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Diana Mostafa Mohamed Magda Hussien Habib

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Auditor independence, audit quality and the mandatory auditor rotation in Egypt

Diana Mostafa Mohamed

*Department of Accounting, The German University in Cairo,
Cairo, Egypt, and*

Magda Hussien Habib

Faculty of Commerce, Ain Shams University, Cairo, Egypt

Abstract

Purpose – The purpose of this paper is to introduce the problem of the lack of auditor independence in the Egyptian context, how it might affect the audit quality, through assessing reasons behind the voluntary switching of auditors, whether this switch is in the side of improving audit quality or not and the suggestion of the mandatory auditor rotation as a solution to such a problem.

Design/methodology/approach – The paper's findings are based on a survey analysis. The survey is done through a questionnaire created by the researcher (author) from the literature and distributed among audit practitioners from the Big Four audit firms operating in Egypt.

Findings – The problem of lack of auditor independence exists in Egypt due to many reasons. The main reason is the poor structure of corporations of being closely held. It was also found that the voluntary switching of auditors are for purposes improving the quality; from these reasons is the search of more reputable auditors and timelier audit opinions. Finally auditor rotation was suggested by the practitioners in order to overcome the problems of lack of independence and that the mandatory firm rotation is suggested instead of the mandatory partner rotation.

Practical implications – The mandatory audit firm rotation in different countries had some positive effect on audit quality. The application of mandatory rotation in the Egyptian context where there the problem of the lack of auditor independence is really clear is suggested so as to overcome the consequences of the independence problem and improve the audit quality.

Originality/value – This research work tries to dig more into the Egyptian context as a developing country regarding the threats to the auditing professionals in terms of the causes that might be impairing their independence as well as assessing the applicability of the mandatory rotation practice in Egypt.

Keywords Auditor independence, Audit quality, Audit rotation

Paper type Research paper

1. Introduction

The audit quality is one of the most significant topics in the auditing profession. If the auditor is able to detect and report on the existing material misstatements, the audit process is considered of a higher quality. What might hinder the auditor's ability to perform at a high level of conduct to provide a high quality is the extended auditor client relationship (Vanstraelen, 2000; Hamilton *et al.*, 2005).

A sound solution that has been proposed and applied in different countries to overcome the problem of the lack of auditor independence is the mandatory auditor rotation. The mandatory rotation practice imposes on every listed company to change



its audit firm or at least its audit partner after a certain period of time (Arel *et al.*, 2005). Changing the auditor is necessary and even required by law in different countries for mainly two reasons; first, in order to maintain the auditor independence which otherwise would be eroded due to the personal attachments between the client. Second, is to enhance the audit quality through promoting the creativity in audit testing approaches and methods which might be restricted due to increased familiarity with the client and staleness in performing the audit (Carey and Simnett, 2006).

Egypt is experiencing the lack of auditor independence due to some deficiencies in the Egyptian Auditing Standards (EAS) and due to other reasons such as the lack of existence of professional organizations for promoting the auditing profession in Egypt and that most of the companies operating in Egypt are closely held (Wahdan *et al.*, 2005a, b).

The main questions this paper intends to answer involves discussing; what are the main reasons for the lack of independence problem in Egypt, what are the suggested solutions to overcome such a problem, whether the audit tenure (extended auditor client relationship) improves or deteriorates the audit quality, what are the main reasons that force clients to voluntarily change their auditors in Egypt, and finally if the mandatory rotation to be applied in Egypt, what is the suitable form of the rotation that would suit the Egyptian economical environment. These questions were answered using a survey distributed among audit practitioners in Egypt and the results were analyzed using the SPSS.

In the next section, the paper will present the literature review concerning two main aspects; the auditor rotation and the audit quality including the discussion of the reasons for the lack of independence problem in Egypt. The following section then will discuss the model and the hypotheses used, followed by the data analysis and findings, then finally the conclusion.

2. Auditor independence and the impact on audit quality

The auditor independence is the cornerstone of the auditing profession. It is defined as the refusal of the auditor to support any detected misstatements and standing against client's attempts to influence his/her audit report (Nichols and Price, 1976; Lu, 2005). The American Institute for Certified Public Accountants (AICPA) in its code of ethical conduct which revolves about the idea that an auditor has a primary responsibility towards the public; in its fourth principle, it states that objectivity and independence should be maintained by the auditor and that independence should be exercised both in fact and in appearance while providing an audit or any other attestation service (Collins and Schultz, 1995). When the auditor is regarded as being independent, the public will be more confident in the financial information thus helping taking right financial decision (Ghosh and Moon, 2004; Cameran *et al.*, 2005).

An auditor should be regarded as independent both in fact and in appearance (Raiborn *et al.*, 2006) where independence in fact represents the state of mind that refers to the factors of integrity, objectivity and professional judgment (Cameran *et al.*, 2005), while the independence in appearance represents the external assessment made by the public about the auditor (Raiborn *et al.*, 2006). Actually, independence in fact can neither be seen nor judged by the public, but it can only be evaluated through the independence in appearance level of the auditor (Lindberg and Beck, 2004; Ghosh *et al.*, 2005).

Auditor's independence in appearance can be affected by factors such as the ownership of direct or indirect material investment in a client firm, the hiring of the

auditor or any of his direct family members in key financial positions at the client's, the provision of book keeping services or other management advisory services (MAS) along with audit services at the same time for a client, and finally the provision of any audit services to a client with whom a lawsuit is being processed in court (Elder *et al.*, 2008). Despite, that these previous can strongly affect the perception of auditor's independence from the public's point of view especially the investors, the auditor independence in appearance can be easily maintained through forcing some regulations such as those imposed by the Stock Exchange Commission (SEC). In January 2003, the SEC has enforced the Sarbanes Oxley Act (SOX) which bans the auditor from having any direct or indirect material financial interest in the client's company, in addition to banning the provision of some services as brokerage and consulting services (Elder *et al.*, 2008).

On the other hand, independence in fact or the actual independence can hardly be maintained for some reasons. From these reasons, is the unconscious bias of the auditor to the client especially due excessive familiarity and long term attachment, which hinders the auditor from doing any harm to the client especially if there is a self interest or a financial bond such as the provision of MAS in addition to the audit (Barret, 2001; Umar and Anandarajan, 2004; Ainsworth, 2006). Also the discounting factor where the foreseen consequences is the strongest factor affecting auditor's current judgment such as the loss of engagements or the damage of relationship between client and management. The auditor sees that such consequences are near while the loss of reputation, disciplinary proceedings are distant. That is why he might sacrifice the far loss for the delayed one (Barret, 2001). Also the self review, where the auditor was previously an employee in a position at the client that has an effect on the financial statements currently being audited. Was, thus he is unable to report material misstatements; he originally had been responsible for one day (Ainsworth, 2006). Finally is the escalation factor where people usually hide minor mistakes until they are converted to fraud, the unconscious bias would force the auditor to accept immaterial misstatements in the financial statements but over time, such misstatements grow material, yet by that time, the correction of such misstatements requires either the re-issuance of the financial statements or the auditor's resignation (Barret, 2001). However, auditors could conceal and hide such fraud as it is possible that people might conceal without knowing (Pritchard, 2005).

