Liker Scale of five points ranging from 1 "strongly agree" to five "strongly disagree".

The data used in this study are obtained from a sample of auditors who are practicing in audit firms in Kingdom of Bahrain. We consider auditors as entire authorized and approved individuals and not specific auditing firms. Also, the increasing use of the word auditors in our study does not by any means refer to both external and internal auditors. That is to say the word auditors in this study refer only to external auditors. Though both types of auditors are required to be independent, the degree of the independence for external auditors is far too strong and mandatory.

The data used in this study are obtained from a sample of auditors who are practicing in audit firms in Kingdom of Bahrain. The number of auditing firms in Bahrain is about 25 firms. We asked each auditing firm to provide us with the number of auditors who are qualified to fill the questionnaire, and the total number of auditors received from all auditing firms in Bahrain was 102. Accordingly, 102 questionnaires were distributed with a response rate of 64.7%. (Appendix contains a list of auditing firms in Bahrain).

The questionnaire comprises three sections. Section one contains some demographic information and the current audit practices.; section two includes questions about potential effects of mandatory audit firm rotation upon audit independence, and section three composes questions about overall opinions on requiring mandatory audit firm rotation. The questionnaire was revised in the light of a feedback from professionals who are working at universities and audit firms. Respondents were asked to express their opinions on the effects potential effects of mandatory audit firm rotation upon audit independence using a Liker Scale of five points ranging from 1 "strongly agree" to five "strongly disagree".

The internal consistency of the questionnaire reliability was measured by using Cronbach's coefficient alpha statistical test as shown in Table 2. The analysis provides an indication of the average correlation among all the items that made up the scale. The results in the Table demonstrate that all indices obtained were considered high (0.766). A sample scale that shows alpha value above 0.70 is considered reliable (Bryman and Cramer, 2001). Therefore, the indices for the questionnaire reliability are generally considered adequate for this research.

RESULTS

Statistical Analysis

Demographics

Analyzing the first section of the questionnaire reveals the demographic background of the respondents, which are examined by looking at the Position; experience; professional qualifications; type of audit firm and number of employees' descriptive analysis regarding demography variables is shown in figures 1 to 4 below:

Table 2. Reliability Statistics

Cronbach's Alpha	Cronbach's Alpha Based on Standardized Items	N of Items
.766	.769	11

Table 3. Respondents distribution according to demography variables

Position	**Frequency**	**Percentage (%)**
partners;	8	12.12
managers	7	10.60
auditors	51	77.28
Experience		
	Frequency	**Percentage (%)**
Less than 5 years	24	36.4
5 – less than 10	26	39.4
10 – less than 15	8	12.1
15 – 20	4	6.1
More than 20	4	6.1
Qualification		
B.S.C.	24	36.4
Graduate degree	12	18.2
CPA/CA/ACCA/CFA/CMA	44	66.7
Others	2	3
Company's auditor		
BIG 4	24	36.4
Non-BIG 4	42	63.6
No. of employees		
Up to 50	46	69.7
Above 50	20	30.3

Table 3 summarizes the job title of the respondents' auditors. Of the 66 auditors analyzed, eight auditors (12.12%) are partners; seven auditors (10.6 %) are managers; with the remaining fifty-one auditors (77.28 %) who is working as seniors in audit firms.

Auditors are varied in years of experience which are classified into three categories for the purpose of this research; less than five years, between 5 to 20 years, and above 20 years of work experience. Table 3 shows that 63.6% of the respondents have over 5 years experience and this result indicates that the extent of experience and maturity that may be reflected positively upon the work.

Respondents were requested to report their professional qualifications and academic degree. Table 3 shows that the majority of the respondents (66.7%) have professional certificate, followed by B.S.C. with 36.4% and graduate degree with (18.2%). These results indicate highest academic level that respondents have, and this may be positively reflected upon the importance of the information given by the respondents. Respondents' auditors are affiliated with several audit firms. Table 3 shows that 36.4% of the auditing offices are BIG 4 and the remainders (63.6%) are associated with local audit firms.

