

Audit firm attributes and independence of auditors: Evidence from listed manufacturing companies in Nigeria

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Abstract

Introduction: This study is carried out to ascertain how attributes specific to audit firms affect the independence of auditors engaged by manufacturing companies listed on the Nigerian stock market.

Objective: The study sought to examine audit attributes and independence of auditors: evidence from listed manufacturing companies, Nigeria.

Methodology: Research survey conducted on 26 listed manufacturing companies with head offices in Lagos, Nigeria. The companies were selected by using the Taro Yamani method while simple random sampling was used to select the respondents and total numbers of 78 questionnaire were administered. The data collected from the survey was analyzed with the aid of Partial Least Square-Structural Equation Model (PLS-SEM) regression technique.

Results:The study found that firm tenure and size have positive and significant relationship with auditor independence. Control variable, provision of non-audit assurance services also has positive and significance relationship with independence. However, the second control variable, audit fees, showed a positive but insignificant relationship with auditor independence.

Conclusion:Based on these findings, the study concluded that audit firm tenure, provision of other non-audit services impairs independence while audit firm size enhances it.

Unique Contribution:The study provides further evidence through a more robust analytical procedure (PLS-SEM regression technique) that audit firm attributes of tenure and rendering of non-audit assurances services impair independence while size enhances it in Nigeria's listed manufacturing companies.

Key Contribution: The study therefore recommends that regulatory provision of rotation of auditors be respected; there should be lifting of the veil of incorporation to ascertain companies that provide non audit services and sanction of auditors if it is discovered that they are providing non-audit services to their audit client under another name. It should also be ensured that accountants that are licensed to practice come together and practice as partners in a partnership instead of practicing as sole practitioners.

Keywords: audit; Film, attributes; manufacturing; Nigeria.

Introduction

This paper investigates the audit firm characteristics and independence of auditors: evidence from listed manufacturing companies in Nigeria. Collapse of large corporations globally and the effect of fraudulent financial reporting after the completion of audit exercise and unmodified audit reports have caught the attention of academic and business researchers in recent times. Corporate financial scandals have been linked with audit failures while the failures have led to increased public scrutiny of the exercises of public accounting firms (Eisenberg & Macey, 2004). They raised issue in relation to the quality of audits carried by auditing profession (Gendron, Suddaby, & Lam, 2006). Fearnley, Beattie, and Brandt (2005) further pay attention to the failure of public corporations which make stakeholders not to have interest in the ethical principles within audit firms.

Investors have advocated that independence is critical issues disturbing audit exercise in recent time. To this end, Abedalgader, Ibrahim and Baker (2010) noted that the independence of the auditor depends majorly on two factors which are auditor tenure (or length of auditor-client relationships) and audit firm size. The auditors have been criticized in carrying out audit exercise for their clients for as long as possible and subsequently concentrated more on non-assurance audit exercises rather than audit (Eyenubo, Mohammed & Ali (2017)) because of the economic profit derivable from non-audit services. It is also observed that big accountancy practices are seen to be more independent than small practices because they possess better capacity and are also capable of withstanding pressure from the client management in conflict situations.

The regulatory agencies have reacted to this cankerworm distressing the practice of auditing with several pronouncements and legislations. In Nigeria, accountancy regulatory agency like Institute of Chartered Accountants of Nigeria (ICAN) pronounced rotation of auditors for audit exercise for the companies every three years; a practice which the Financial Reporting Council of Nigeria reinforced by prescribing that companies change its auditors every ten years apart from placing restrictions on some assurance services provision to audit clients by audit firms. These restrictions were intended to safeguard auditors' independence which seems to be under threat from close audit firm attributes. It is, however, not certain whether companies comply with these provisions.

Conceptual Review and Theoretical Framework

An audit could be seen as rendering third party assurance to various stakeholders that the subject matter is free from material misstatement in the financial statements (Huyghe, 2017). This assurance is done by extensively evaluating internal and external evidence of the transactions made available to the auditor. Researchers have put forward various definitions for auditor independence based on individual perceptions of the concept and as such, no generally accepted definition is available in the literature. This fact is adduced to by Scheutze 1994; De Angelo 1981). Regulators like International Federation of Accountants (IFAC) defined it as '*the ability to act with integrity and objectivity*', which means that the accountant should execute his investigation in an objective and impartial manner. It also means that while verifying the accounting books and records the auditor must be free from influence of the client in any given circumstance.