Actually, the lack of auditor independence in fact (due to the long term attachment, whether financial or psychological) would be the main reason behind deteriorating the audit quality because it would hinder the auditor from carrying out his basic responsibility in being able to detect and report the material misstatements in the client's financial records (Kim *et al.*, 2007), thus increasing the information asymmetry between the management and the shareholders allowing non GAAP reporting practices such as the earnings management practices, and becoming less motivated in issuing going concern opinions (Kim *et al.*, 2007).

3. Auditing in Egypt

The auditing profession in Egypt has started in the 1942 by the Law No. 52, when the State Audit Bureau was established to audit the revenues and expenditures of the public sector. In 1951, the Accounting Practice Law No. 133 was issued which had regulated the auditing for private businesses. Later on, in 1964, after the public sector has expanded due to the nationalization of major enterprises and according to the Law No. 129,

the Central Auditing Organization (CAO) of Egypt was established (CAO, 1995). Also in 1946, the Egyptian Society of Accountants and Auditors (ESAA) which has an important role in the accounting profession and a member of the International Federation of Accountants (IFAC) since 1983, was established (Samaha and Hegazy, 2010).

The CAO is an independent organization attached to the parliament that helps the citizens to control the stock funds as well as the funds of the public entities. It is responsible for performing three types of audits; first is the financial audit which includes the examination of the integrity of records and accounts as well as the legality of transactions undertaken by governmental entities. Second, is the performance audit which focuses on the follow up of the implementation of the national plan through focusing on evaluating the efficiency and the effectiveness of the operations of public entities. Finally is the legal audit, which focuses on the examination of actions, taken by the entities regarding the violations of its members in order to safeguard the public property and funds (CAO, 1995). Later on in 1981, the Company Law No. 159, was enacted to require all listed companies to maintain separate, proper accounting records from those of their owners and to have an annual external audit at the end each fiscal year. The act also called for an annual meeting with the auditor to have his performance evaluated by the shareholders and decide whether his engagement should be renewed or he should be rotated (Wahdan *et al.*, 2005a, b). This act also requires auditors to report whether the company is maintaining proper accounting records, all legal requirements was applied to the accounts and financial statements fairly present the entity's financial condition and reflect the result of his operations. This company act also stresses on sustaining the auditor's independence and preserving the public rights through requiring an auditor who conducts an external audit for a listed company should not to assume the role of a founder, a director or even an employee with the auditee or to be bound by any other beneficial contract with him (Wahdan *et al.*, 2005a, b).

4. Audit quality and the problem of lack of independence in Egypt

Audit quality is defined as:

[...] the probability that an auditor will both discover and report a breach in the client's accounting system. Although, the probability of discovering a breach depends on auditor's technical capabilities, the probability of reporting of the errors depend on the degree of the auditor's independence (Vanstraelen, 2000; Deis and Giroux, 1992; De Angelo, 1981).

This follows that a high audit quality audit refers to the high independence of the auditor proved through his strong ability to inform the public about the embedded business failures of the company, or those which may appear in the short run (Lennox, 1998).

Actually in Egypt there are many factors that can cause the lack of auditor independence, which might have a negative impact on the audit quality. From these reasons, first, is that the auditors' work and practice is not governed through a code of ethics in Egypt. Although the Syndicate of Law No. 40 for the year 1972 had discussed and highlighted the legal requirements especially those concerning fraud, some auditors and accountants ignore this code (Wahdan *et al.*, 2005a).

Second, the ESAA which should be responsible for promoting the profession neither has the authority to give a license to auditors for public practice nor does it issue auditing standards to guide the public accountants. It also does not test whether its members comply with the international or local ethical conduct standards or code of

ethics, thus there are no available measures to prevent or detect corruption (Samaha and Hegazy, 2010).

Third, there is no separation between the auditing and the other MAS, that auditors are sometimes hired as tax advisors and go more for tax minimization than for ensuring that sound accounting policies are adopted (Wahdan *et al.*, 2005a). Even more, auditors are sometimes involved in preparing the financial statements and the accompanying footnotes as well as taking important decisions related to year-end accounts on behalf of their audit clients (Samaha and Hegazy, 2010).

Fourth, the auditors should normally be paid and hired by the shareholders; however in Egypt, auditors suffer from the problem of closely held companies where the shareholders assume the role of the management. This problem leaves the auditor faced with the conflict of interest between his fairness and the audit fees (Wahdan *et al.*, 2005b). This is in addition to that the directors of some companies invite the auditors to attend the regular meetings of the board of directors (BOD) and receive compensations after the end of each meeting (Wahdan *et al.*, 2005a). Fifth, auditors do not have to take any qualifying exams before registering in the accountants' registry (Samaha and Hegazy, 2010).

Finally, from a comparison which was made between the Generally Accepted Auditing Standards (GAAS) and the EAS, it was found that the latter lacks very important basics that exist in GAAS for enhancing the auditor independence. In the EAS, the auditor's report is titled "The Auditor's Report" without any reference to the degree of independence of such an auditor. This actually is opposed to the GAAS which requires the stating of the word "independent" to stress on the auditor's fairness, objectivity and un-biasness. Also, according to the EAS, the auditor report could be addressed to the BOD, investors, stockholders or to the management. However, in the GAAS, the auditor report should not be addressed to the management (except in the case of an internal audit) as this opposes the independence criteria that should be considered by the auditor. Finally, concerning the issuance of a disclaimer audit opinion; in the EAS, an auditor can disclaim his opinion either when there is a scope restriction on the auditor's work either by the client or by circumstances (Hamed, 2008; Arens *et al.*, 2008). However, a very important reason which is absent in the EAS, though stated as one of the disclaimer conditions in the GAAS, is the lack of auditor independence; such as having a direct financial interest in the auditee, having a post or providing a MAS to the auditee (Arens *et al.*, 2008).

In order to overcome the problem of the lack of auditor independence and to improve the audit quality, the auditor rotation practice is suggested in the Egyptian context for many reasons. First, given the structural changes in the market for audit services, it is beneficial for rotation to be adopted especially in markets with relatively few new client opportunities (thin audit market) which is the case in Egypt. The adoption of rotation is economically desirable since the improved incentives for independence outweigh the additional cost associated with understanding of a new client's system upon rotation (Wahdan *et al.*, 2005a, b). Second, to conform to international acts of auditing, e.g. Sarbanes Oxely Act 2002 especially that most of the large audit firms in Egypt have international partners, e.g. KPMG and Hazem Hassan or PricewaterhouseCoopers (PwC) and Mansour (Wahdan *et al.*, 2005a, b). Finally, to eliminate or reduce conflict of interest that may occur in the Egyptian market due to many factors such as weakness of communications with shareholders, lack of disclosure practices, shareholders can be hired as auditors (Wahdan *et al.*, 2005a, b).