Moreover, Table 3 shows that the number of employees working in audit offices is 50 employees on average with 69.7% and 30.3% above 50 employees. This results indicate that the auditing offices are working very well and are established themselves in the market. (Table 2).

Table 4 shows the distribution of respondents according to current audit practice. It is apparent that the auditors provide other services other than audit service to the

Table 4. Respondents distribution according to current audit practices

Services provided to audit clients (other than audit)	Frequency (%)		Frequency (%)	
	yes	%	No	%
Financial system design and implementation	36	54.5	30	45.5
Taxation	12	18.2	54	81.8
Accounting services	64	97	2	3
Internal audit services	50	75.8	16	24.2
Management functions or human resources	26	39.4	40	60.6
Legal services	36	54.5	30	45.5
Other non-audit services	34	51.5	32	48.5

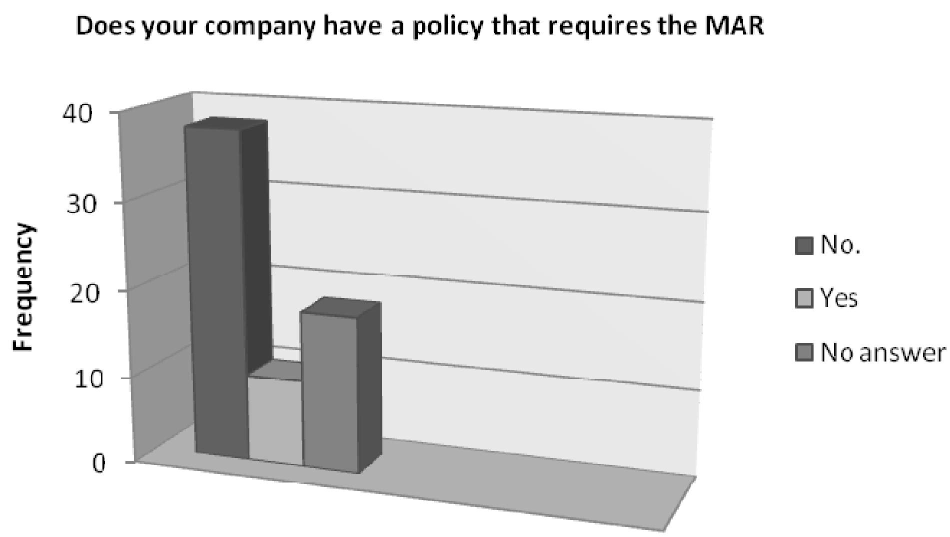

Figure 1. Respondents' answers regarding MAR policy

and legal service with (54.5%) for each.

Respondents were asked to indicate their perceptions regarding mandatory audit firm rotation rules. Figure 1 shows that 38 of the respondents (57.6%) do not require the MAR rule whereas 10 (15.2%) of the respondents have a policy that require the mandatory audit firm rotation rule and 18 (27.3%) have no answer. Figure 2 indicates that 40 of the respondents (60.6%) have no answer regarding the number of years that should the mandatory firm be permitted to once again compete for audit services followed by choice of three to less than five years and then five years to less than eight years.

The results regarding what should be the limit on the mandatory firm's audit tenure period also indicates that the choices "three to less than five years" and "five years to less than eight years" have 33.34% for each (Figure 3).

Figure 4 regarding the statement "do you believe that mandatory firm's should be applied uniformly for audits of all public companies regardless of the nature or size of the public company" indicated that the respondents were not in agreement, in which 50 % have no answer, 45.45% answer Yes, and 4.54 % answer No.

Auditors' perceptions on effects of audit firm rotation on perceived auditor independence

Respondents are requested to express their opinions on eleven statements using a Likert -scale of 5 points ranged from 1 "strongly agree"; to 5 "strongly disagree". This study defines any factors with the mean values up to 2.0, at least "agree" or "strongly agree" upon; in the range of 2.1 to 3.0, are "uncertain" and 3.1 or above indicating that the respondents either "disagree" or "strongly disagree" that MAR would enhances auditor independence.