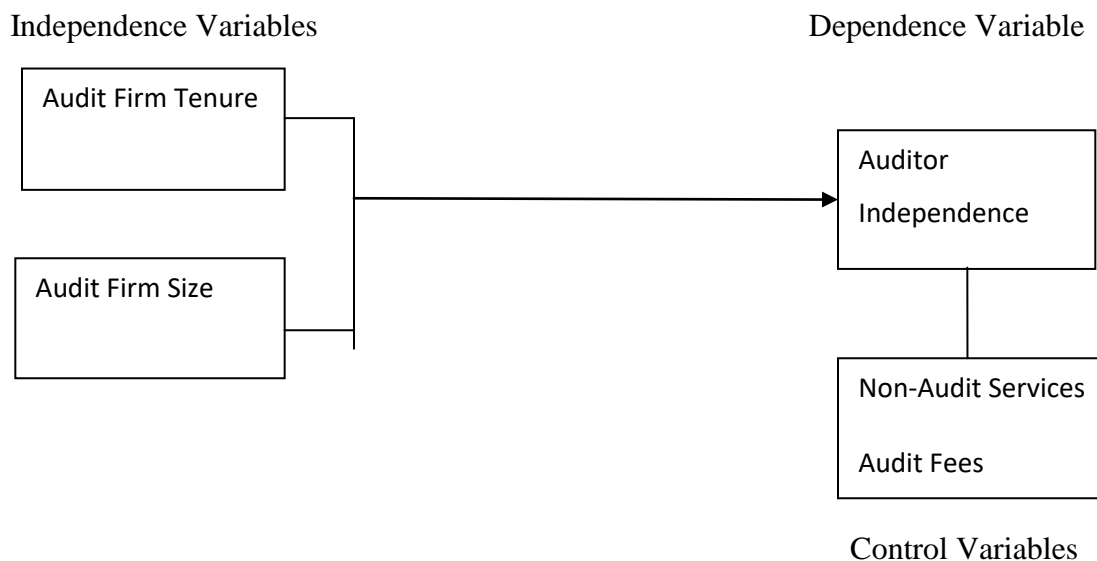
Audit firm tenure is the length of time an audit firm has been executing audit exercises for his client (Huyghe, 2017). Auditor tenure could be short or long (Carren, 2013). Short audit tenure means short relationship between the company and its auditor which can be between 1 and 5 years while long tenure denotes long auditor-client relationship of up to 10 years and above (Barizah Abu Bakar, Rahim Abdul Rahman and Majdi Abdul Rashid, 2005). Non-audit services are those other services which auditors often render to their clients which are vividly different from audit engagement. Such

services include among others accounting and bookkeeping services, internal audit services, investment advisory and investment banking and management consultancy services. It has been noted that these services do create a bond between auditors and clients which raises the question of preservation of auditors' independence (Huyghe, 2017).

Accountancy firms can be classified as big or small (Big N and Non-Big N) according to the size of the firm. Earlier study by De Angelo (1981) has affirmed a positive relationship between big sized audit firms and auditor independence since Big N firm can suffer reputation loss in case of client misreporting (Krishnan, Ma & Yan 2015; Abid, Shaique & Anwar ul Haq (2018). Audit fees represent the monetary compensation the auditor receives from the company for which an audit is performed (Mautz & Sharaf, 1961; Huyghe, 2017). Barizah Abu Bakar *et al*, (2005) maintain that large audit fees are associated with a higher risk of damaging auditor independence.

The study is anchored by the agency and deep pocket theories. Agency theory maintains that the inability of shareholders to fully trust the management due to information asymmetry and the self-interest characteristics of the management make them put mechanisms in place to align the interests and reduce the problem of information asymmetry. The auditor with deep pocket is the one that has a lot of wealth which is an assurance for him to be independent and thus provide high audit quality.

The diagram below depicts the conceptual framework which shows the linkage between the dependent variable which is auditor independence and independent variables of audit firm attributes proxied by audit firm tenure and audit firm size. Provision of non-audit services and audit fees are control variables because the literature has shown that they also affect auditor independence.



From the empirical studies on tenure, Watts and Zimmerman (1983) opined that the as long as auditor tenure, the more dependent on clients the auditor will be which will result in the independence and objectivity of the auditor been dented. Similar findings by Adeniyi and Mieseigha (2013) in Nigeria show that the significant influence between audit firm tenure and audit quality was inverse (though not significant); meaning that shorter audit tenure promotes auditor independence and longer auditor tenure impaired the audit exercise. Okaro and Okafor (2013) and Okolie (2014) also document similar finding.

Over the years, there are a lot of debates between audit assurance exercises and others provided by auditor and audit services. Specifically, rendering of non-audit assurance exercise has been said to

create common interests between the audit firm and the client and this raises issue about the going concern of the auditor's independence (Huyghe 2017). Empirical evidence show that researchers differed in their views on the provision of non-audit services to audit clients. While some researchers see the provision of non-audit services to audit clients as independence impairing, others are of the view that it enhances auditor independence.