5. The auditor rotation and the effect on audit quality

The idea of the auditor rotation was first introduced and discussed in 1976 (Hoyle, 1978). Auditor rotation can either be mandatory or voluntary. The mandatory rotation pushes firms to change their auditors after a fixed duration (Lu, 2005) while the voluntary rotation is the optional switching of the auditors (Davidson *et al.*, 2005). Actually mandatory rotation could be either through the audit-firm rotation which requires listed companies to change or rotate their audit firms after a specific period of time (almost five years) or through the audit-partner rotation instead, which requires listed companies to change or rotate their audit lead partner who is responsible for the audit decisions on the engagement after a specific period of time (Arel *et al.*, 2005; Orin, 2008). On the other hand the voluntary rotation is mainly based on the management decisions and choice regardless of time (Davidson *et al.*, 2005). Though the SOX 2002 of the USA is most famous, many countries has applied the auditor rotation practice such as Austria, Japan, Singapore, Taiwan, France, Brazil, Spain and many other (Cameran *et al.*, 2005; Sori and Karbhari, 2005).

Proponents of the auditor rotation see that the mandatory rotation first, bounds opinion shopping practices by limiting its opportunities (Lu, 2005). Second, the rotation also provides a new insight to the client's financial statements (Davis *et al.*, 2009; Raiborn *et al.*, 2006) since the auditing practice is based on employing professional skepticism and the long term attachment with the client and working for long years for the same client can reduce the sharpness of his professional judgment (Wolf *et al.*, 1999; Nagy, 2005). Third, the mandatory rotation helps in enhancing the competition in the audit market, thus small companies (non Big Four) are encouraged to grow and develop more niche specialization as the rotation puts all audit firms on the same level and gives them equal opportunities (Raiborn *et al.*, 2006).

Finally it was found that both auditors and clients suffer great losses in case of an audit failure and that the cost of auditor rotation would be less than the cost of excessive litigation and loss of reputation resulting from such audit failures (Cameran *et al.*, 2005; Jackson *et al.*, 2008).

On the other hand, opponents to the auditor rotation found that first; the rotation is of no use, since the excessive litigations that could be faced by the auditor would force them to struggle to preserve their reputation (Davis *et al.*, 2009). Second, mandatory rotation will increase the switching and start up costs to both the auditors and the clients than with existing clients due to the creation of the learning curve (Davis *et al.*, 2009). As a result auditor fees charged by the auditor will increase, so as to absorb the high cost of audit, thus the cost increases for the client as well (Wolf *et al.*, 1999; Johnson *et al.*, 2002). Finally, auditors normally interact with the company's management daily during the audit process; an issue that makes them more attached to them regardless the audit tenure (Arel *et al.*, 2005).

It could be inferred that the main debate raised around the auditor rotation is whether it improves or deteriorates the audit quality. The proponents of the auditor rotation concept see that the main purpose of the rotation is that the auditor tenure can negatively impact the audit quality where the auditor tenure increases the auditor lack of independence and the auditors become lax in their audit of a company's financial reporting (Kim *et al.*, 2007; Lu, 2005). Also a financial bond is created where the client is changed to be a source of a continuous (perpetual) annuity to the auditor. Therefore, if the rotation is mandatory and the auditor knows that he will not be sustained forever,

the present value of expected future benefits from the auditor-client relationship to the auditor decreases thus reducing incentives for dependency and non-objectivity (Ghosh and Moon, 2004; Schelker, 2007; Wolf *et al.*, 1999; Raiborn *et al.*, 2006; Jackson *et al.*, 2008; Nagy, 2005; Davis *et al.*, 2009). Moreover, after the application of the SOX 2002 which imposed the rotation of the auditor every five years, it was found that non GAAP earnings management practices had considerably declined (Davis *et al.*, 2009).

On the other hand, the opponents to the rotation found that rotation would reduce the audit quality. Actually, the auditor tenure would positively affect the audit quality, that an audit failure would occur more for new clients due to having less information about such clients. That is why it is said that the auditor independence and thereafter the audit quality increases as auditor experience increases over time and as he becomes more acquainted with the client's system (Ghosh and Moon, 2004).

6. The model and the hypotheses

There are different measures or as called proxies of the audit quality. In this paper, six different proxies will be used, these are: the audit report, the audit report lag (ARL), the auditor experience, the auditor reputation, the auditor fees and the level of earnings management. These factors were chosen as they are the most widely used in the literature and the mostly used in empirical studies of assessing the impact of the rotation on the quality and the most relevant and covering all the other factors as well (Jackson *et al.*, 2008; Lennox, 1998; Geiger and Raghunandan, 2002; Meyer *et al.*, 2007; Lowensohn *et al.*, 2007; Knechel *et al.*, 2007; Roberts *et al.*, 1990; Gul *et al.*, 2007; Ghosh and Pawlewicz, 2008; Davidson *et al.*, 2005).

6.1 Auditor report

A company's financial statements are considered the means to communicating and passing financial information to a third party. Although it was proved that when the tenure increases, the auditor's judgment is improved to give the appropriate audit opinion (Carey and Simnett, 2006; Jackson *et al.*, 2008), some companies might still voluntarily rotate their auditors. It was found that managers rotate their auditors in order to avoid the receipt of a qualified opinion. However, if the auditor accepts to give a clean report he will not be rotated, but if the incumbent auditor is more likely to provide a qualified opinion, the client might terminate the engagement (Jackson *et al.*, 2008; Vanstraelen, 2000; Lennox, 1998). In addition it was also argued that there was no relation between the extended auditor tenure and the removal of a going concern qualification from the audit opinion that means that neither the auditor's judgment nor his independence would be affected by the tenure (Meyer *et al.*, 2007; Knechel and Vanstraelen, 2007).

In this paper the audit opinion is considered an indicator of the audit quality if the auditor was successful in issuing the appropriate audit opinion. However, the appropriate audit opinion sometimes might not be appreciated by the company management if it includes a qualification. Thus, they decide to switch their auditor searching for another one who might give them an unqualified opinion, thus the first hypothesis is developed:

H_1 . The auditor will be rotated if he did not issue a standard unqualified audit opinion.

6.2 Auditor's reputation

The auditor reputation is important for the audit quality that reputable auditors perform a high quality audit and their audit opinion concerning the appropriateness of the financial statements is more reliable (Krishnamurthy *et al.*, 2006). When a sample of Arthur Anderson (AA) clients were investigated as whether the auditor's reputation impacts the market perception of audit quality, it was found that the decreased reputation means the impairment of the auditor independence which will adversely affect the audit quality. When the firm announced that AA is replaced by one of the non Big Four, the market return was negatively affected which in return had affected the company's value and stock price (Krishnamurthy *et al.*, 2006). Also it was found that the Big Four have more tendency to report earnings misstatements as it was found that Big Four report more frequent accounting irregularities and financial reporting malpractices than non Big Four (Davidson *et al.*, 2005).