Table 5 shows the means and standard deviations for each question individually and all questions together that

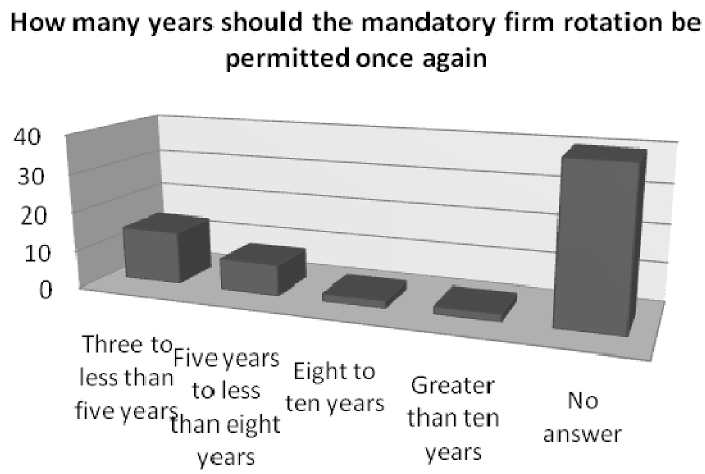

Figure 2. Respondents' answers regarding number of years permitted.

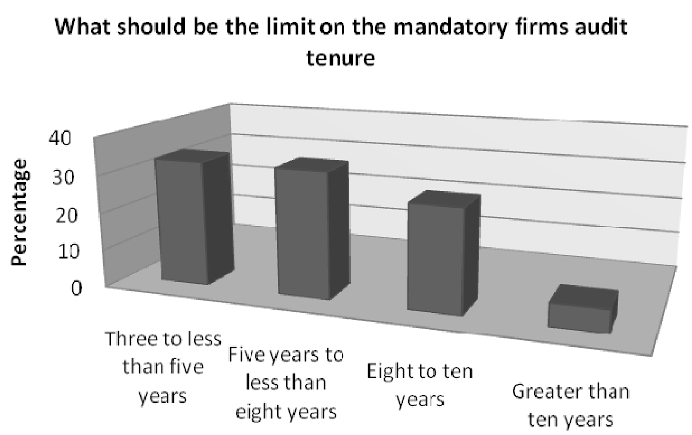

Figure 3. Respondents answer regarding limit on mandatory firms audit tenure

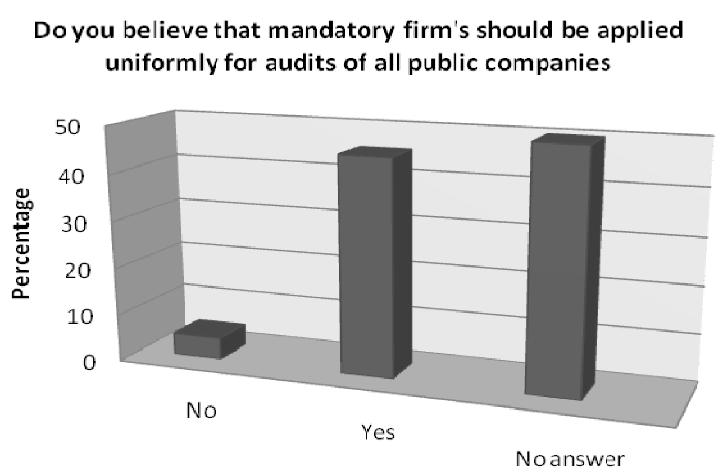

Figure 4. Respondents' answers regarding implementing MAR.