Some researchers believe that high fee paid to the auditor may encourage him to put his maximum efforts in conducting the audit and disclose material financial misstatements of his client. Those with this line of thought include Hope and Langli (2009) and Onaolapo, Ajulo and Onifade (2017). On the other hand, high fee paid to auditor may make him economically dependent upon his client and the auditor will be reluctant to disclose material misstatements, if any, of the client.

This study is therefore, designed to contribute to the understanding of the nexus between audit firm attributes and auditor independence since the independence of the auditor is at the heart of the auditing profession and anything that affects it is always of interest to the stakeholders.

Based on the forgoing the study hypotheses that:

Ho₁ Auditor tenure has no significant influence on the independence of auditors of listed manufacturing companies in Nigeria;

Ho₂ Audit firm size does not have any significant effect on the independence of auditors of listed manufacturing companies in Nigeria.

Methodology

This study adopts a cross-sectional descriptive research design using survey method with the aid of self-administered questionnaire. 28 listed manufacturing companies with operational base in Lagos constitute the population of the study. The sample size for this study is determined through a two-stage procedure. In the first stage, the sample size is computed by using the Taro Yamani method. This produced 26 manufacturing companies. Thereafter, three managers were randomly selected in each manufacturing company and as a result of this, a total of seventy-eight (78) research instruments were distributed in the selected companies. The analysis of the data was done by using both descriptive and inferential statistical techniques. Descriptive statistics used include tables, percentages, charts, ratios. The inferential statistics used is Partial Least Square (PLS) analytical method which is a variant of the structural equation model (SEM).

Model Specification

Variables for the study include one dependent variable, two independent variables and two control variables. The model for the study was adopted from the work of Omondi (2017) and thereafter amended to suit the purpose of this study. The model is presented thus:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon + \beta_4 X_4 + \varepsilon \dots \dots \dots (1)$$

Where:

Y is the dependent variable (auditors' independence),

β_0 is the constant of the regression model,

β_1 , β_2 , β_3 and β_4 are the coefficient of independent and control variables;

X_1 is audit firm tenure; X_2 is audit firm size; X_3 is provision of non-audit exercises; X_4 is audit fees. While ϵ is the error term.

Data Analyses and Discussion of Finding

The study administered seventy-eight(78)questionnaire to the respondents of listed manufacturing companies with headquarters in Lagos State. Out of this number, 74 questionnaires representing 94.9% were returned while 69 copies (88.5%) were found useable for analysis. The remaining 5 questionnaires (6.4%) could not be used and as a result were excluded.

Demographic Profile of the Respondents

The people sampled are represented by 43 men (62.3%) and 26 women (37.7%). This means that majority of the respondents are predominantly men that are spread in various departments. However, 49% of these people are in the accounting/finance department and since these are the people that the auditor interacts with the most, it is expected that they are in vantage position to understand those relationships that can affect auditor independence. The respondents are matured men and women of over 40 years of age. This suggests that they are matured enough to interpret the questions in the survey instrument and respond to them accordingly. In addition, most of the respondents (80%) are professionally qualified accountants while the remaining (20%) have post graduate certificates. The implication of this is that the respondents have a better understanding of the constructs in the questionnaire. Regarding length of service of the respondents with the company, over 60% of the respondents have spent more than 7 years in the company, meaning that they have substantial knowledge of company operations and are better positioned to understand those factors that affect independence either positively or negatively.

Convergent Validity

To establish convergent validity, factor loadings and cross loadings of the constructs as well as average variance extracted (AVE) were used. The rule is that both loadings and AVE should be 0.5 and above (Ahmad, *etal.*, 2016). The table below shows that the cross loadings and AVE values of all the latent variables and have been found to be more than the prescribed value of 0.5 and therefore establish convergent validity.