In this paper, the auditor reputation is considered a measure of the audit quality, as the reputation increases, the audit quality increases. Thus, a client company which wants to promote the audit quality would change from a less reputable audit firm to a more reputable audit firm:

H_2 . The auditor will be rotated if it is a non Big Four audit firm.

6.3 Auditor experience

It was found that the brand name (high reputation) of an audit firm is not enough to promote the audit quality, but the industry knowledge and specialization is an important part of the auditor's experience. As the auditor's knowledge and experience with a client's industry increase, the auditor is more able to detect potential material misstatements and to put basis and hypotheses for industry specific routine errors (Knechel *et al.*, 2007). Moreover, it was found that the auditor's experience in detecting material misstatements decline when they spend longer tenure with their clients, that they rely on their previous experience with the client rather than exerting more effort (Meyer *et al.*, 2007), an issue that would suggest the mandatory rotation as a solution to overcome auditor staleness.

Since the auditor's experience is an indicator of a high quality as it increases, in this paper it is assessed whether a client company will switch to a more experienced one in order to promote the audit quality. This is hypothesized as follows:

H_3 . The auditor will be rotated if he has few years of experience in the client's firm industry (i.e. specialized in the client's business).

6.4 Earnings management

Earnings management is the choice of the adoption of certain accounting policies in order to achieve managers' specific objectives. Such earnings are considered of poor quality if they do not give a true image for the company's value and financial position. The main factor affecting the level of earnings management practice is the auditor tenure. It was found that there is a negative relation between the auditor tenure and the extent of the earnings management practices, that the longer the auditor tenure, the more familiar the auditor is with the clients' reporting systems, thus the more material misstatements or unexplained adjustments in the financial statements are detected (Ebrahim, 2001).

However, on the other hand, it was found that sometimes there is a positive relationship between the auditor tenure and the level of earnings management, that when the auditor tenure increases, his independence is impaired due to the excessive familiarity and personal attachment with the client. In addition, this would make the auditor's work more routine and systematic, as he would devote less effort in detecting the material misstatements and the irrelevant reporting practices. Supporting to this, it was found that the auditor is more likely to detect material misstatements in earlier years of the engagement, then such capability decreases gradually for the following twenty years of engagement (Piot and Ganin, 2005; Davis *et al.*, 2000).

In this paper, the degree of allowance of earnings management practices is used as a measure of quality. As due to the repeated bankruptcies being suffered by many companies in Egypt as well as what had been previously stated that the focus of auditing in Egypt is tax minimization rather than mere compliance of accounting principles which are against earnings management practices, when the auditor allows more earnings management practices which are favored by the client company, the audit quality is said to be impaired as the auditor is not following the consistent application of GAAP. Thus, it is assessed from the following hypothesis, as whether the auditor will be changed if he/she did not approve such practices:

H₄. The auditor will be rotated if he did not approve the client's reporting practices.

6.5 Audit report lag

The ARL is defined as "the period from the company's year end date to the audit report date" (Lai and Cheuk, 2005; Krishnan and Yang, 2009). It was found that there is a negative relationship between the value of the financial statements to the investors and the time taken to prepare them (Lai and Cheuk, 2005). Although the delay in filing the company's financial statements would be an indicator of low quality of financial and audit reporting, sometimes the auditor needs more time for assessment. This reflects that when the auditor is more independent, he is more devoted with time and effort to detect material misstatements and that would lead to a longer ARL (Scholozter, 2006).

In this paper, due to the importance of the audit report timeliness to the investors for effective investing decision making, it is assumed that a will the company try to switch its auditor who provided less timely opinion to those who would provide a timelier audit opinion; this is reflected in the following hypothesis:

H₅. The auditor will be rotated if he produces an ARL.

6.6 Auditor fees

There are many reasons that cause a positive relationship between the auditor fees and the audit quality. Actually more investigation and audit procedures will require more audit hours, higher cost due to the use of more experienced and specialized staff thus, higher audit fees (O'Sullivan, 2000; Ghosh and Pawlewicz, 2008). On the other hand, large audit fees paid by the client make the auditor more economically dependent on the client, thus it forces the auditor to be more reluctant in inquiring the client during the audit as fearing from losing him. After the SOX, total fees to audit firms have increased indicating that total revenues from audit clients would increase after the SOX rotation decision. That is actually due to the increased litigation an auditor would

be exposed to, consequently, the auditor will exert more effort and time and this will dictate on him increasing his audit fees required and thereafter, the quality (Ghosh and Pawlewicz, 2008).

However, based on the poor and deteriorating economic conditions in Egypt, a client company might decide to switch its auditor if he/she required high fees. This is reflected in the following hypothesis:

H_6 . The auditor will be rotated if he requires large audit fees.

7. Methodology and sample

A self-made questionnaire has been used in this paper and distributed among auditors in Egypt to know their evaluation concerning the current practice of the voluntary rotation of the auditors and whether it is for the improvement of the audit quality. This questionnaire's reliability was tested using Cronbach's α coefficient and was determined to be 0.625 suggesting a good internal reliability of the questionnaire. This is in addition to assessing the extent of the lack of auditor independence problem in Egypt and the extent of the feasibility of the application of mandatory rotation as well as the suitable type of the mandatory rotation to be applied. The questionnaire is designed based on the Likert scale model with five columns of choice; "strongly agree", "agree", "neutral", "disagree", "strongly disagree" (1) represents strongly agree and (5) represents strongly disagree.

The questionnaire was distributed among 50 auditors who were randomly selected from two of the big Four audit firms in Cairo, Egypt. The two firms were PwC and Ernest & Young. Of this sample, only 31 replied representing 62 percent response rate.

8. Findings and data analysis

Impact of the long audit tenure

The frequencies in Table I show that 82.2 percent of the participants agree and strongly agree that as the auditor spends more years auditing the same client, the audit quality is improved. On the other hand, only 17.8 percent of the participants agree and strongly agree that the long audit tenure negatively affects the audit quality. From the mean results, it could be concluded that the long tenure increases the audit quality as it has an average of 2.0. While, the majority was disagreeing towards the concept that the extended tenure deteriorates and decreases the audit quality as its mean was approximately 3.36 (Figure 1).