Table 5. Effects of audit firm rotation on perceived auditor independence

Question No.	Questions	Mean	Std. Deviation	t-Value	P-Value
1	Auditor's independence is a key priority not only for auditors, but also for management and investors..	1.67	.53	25.266	0.000
2	Under mandatory audit rotation, the audit firm will be more independent and objective in performing services.	2.15	.89	19.452	0.000
3	The longer audit tenure may adversely impact auditor objectivity and professional skepticism and therefore, impair the appearance of independence.	2.75	.89	25.018	0.000
4	A long term auditor-client relationship can induce an auditor to give much importance on the economic interest in preserving the client than to independence.	2.75	.99	22.556	0.000
5	Mandatory audit rotation would decreases auditors' incentive to compromise their independence through biased reporting in favor of management,	2.45	.86	23.117	0.000
6	Mandatory rotation would increase auditor's willingness to resist pressure from management.	2.45	.70	28.260	0.000
7	There are other factors motivating the auditor to maintain his independence, such as the need to preserve reputation and client revenue.	2.15	.96	18.120	0.000
8	Mandatory rotation will increase the auditor's potential for dealing more appropriately with financial reporting that may materially affect client's financial statements.	2.45	.83	24.137	0.000
9	Auditor's tenure exceeding five years is not significantly perceived as reducing auditor independence.	2.75	.93	24.110	0.000
10	Mandatory audit rotation can impair independence because it undermines the incentive to build up a reputation for honesty or because of the interest of the auditor in maintaining the client for the recovering of the initial investment.	3.27	.93	28.370	0.000
11	Mandatory audit rotation would decrease management's ability to influence the auditors.	2.33	.88	21.471	0.000
	Average mean & standard deviation for all first hypothesis questions together	**2.5**	**.86**	**29.110**	**0.000**

t-distribution with 65 degree of freedom ,for level of significance of .05 , the table critical value is 1.66.

test the hypothesis. The analysis indicates that the means range from 1.67 - 3.27. The standard deviation range from .53 –.99 which means that there is agreement among respondents about the hypothesis and the variances are low since the standard deviation of any question is less than half of the related mean. The respondents express that Auditor's independence is a key priority not only for auditors, but also for management and investors (mean=1.67, p-value= 0.000), and that under MAR, the audit firm will be more independent and objective in performing services (mean=2.15, p-value= 0.000).

Furthermore, respondents express their opinions and agree that the longer audit tenure may adversely impact auditor objectivity and professional skepticism and therefore, impair the appearance of independence (mean=2.75, p-value= 0.000). The respondents express that a long term auditor-client relationship can induce an auditor to give much importance on the economic interest in preserving the client than to independence (mean=2.75, p-value= 0.000). The respondents express the MAR would decreases auditors' incentives to compromise their independence through biased reporting in favor of management (mean=2.75, p-value= 0.000). And that MAR would decreases auditors' incentives to compromise their independence through biased reporting in favor of management (mean=2.45, p-value= 0.000). Furthermore, the results in table 3 suggest that respondents have expressed their opinions on the MAR would increase auditor's willingness to resist pressure from management (mean=2.45, p-value=0.000). The respondents agreed that there are other factors motivating the auditor to maintain his independence, such as the need to preserve reputation and client revenue (mean=2.15, p-value= 0.000), and that MAR will increase the auditor's potential for dealing more appropriately with financial

Table 6. Respondents distribution according to overall opinions on requiring mandatory audit firm rotation

Answer No.	**There should be compulsory rotation of audit firm after a fixed number of years**	Frequency	Percentage (%)
1.	Yes, I believe it enhances auditor quality, independence and objectivity and should be implemented.	30	45.5
2.	Yes, it can work if rotation period is long enough.	24	36.4
3.	No, the benefits of mandatory audit firm rotation would exceed the costs of implementing such a requirement.	8	12.1
4.	No answer.	4	6.1
	Regarding your public company's (or firm's) overall current opinion on whether or not your company supports requiring mandatory rotation of registered public accounting firms		
1	The company (firm) supports requiring mandatory rotation of public accounting firms at this time provided that the period of time for rotation is reasonable. (Please provide the principal reason for supporting mandatory rotation below.)	22	33.3
2	The company (firm) supports the concept of requiring mandatory rotation, but believes more time is needed to evaluate the effectiveness of the various requirements of the Sarbanes-Oxley Act of 2002 for enhancing audit quality.	14	21.2
3	The company (firm) does not support requiring mandatory rotation of public accounting firms. (Please provide the principal reason for not supporting mandatory rotation below.)	4	6.1
4	No answer	26	39.4