Table 1 Cross Loadings and Factor Loadings

	NAS	Audit fees	Size	Tenure	Independence	AVE
NAS1	0.925	0.914	0.962	0.805	0.943	0.796
NAS2	0.854	0.651	0.754	0.629	0.763	
NAS3	0.907	0.819	0.831	0.870	0.855	
NAS4	0.852	0.662	0.737	0.663	0.744	
NAS5	0.919	0.888	0.915	0.825	0.938	
Fees1	0.804	0.909	0.813	0.889	0.854	0.680
Fees2	0.575	0.764	0.679	0.573	0.656	
Fees3	0.890	0.911	0.866	0.814	0.916	
Fees4	0.625	0.693	0.644	0.629	0.638	
Size1	0.696	0.835	0.797	0.845	0.790	0.701
Size2	0.857	0.841	0.946	0.780	0.908	
Size3	0.770	0.659	0.805	0.531	0.729	

Size4	0.850	0.727	0.791	0.641	0.787	
Tenure1	0.727	0.820	0.737	0.945	0.787	0.693
Tenure2	0.538	0.642	0.532	0.712	0.548	
Tenure3	0.883	0.903	0.867	0.904	0.933	
Tenure4	0.722	0.557	0.598	0.745	0.677	
Independence1	0.759	0.847	0.769	0.871	0.831	0.690
Independence2	0.807	0.662	0.775	0.607	0.767	
Independence3	0.893	0.891	0.906	0.822	0.926	
Independence4	0.724	0.605	0.683	0.674	0.691	
Independence5	0.762	0.854	0.866	0.822	0.880	
Independence6	0.715	0.859	0.754	0.878	0.813	
Independence7	0.863	0.703	0.812	0.578	0.828	
Independence8	0.855	0.827	0.876	0.847	0.860	
Independence9	0.850	0.791	0.813	0.688	0.882	
Independence10	0.717	0.740	0.717	0.707	0.802	

Source: Author’s compilation, 2021

8. Discriminant Validity

The criterion and cross-loading scores of Fornell and Larcker (1981) were used to establish discriminant validity in this study. As a rule of thumb, Fornell *et al.*, (1981) suggested the use of AVE with a score of 0.50 or more. From the table below, all the cross loadings and AVE are greater than 0.5.

Table 2 Fornell-Larcker Criterion

	Audit Fees	Audit Tenure	Auditor's Independence	Firm Size	NAS
Audit Fees	0.825 (0.825)				
Audit Tenure	0.894	0.832(0.833)			
Auditor's Independence	0.942	0.907	0.830(0.831)		
Firm Size	0.918	0.841	0.963	0.837(0.8372)	
NAS	0.892	0.856	0.958	0.948	0.892(0.8922)

Source: PLS-SEM output, 2021

Internal Consistency Reliability

Composite reliability was used to measure internal consistency reliability because of the limitations of cronbach alpha as a measure of reliability. The composite reliability coefficient ranges between 0 and 1, where a higher value indicates a higher level of reliability. It is suggested that composite reliability values should be 0.70 or higher (Hair, *et al.*,2012). Since the composite reliability values are higher than 0.70 as shown in Table 3, the condition of internal consistency is met.

Table 3: Construct Reliability

Latent Variable	Code	Loading	Cronbach's Alpha	Composite Reliability	AVE	Discriminant and Convergent Validity
Audit Fees	fees 1	0.909	0.838	0.894	0.680	Yes
	fees 2	0.764				
	fees 3	0.911				
	fees 4	0.697				
Audit Firm Tenure	tenure1	0.945	0.847	0.899	0.693	Yes
	tenure 2	0.712				
	tenure 3	0.904				
	tenure 4	0.745				
Non-Audit Services	NAS 1	0.925	0.936	0.951	0.796	Yes
	NAS 2	0.854				
	NAS 3	0.907				
	NAS 4	0.852				
	NAS 5	0.919				
Audit Firm Size	size 1	0.797	0.855	0.903	0.701	Yes
	size 2	0.946				
	size 3	0.805				
	size 4	0.791				

Source: Author's compilation, 2021

Assessment of R-square (R²)

The predictive accuracy of the model was categorized as substantial, moderate or weak if the R² values are 0.75, 0.50 or 0.25 (Hair, *et al.*, 2012; Henseler, *et al.* 2009). In this study, the endogenous variable has R² value of 0.97 which means that 97% of the independent variables explained the dependent variable Auditors Independence (Table 4). This evidenced that the structural model developed in this study has strong predictive relevance.

Table 4: (R²)

	R Square	R Square Adjusted
Auditor's Independence	0.970	0.968

Source: PLS-SEM output, 2021

11. Effect Size (F²) Assessment

F² Size effect shows the impact of a specific predictor latent variable on the construct variables. According to Cohen (1988), the impact is small, medium or large if the f² values are 0.02, 0.15 or 0.35 accordingly. The f² for this study is shown in the table below.