The reasons for lack of auditor independence in Egypt

From Table II, it was found that more than 50 percent of the participants agree and strongly agree that the reason of the lack of auditor independence is that companies operating in Egypt are closely held. Also it was found that 56 percent of the participants agree and strongly agree that the lack of a code of ethics would be a cause for the lack of independence problem in Egypt. It was found that 71 percent agree and strongly agree that it was the shortage in existence of professional organization. Also 36 percent agree and strongly agree that the management's authority in being able to hire and fire auditors is a reason for the lack of independence in Egypt. However, it was found that 48.1 percent agree and strongly agree that the provision of non-audit services or the provision of MAS would impair the auditor's independence. Finally, 71.4 percent of the participants agree and strongly agree that having financial interest in the client's

Table I.

Long audit tenure increases audit quality			Long audit tenure decreases audit quality		
	Rank	Frequency percentage	Rank	Frequency percentage	
Valid	29		28		6.5
Missing	2		3		9.7
Mean	2.0000		3.3571		29.0
SD	1.10195		1.06160		35.5
Skewness	1.548		− 0.596		9.7
SE of skewness	0.434		0.441		90.3
			Total		9.7
			Missing system		100.0
			Total		

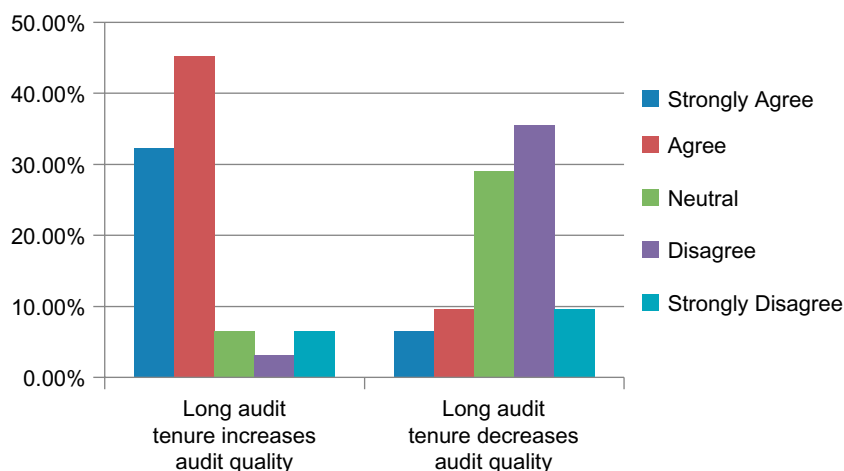


Figure 1.
The impact of long audit
tenure on audit quality

company affects the auditor's independence. From the mean analysis in Table III to investigate and rank the six suggested causes selected from the literature, it was found that the most agreed upon by the majority was the lack of professional organizations with a mean of 2.19. Second, comes the problem that most of the companies operating in Egypt are closely held with a mean of 2.36. Next in the rank is the lack of the code of ethics problem with a mean of approximately 2.40. Fourth in rank is having financial interest in the client's company with a mean of 2.62. The fifth cause in rank was the provision of non-audit services which had an average of 2.81. Finally was the problem of hiring the auditor with an average of the answers of 2.84 (Figure 2).

The best ways to enhance the auditor independence

From Table IV, 83.4 percent of the participants agree and strongly agree that changing the auditors after a set of years would be the best solution enhancing the auditor independence. The data also revealed that exactly 72.4 percent of the participants agree and strongly agree that creating a threat to the auditor by increasing the litigation against him would be the best solution to enhance the auditor independence. 62.1 percent of the participants agreed and strongly agreed that to enhance the auditor independence, it would be a good solution if the auditor is to be elected and selected by the company's shareholders. Finally, 68.2 percent of the participants agreed and strongly agreed to ban the provision of the MAS as a solution to improve the auditor independence. Using the mean analysis in Table V, it was found that the best solution to enhance and help in sustaining the auditor independence out of the four suggested solutions was the auditor rotation with a mean of 1.96. Second ranked was increasing the litigation solution, with an average of 2.2. Third, comes the election-selection process as a solution of the auditor independence with an average of 2.41. Finally, with the least mean of 2.48 was the ban of MAS solution it had the least agreed upon solution by the participants. This indicates that the rotation as a solution for independence would be highly supported by the auditors as the larger portion of the sample is supporting it (Figure 3).

Table II.

Valid (%)	Independence problem is due to closely held companies	Independence problem is due to lack of code of ethics	Independence problem is due to lack of professional organizations	Independence problem is due to hiring by management	Independence problem is due to the provision of non audit services	Independence problem is due to having financial interest
Strongly agree	12.9	19.4	25.8	6.5	16.1	19.4
Agree	32.3	29.0	45.2	22.6	25.8	29.0
Neutral	29.0	22.6	12.9	29.0	9.7	22.6
Disagree	6.5	16.1	16.1	22.6	29.0	12.9
Strongly disagree	0	0	0	0	6.5	9.7
Total	80.6	87.1	100.0	80.6	87.1	93.5
Missing system	19.4	12.9	0	19.4	12.9	6.5
Total	100.0	100.0	100.0	100.0	100.0	100.0

	Independence problem due to lack of code of ethics	Independence problem due to lack of professional organizations	Independence problem due to hiring by management	Independence problem due to provision of non audit services	Independence problem due to having financial interest	Independence problem due to closely held companies
Valid (n)	27	31	25	27	29	25
Missing	4	0	6	4	2	6
Mean	2.4074	2.1935	2.8400	2.8148	2.6207	2.3600
SD	1.04731	1.01388	0.94340	1.30198	1.26530	0.86023
Skewness	0.156	0.611	-0.304	0.031	0.447	0.046
SE of skewness	0.448	0.421	0.464	0.448	0.434	0.464

Table III.

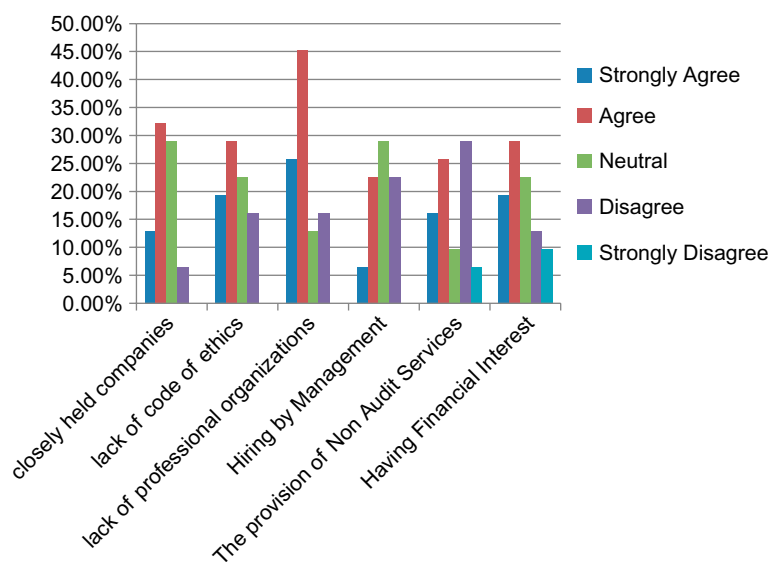


Figure 2.
Reasons behind
lack of auditor
independence
in Egypt

Table IV.