reporting that may materially affect client's financial statements (mean=2.45, p-value= 0.000). furthermore, respondents believe that Auditor's tenure exceeding five years is not significantly perceived as reducing auditor independence (mean=2.75, p-value= 0.000). Respondents were uncertain that MAR can impair independence because it undermines the incentive to build up a reputation for honesty or because of the interest of the auditor in maintaining the client for the recovering of the initial investment (mean=3.27, p-value= 0.000), and that MAR would decrease management's ability to influence the auditors. The results suggest that auditor tenure impacts the auditor independence, where auditors have relations with the client that add much pressure on his opinion, hence this might prevent him from issuing a qualified report that might lead to losing his client, and MAR will enhance auditor independence . Accordingly, the average mean for all questions together of the hypothesis equal 2.5 with standard deviation of .86 which is less than half of the mean. This means that no dispersion views among respondents about the questions of the hypothesis. Also, the analysis shows that the *t value is (*29.110*) which is* greater than the table critical value of t (1.66), and the p-value is 0.000 less than the value of significance of 0.05 ($p<0.05$), This result indicates that *there* is a statistically *significant relationship* between MAR and auditor independence, which means that the null hypothesis is rejected, and that there is a statically significant correlation between MAR of external auditors and audit independence at value of significance ($p<0.05$). This result is highly consistent with the findings of prior research on the correlation between MAR and auditor independence (Hussey and Lan, 2001; Stefani, 2002; Cameron et al. 2005; Moody et al. 2006; Ebimobowei and Keretu, 2011).

Auditors' perceptions of importance of mandatory audit rotation

Table 6 reports respondents' perceptions as to the importance of mandatory audit firm rotation. The analysis indicates that 45.5% believes that audit firm rotation would enhance auditor quality, independence and objectivity and should be implemented, 36.4% believe that it can work if rotation period is long enough, whereas 12.1% believes that the benefits of mandatory audit firm rotation would exceed the costs of implementing such a requirement.

Regarding the question "your public company overall current opinion on whether or not your company supports requiring audit mandatory rotation of registered public accounting firms". The table shows that 33.3% of the respondents supports requiring mandatory rotation of public accounting firms at this time provided that the period of time for rotation is reasonable, 21.2% believes that the company (firm) supports the concept of requiring mandatory rotation, but believes that more time is needed to evaluate the effectiveness of the various requirements of the Sarbanes-Oxley Act of 2002 for enhancing audit quality and 6.1% believes that the company (firm) does not support requiring mandatory rotation of public accounting firms.

Auditors' background variables and perceptions of MAR and auditor independence

It has been argued that respondents' background variables could affect perceptions of auditor independence. In this section, the relationships between the background variables such as auditors' position, working experience, qualification, and audit firm and perceptions of auditor independence are examined.

ANOVA was conducted to determine whether auditors' perceptions of the impact of MAR on the auditor independence was influenced by demographic characteristics. The results of the tests are presented in table 7 below.