Table5 Effect Size (F²)

Table 5: Effect Size (F²) Assessment

I	Variable	f ²	Decision
1	fees	0.106	Small
2	Auditor tenure	0.242	Medium
3	firm size	0.323	Medium
4	provision of audit and non-audit services	0.247	Medium

Source: PLS-SEM output 2021

12. Predictive Relevance (Q²)

The Q² is a criterion for measuring how well a model predicts the data of omitted cases (Hair *et al.*, 2014). According to Henseler, *et al.*, (2009), a research model with Q² statistic(s) greater than zero is considered to have predictive relevance. In addition, a research model with higher positive Q² values suggests more predictive relevance.

Table 6:Q²

	Audit Fees	Audit Tenure	Auditor's Independence	Firm Size	NAS	Q ²
Audit Fees			0.106			0.234
Audit Tenure			0.242			0.342
Auditor's Independence						
Firm Size			0.323			0.432
NAS			0.247			0.238

Source: PLS-SEM output, 2019

13. Structural Model

Assessment of the structural model was designed to estimate and test the relationship that exist between latent independent variables (audit fees, audit firm tenure, non-audit services and audit firm size) and dependent variable (auditor independence). The result of the structural model in table 7 below reported the estimation parameters that were used to test the hypotheses.

Table 7: Total Effects and Decision table

Hypothesis	Path	Path Coefficient	Standard Error	t-Statistic	P-value	Decision
H ₀₄	Audit Fees → AI	0.173	0.065	0.139	0.232	Accepted
H ₀₁	Audit tenure → AI	0.200	0.067	3.7456*	0.001	Rejected

H ₀₂	Firm size → AI	0.362	0.034	4.672*	0.002	Rejected
H ₀₃	NAS → AI	0.289	0.013	2.814*	0.000	Rejected

$\alpha = 0.05$

Discussion of Findings

From the empirical analysis conducted, audit firm tenure has a positive and significant impact on the independence of auditors of listed manufacturing companies in Lagos. The PLS result showed that $\beta = 0.200$; $t = 3.7456$; $p = 0.001 < 0.05$. This result indicates that listed manufacturing companies with headquarters in Lagos, Nigeria perceive long term relationship with their auditors as an impairment of auditor independence. As a result of this, the alternative hypothesis accepted. This finding is in line with that of Moré and Berg (2016); Yip and Pang (2017) and Hamuda (2018). It also supported by the agency theory.

The second objective deals with how audit firm size could significantly influence the independence of auditors of listed manufacturing companies in Nigeria. Result of the empirical study revealed that audit firm size has a positive and significant effect on the independence of auditors of listed manufacturing companies with head offices in Lagos, Nigeria. The PLS result showed that $\beta = 0.289$; $t = 2.814$ and $p = 0.000 < 0.05$ which mean that the respondents see size of audit firm as significantly affecting the independence of their auditors positively. Therefore, the alternative hypothesis is accepted. The finding, which is in line with those of Krishnan, Ma and Yan (2015) and Choi, Lim and Mali (2017) is supported by the deep pocket theory which sees large audit firms as having enormous wealth which make it easy for them to resist client pressure in conflict situations.

Result of the first control variable showed that the joint provision of audit and non-audit services has positive and significant effect on the independence of auditors of listed manufacturing companies with head office in Lagos, Nigeria. The PLS result showed that $\beta = 0.289$; $t = 2.814$; $p = 0.000 < 0.05$. This result being significant at 5% level of significance means that provision of non-audit services also has implication on auditor independence.

For the second control variable, result show a positive but insignificant relationship between audit fee and independence ($\beta = 0.173$; $t = 0.139$; $p = 0.232 > 0.05$). However, the fact that the result is statistically insignificant means that the effect of this variable on auditor independence cannot be confirmed. It also means that the result is inconclusive meaning that it cannot be predicted whether audit fees affect auditor independence or not.

Conclusion

The study found that auditor tenure exhibited a significantly strong impact on independence and as a result, the study concluded that an unduly long relationship between the auditor and client management that is not maintained at arm's length could create familiarity threat which can impair auditor independence. The study, based on the empirical finding also concludes that listed manufacturing companies should continue to engage international audit firms like the Big 4 audit firms and/or big national firms (either as sole auditor or as joint auditors) that are known to possess deep pockets and at the same time have the capability to withstand unnecessary pressures from client management.

Recommendations

Based on the findings of the study, the following recommendations are made with the aim of ensuring that audit firm attributes strengthen auditor independence in listed manufacturing companies in Nigeria.

(i) The rules of professional bodies and relevant government regulations on auditor tenure should be respected by auditing firms. Appropriate penalties should be stipulated for noncompliance and this should be strictly enforced.

(ii) In accordance with the finding of the study that audit firm size enhance auditor independence, the study recommends that professional accountants that are given license to practice be encouraged to come together and register their practice as partnerships rather than going into practice as sole practitioners.

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