Valid (%)	Apply rotation	Increase litigation	Election-selection process	Ban MAS
Strongly agree	25.8	4	19.4	16.1
Agree	54.8	17	38.7	32.3
Neutral	12.9	6	19.4	29.0
Disagree	0	2	9.7	16.1
Strongly disagree	3.2	0	6.5	0
Total	96.8	29	93.5	93.5
Missing system	3.2	2	6.5	6.5
Total	100.0	31	100.0	100.0

Table V.

Valid	Apply rotation	Increase litigation	Election-selection process	Ban MAS
Valid (n)	30	29	29	29
Missing	1	2	2	2
Mean	1.9667	2.2069	2.4138	2.4828
SD	0.85029	0.77364	1.15007	0.98636
Skewness	1.508	0.608	0.756	0.051
SE of skewness	0.427	0.434	0.434	0.434

The frequency of auditor rotation

From Table VI, it was found that only 30 percent of the participants agree and strongly agree that client companies in Egypt frequently rotate their auditors. Also the mean for this question was 3.2 indicating that the majority disagree that there is voluntary

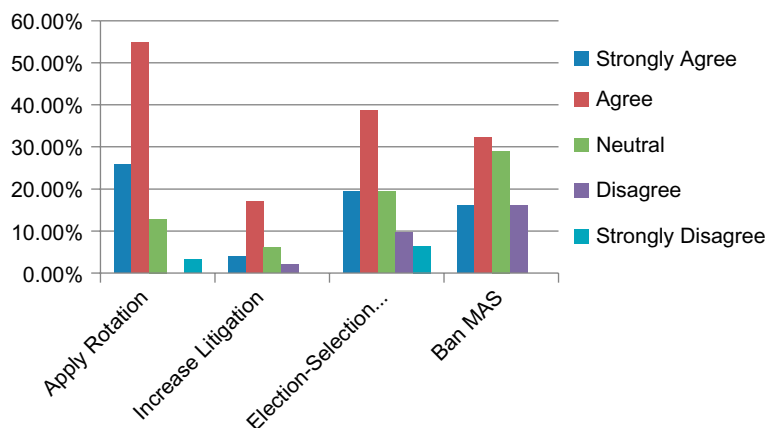


Figure 3.
Ways to enhance the
auditor independence

Is there a voluntary auditor rotation practice in Egypt		Rank	Frequency percentage
Valid	30.000	Strongly agree	19.4
Missing	1.000	Agree	9.7
Mean	3.200	Neutral	12.9
SD	1.375	Disagree	41.9
Skewness	-0.556	Strongly disagree	12.9
SE of skewness	0.427	Total	96.8
		Missing system	3.2
		Total	100.0

Table VI.

auditor rotation in Egypt. Upon the findings of Question 3 regarding the use of auditor rotation as a way to enhance auditor independence, the findings of Question 4 encourage and support recommending the adoption of mandatory auditor rotation in Egypt especially since it is not voluntarily applied until now (Figure 4).

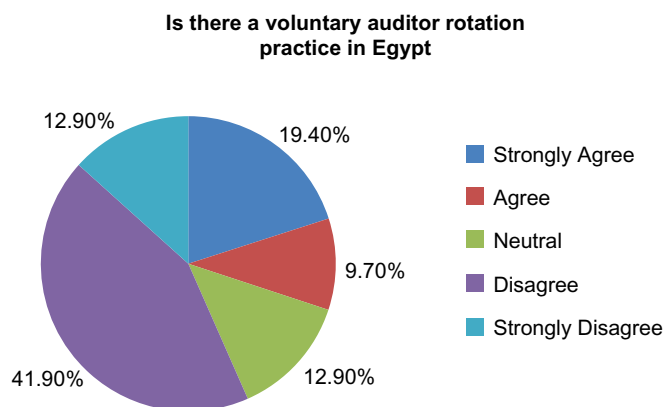


Figure 4.
The auditor practice
in Egypt

The main reasons behind auditor switching

From Table VII, it can be seen that 75 percent of the participants agree and strongly agree that ARL is the most important reason for initiating auditor rotation. The data also shows that 77.4 percent of the participants agree and strongly agree that clients switch their auditors to search for auditors with better reputation. It was found that 71 percent of the participants agree and strongly agree that clients normally switched their auditors to engage more experienced auditors. It can also be found from the data that 58.1 percent of the participants agree and strongly agree that the auditor would be switched when the management is changed. The results also show that 40.7 percent agree and strongly agree that clients switch their current auditors to other auditors who are more flexible and can allow their earnings management practices. Also it was found that 60.7 percent of the participants agree and strongly agree that a company might rotate its auditor to another one that would provide it with a better audit opinion which is an unqualified one. The data also reveals that 57.1 percent of the participants agree and strongly agree that the auditor might be rotated when there are legal disputes and conflicts with the client. Finally, it was found that 41.9 percent of the participants agree and strongly agree that clients change their auditors searching for others who take lower fees (Figure 5).

According to the mean analysis in Table VIII, it was found that the most of the participants agree that the first reason with the lowest mean of 1.92 was the auditor switching to find another one that would provide timelier audit opinion and to avoid ARL. The second ranked reason was the auditor reputation with an average of 2.03 meaning that most of the participants agree that the auditor rotation is due to searching for an auditor with better reputation. The third ranked reason is the auditor experience with an average of 2.12, meaning that most of the participants agree that companies might rotate their auditor to hire a more experienced one. Fourth in the rank came the change of the company's management with a mean of 2.19 as a reason for the auditor rotation. With the same mean of 2.57 then comes the search for a better audit opinion (clean one) and the litigations problem reasons. Next in rank comes the allowance of earnings management reason with an average of 2.59 which indicates that participants agree that clients might rotate their auditors when auditors refuse to allow their reporting practices that are not in consistence with GAAP. Finally with the highest average of 2.77 comes the lower fees reason. It could be inferred that the majority are least agreeing that an auditor would be rotated to find another auditor that would charge them less audit fees. We would conclude that from the main causes initiating the auditor rotation is the search for a more experienced and a more reputable auditor and for a timelier audit report. This reveals that the auditor switch in Egypt is for improving the audit quality. Actually this indicates that the H_3 , the H_5 and the H_2 are supported. However, the H_1 , the H_4 and the H_6 are not strongly supported.