Table 7 shows that respondents' positions did not have any significant impact on the perceptions of auditor independence. However, respondents' perceptions of the MAR will increase the auditor's potential for dealing more appropriately with financial reporting (statement 8 with $p < .05$), and that MAR can impair independence (statement 10 with $p < .05$) seems to be affected by the respondents' position. It was found also that experience has a significant impact on auditors' perceptions on some statement related to the impact of the MAR on the auditor independence at (statements 8 with $p < .05$). The results also reveal that perceptions of auditors' independence were not affected by respondents' qualifications only on some statement (statements 2, 8, and 11 with $p < .05$). Furthermore, it was found that type of audit firm has no impact on auditors' perception of the impact of MAR upon the auditor independence. In the light of on the above findings, Hypothesis 2, is not rejected since the evidence presented indicates that respondents' demographic characteristics have no significant impact on perceptions of auditor independence, but can be rejected only for the respondents' position (statement 8 and 10), experience (statement 8) and qualification (statements 2, 8, and 11).

Summary and Conclusion

The main purpose of this study is to presents the opinions of sample of auditors who are practicing in audit firms in Kingdom of Bahrain on potential effects provided by implementing mandatory audit firm rotation (auditor independence). It is believed that this study would supplement literature by providing answers to the following research questions. 1) Does mandatory audit firm rotation improve auditor independence? And 2) to what extent the auditors' perceptions about the impact of mandatory audit firm rotation on the auditor independence is influenced by demographic characteristics. Data for the study were collected by distributing an administered questionnaire to the sample study that consist all auditors working in audit firms in Bahrain. We started our study by asking auditors the most basic question: Does your company have a policy that requires the mandatory audit firm rotation rules? 57.6 percent of the respondents 'indicated that they don't have such a policy. Nearly 40 percent of the respondents agreed with the statement that mandatory firm's should be applied uniformly for audits of all public companies regardless of the nature or size of the public company with audit tenure period of three to less than eight years. As a contribution to previous research, the perceived effects of mandatory audit firm rotation on auditor independence found in this study was compared with the perceived effects found in previous studies by the first hypothesis. The Average mean and standard deviation for all first hypothesis questions together resulted in rejection to the null hypothesis. This means that there is a statistically significant relationship between mandatory audit firm rotation and auditor independence and that coincide by finding of prior studies. The average mean of all questions together of the hypothesis is 2.5 with average standard deviation of .86 which is less than half of the mean. This indicated that there is no dispersion existed among respondents about the questions of the hypothesis. Also, the analysis shows that the *t value is (29.110)* which is greater than the table critical value of t (1.66), and the p-value obtained is 0.000 which is less than the value of significance at ($p<0.05$), these results confirm that there is a statistically significant relationship. This study investigates auditors' opinions on requiring mandatory audit firm rotation. 45.5 percent of the respondents believe that mandatory audit firm rotation will enhances auditor independence and should be implemented. Moreover 36.4 % of them see it works if rotation period is long enough. Respondents were also asked their overall current opinion on "whether or not your company supports requiring mandatory rotation of registered public accounting firms", 33.3% of the respondents indicated agreement on this issue. While only 6.1% believes not.

Another relevant question addressed by this study is to what extent the auditors' perceptions of the impact of mandatory audit firm rotation on the auditor independence is influenced by demographic characteristics? Analysis of variance (ANOVA) was conducted to answer this question. As shown in table 7, it was found that respondents' positions do not have any significant impact upon the perceptions of auditor independence except for (statement 8 with $p < .05$), and (statement 10 with $p < .05$) seems to be affected by the respondents' positions. It was found also that experience has a significant impact on auditors' perceptions on some statement related to the impact of the MAR on the auditor independence at

Table 7. Analysis of differences in perceptions of MAR and auditor independence with demographic Variables