The client attachment to the audit firm

Table IX shows that 80 percent of the participants strongly agree and agree that when the audit firm is more reputable whether according to size or rank, the client becomes more attached to it. The data also shows that 87.1 percent of the participants strongly agree and agree that when the audit firm is able to release the audit opinion and finish the audit process on a timely basis, this makes the client more attached to it. It was also found that 77.4 percent of the participants agree and strongly agree that a client is

Valid (%)	Switching to pay lower fees	Switching to allow earnings management	Switching due to raising litigation	Switching to have a clean opinion	Switching to hire a more reputable auditor	Switching to hire a more experienced auditor	Switching to have a more timely auditor report	Switching due to changes in the company management
Strongly agree	16.1	12.9	9.7	6.5	35.5	25.8	32.3	35.5
Agree	25.8	22.6	41.9	48.4	41.9	45.2	35.5	22.6
Neutral	25.8	38.7	22.6	16.1	12.9	22.6	19.4	29.0
Disagree	29.0	12.9	9.7	16.1	3.2	3.2	3.2	12.9
Strongly disagree	3.2	0	6.5	3.2	6.5	3.2	0	0
Total	100.0	87.1	90.3	90.3	100.0	100.0	90.3	100.0
Missing system	0	12.9	9.7	9.7	0	0	9.7	0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Auditor
independence
in Egypt

Table VII.

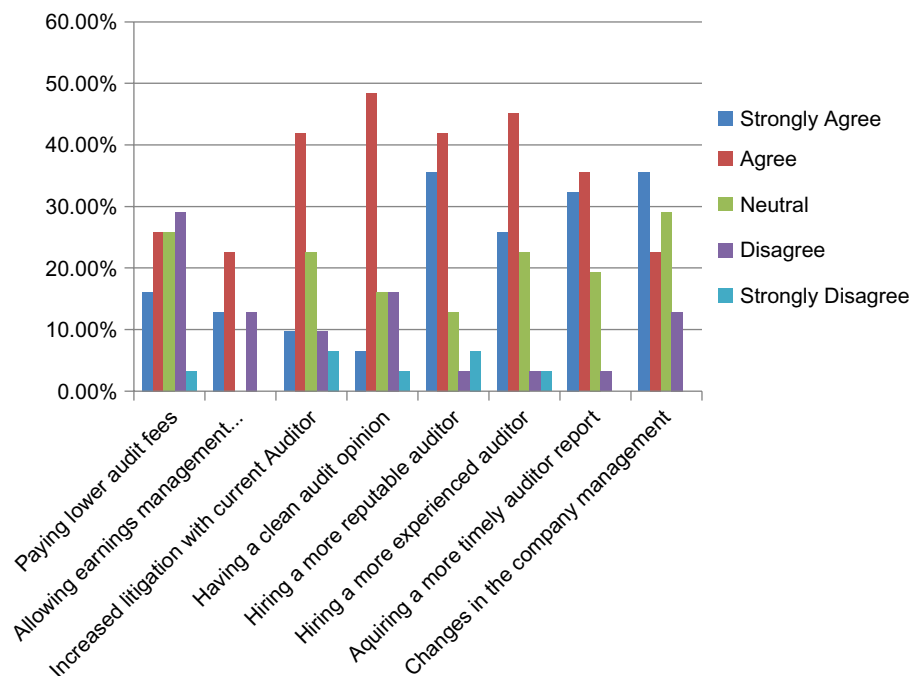


Figure 5.
Reasons for the
voluntary switching
of auditors in Egypt

more attached to the audit firm for its lower fees. Finally, the results also showed that 70.9 percent agree of the participants and strongly agree that clients are attached their audit firm, due to its strictness in the application of conservative accounting practices. According to the mean analysis in Table X, the most agreed upon reason by the majority of participants was the timeliness of issuing the audit opinion with a mean of 1.74 followed by the auditor reputation with a mean of 1.80. Then ranked as the third reason, was the amount of fees charged by the audit firm. It had a mean of approximately 2.06 meaning that the majority of the participants agree that when the audit firm charges its client reasonable fees, they become more attached to this audit firm. Finally in the ranking of importance comes being conservative and consistent in following GAAP with a mean of 2.19. It could be inferred that most of the participants agreed the least on that when the audit firm is strict in applying GAAP and is conservative; this makes the client attached to it, although the concept itself should not be undermined since it has an average of 2.19 indicating that auditors agree that it is one of the reasons for attachment to the audit firm (Figure 6).

The client attachment to the audit personnel (audit partners)

From Table XI, 83.9 percent of the participants agree and strongly agree that a client would be more attached to audit personnel/partner due to his/her experience. Also it was found that 74.2 percent of the participants agree and strongly agree that a client would be more attached to an audit personnel/partner for being flexible in accepting the client's reporting practices that would sometimes be against GAAP. It also can be inferred from the data that 65.5 percent of the participants agree and strongly agree

	Switching to pay lower fees	Switching to allow earnings management	Switching due to raising litigation	Switching to have a clean opinion	Switching to hire a more reputable auditor	Switching to hire a more experienced auditor	Switching to have a more timely auditor report	Switching due to changes in the company management
Valid	31	27	28	28	31	31	28	31
Missing	0	4	3	3	0	0	3	0
Mean	2.7742	2.5926	2.5714	2.5714	2.0323	2.1290	1.9286	2.1935
SD	1.14629	0.93064	1.06904	0.99735	1.11007	0.95715	0.85758	1.07763
Skewness	-0.093	-0.291	0.780	0.753	1.339	0.947	0.523	0.272
SE of skewness	0.421	0.448	0.441	0.441	0.421	0.421	0.441	0.421

Table VIII.

EBS
6,2

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Table IX.

Valid (%)	Client is attached to audit firm due to reasonable fees	Client is attached to audit firm due to accurate timings	Client is attached to audit firm due to conservatism	Client is attached to audit firm due to reputation
Strongly agree	25.8	45.2	29.0	45.2
Agree	51.6	41.9	41.9	32.3
Neutral	12.9	6.5	16.1	16.1
Disagree	9.7	6.5	6.5	0
Strongly disagree	0	0	6.5	3.2
Total	100.0	100.0	100.0	96.8
Missing system	0	0	0	3.2
Total	100.0	100.0	100.0	100.0

Table X.