Question No.	Questions	ANOVA Test Significant Level			
		Position	**Experience**	**Qualification**	**Audit Firm**
1	Auditor's independence is a key priority not only for auditors, but also for management and investors..	0.482	0.948	0.831	0.979
2	Under mandatory audit rotation, the audit firm will be more independent and objective in performing services.	0.870	0.241	0.004*	0.749
3	The longer audit tenure may adversely impact auditor objectivity and professional skepticism and therefore, impair the appearance of independence.	0.502	0.255	0.470	0.116
4	A long term auditor-client relationship can induce an auditor to give much importance on the economic interest in preserving the client than to independence.	0.864	0.774	0.969	0.319
5	Mandatory audit rotation would decreases auditors' incentive to compromise their independence through biased reporting in favor of management,	0.864	0.979	0.920	0.331
6	Mandatory rotation would increase auditor's willingness to resist pressure from management.	0.325	0.902	0.936	0.616
7	There are other factors motivating the auditor to maintain his independence, such as the need to preserve reputation and client revenue.	0.110	0.987	0.428	0.229
8	Mandatory rotation will increase the auditor's potential for dealing more appropriately with financial reporting that may materially affect client's financial statements.	0.018*	0.041*	0.002*	0.071
9	Auditor's tenure exceeding five years is not significantly perceived as reducing auditor independence.	0.321	0.951	0.671	0.377
10	Mandatory audit rotation can impair independence because it undermines the incentive to build up a reputation for honesty or because of the interest of the auditor in maintaining the client for the recovering of the initial investment.	0.006*	0.481	0.573	0.991
11	Mandatory audit rotation would decrease management's ability to influence the auditors.	0.343	0.027	0.005*	0.197

(statements 8 with $p < .05$). The results also reveal that, perceptions of auditor independence were not affected by respondents' qualifications only on some statement (statements 2, 8, and 11 with $p < .05$). Furthermore, it was found that type of audit firm has no impact on auditors' perceptions of the impact of MAR on the auditor independence.

We also conclude that the adoption of rotation rules wasn't given enough attention among the auditing firms in Bahrain. For that, 27.3 % of respondents' don't know "whether their company have a policy that requires the mandatory audit firm rotation rules". 60.6% don't know how many years the mandatory firm should be permitted to once again compete for audit services. In asking the respondents their beliefs regarding whether MAR should be applied uniformly for audits of all public companies regardless of the nature or size of the public company, 54.5% indicate no answer. Also 39.5% of respondents' don't know "whether or not their company supports requiring mandatory rotation of registered public accounting firms.

This study is subject to a number of limitations that need to be acknowledged, which are mainly related to its research design. Firstly, the study only examined the perceptions of one groups of financial statement users" auditing firms located in Bahrain". The findings from the study can be generalized only to this group. Future studies could investigate the perceptions of other users such as institutional and private investors, audit committees and members of regulatory bodies. Secondly, the findings of such a study may not be generalized to different countries at different stages of development or with different business environments and cultures. A comparative study of MAR practice for different countries with emerging capital markets might also be fruitful. Therefore, it would be interesting to replicate this study in other GCC countries or Middle Eastern countries.

Thirdly, as this study focused on the impact of mandatory audit rotation on auditor independence in Bahrain, further research may be directed towards examining the impact of MAR upon audit quality and on the cost of audit rotation. The results are based on a limited number of respondents, we cannot assume that the views of non respondents are similar to the study finding .However, variables other than those included in the questionnaire of the study may affect the mandatory audit rotation.

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Conflict of Interests

The author(s) have not declared any conflict of interests.

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Appendix

Listed Audit Firms in Bahrain
•KPMG Fakhro
•Ernst & Young
•Deloitte & Touche Bahrain
•PricewaterhouseCoopers
•PKF Bahrain
•Horwath Bahrain
•Moore Stephens International Ltd
•National Audit Office
•Grant Thornton
•Talal Abu-Ghazaleh & Co
•BDO Jawad Habib
•Assure Consulting WLL
•Abdulaal Gulf Audit
•Al Mezan Bureau
•Al-Mudhaffar Public Accountants
•HLB R. Yassa & Co (N & Co) Chartered Accountants
•Nabeel Al Saie - Public Accountants
•Jawad Habib & Co
•Dynamic Structures
•Accounting & Auditing Organization for Islamic Financial Institutions
•Raafat Yassa & Co Chartered Accountant
•Saba & Co
•El Sayed El Ayouty & Co
•Xpress Accounting - Bahrain
•Al atheer Audit and Consulting