	Client is attached to audit firm due to reasonable fees	Client is attached to audit firm due to accurate timings	Client is attached to audit firm due to conservatism	Client is attached to audit firm due to reputation
Valid	31	31	31	30
Missing	0	0	0	1
Mean	2.0645	1.7419	2.1935	1.8000
SD	0.89202	0.85509	1.13782	0.96132
Skewness	0.772	1.226	1.046	1.427
SE of skewness	0.421	0.421	0.421	0.427

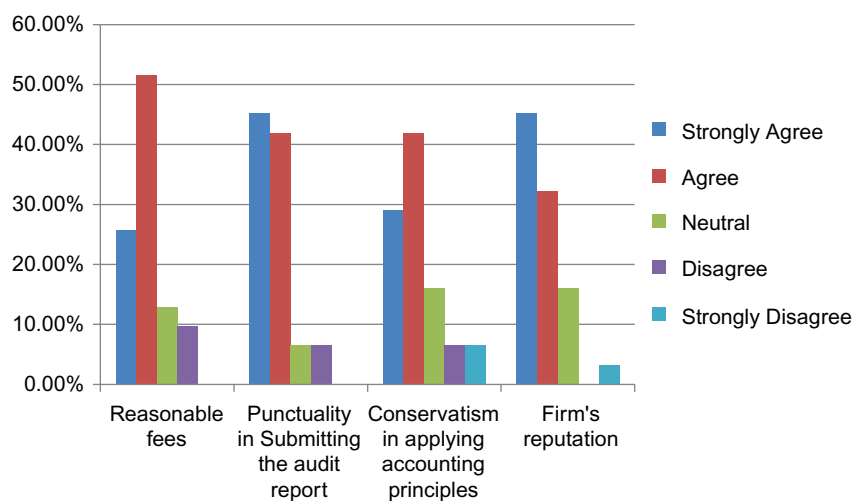


Figure 6.
Reasons for the
client attachment to
an audit firm

that a client would be more attached to an audit personnel due to increased tenure. This reflects that the majority agreed that the extended tenure creates a psychological attachment with audit partner/personnel. According to the mean analysis in Table XII, it was found that participants gave the lowest mean of 1.90 to the experience.

Table XI.

Valid (%)	Client is attached to audit personnel due to long tenure	Client is attached to audit personnel due to auditor flexibility	Client is attached to audit personnel due to experience
Strongly agree	16.1	25.8	38.7
Agree	45.2	48.4	45.2
Neutral	25.8	22.6	6.5
Disagree	6.5	3.2	6.5
Strongly disagree	0	0	3.2
Total	93.5	100.0	100.0
Missing system	6.5	0	0
Total	100.0	100.0	100.0

Table XII.

	Client is attached to audit personnel due to long tenure	Client is attached to audit personnel due to auditor flexibility	Client is attached to audit personnel due to experience
Valid	29	31	31
Missing	2	0	0
Mean	2.2414	2.0323	1.9032
SD	0.83045	0.79515	1.01176
Skewness	0.309	0.366	1.443
SE of skewness	0.434	0.421	0.421

This means that the majority are strongly agreeing that a client would be more attached to the auditor himself or to the audit team as that auditor possesses more experience. The second agreed upon reason is being flexible in accepting the client's reporting practices that would sometimes be against GAAP. It had an average of 2.03. The least reason to be accepted by the majority is the auditor tenure. It had an average of 2.24; meaning that the participants are in the agree zone that the client becomes attached to the auditor or the audit team if they have spent with them longer tenure (i.e. many engagements) (Figure 7).

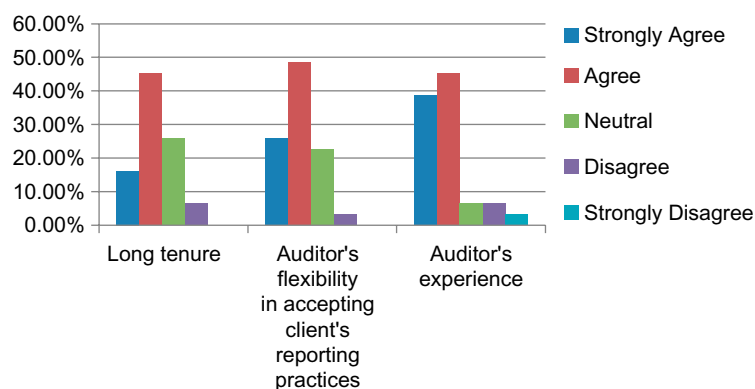


Figure 7.
Reasons for the client
attachment to
the audit personnel

Presence of other audit firms than the Big Four

Table XIII reveals that 70 percent of the participants agreed and strongly agreed that there are many reputable and qualified audit firms in Egypt (Figure 8).

Assignment to audit engagements

Table XIV, showed that 80 percent of the participants agree and strongly agree, that the audit firm decides to assign an audit partner or team to a certain client based on the degree of the partner or team knowledge about the client's business whether due to experience in the field or due to auditing the client before. However, it was found that 65.5 percent of the participants agree and strongly agree that an audit partner/team is assigned to an engagement based on the client's desire and request. From the means analysis, it was found that concerning the decision of selecting the audit partner/team (personnel) for a repeated engagement, the most agreed upon factor by the respondents with a mean of 2.06 is the auditor's knowledge in the client's business. The other factor considered affecting the assigning decision, is the client request of a certain audit team or partner. This factor had an average of 2.41, which means that the respondents are also in the agree zone. This conveys that sometimes an audit team or partner is assigned to an audit client based on his request for this team or partner in specific. It could be inferred from this that clients are attached to the audit personnel, an issue that

Table XIII.

There are many reputable firms other than the Big Four in Egypt			
		Rank	Frequency percentage
Valid	30.000	Strongly agree	16.1
Missing	1.000	Agree	51.6
Mean	2.300	Neutral	12.9
SD	0.952	Disagree	16.1
Skewness	0.621	Strongly disagree	0
SE of skewness	0.427	Total	96.8
		Missing system	3.2
		Total	100.0

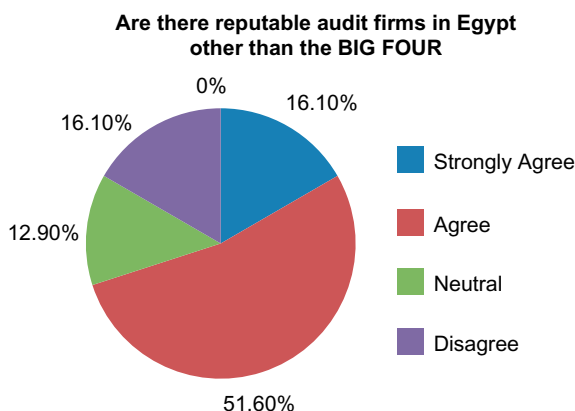


Figure 8.
Presence of audit firms
other than the Big Four

The same audit team audits the same client due to more knowledge			The same audit team audits the same client due to the client's request		
Rank			Rank		
Valid	30	Strongly agree	29	Strongly agree	25.8
Missing	1	Agree	2	Agree	35.5
Mean	2.0667	Neutral	2.4138	Neutral	6.5
SD	0.90719	Disagree	1.29607	Disagree	19.4
Skewness	1.347	Strongly disagree	0.627	Strongly disagree	6.5
SE of skewness	0.427	Total	0.434	Total	93.5
		Missing system		Missing system	6.5
		Total		Total	100.0

Table XIV.

would impair their independence and makes the audit partner rotation suitable in the Egyptian market (Figure 9).

9. Conclusion, recommendations and limitations

This paper intended to assess the applicability of the mandatory auditor rotation concept in the Egyptian environment so as to enhance the auditor independence and thus improves the audit quality. The model introduced to measure the audit quality, used different proxies of the audit quality; the audit report, ARL, the auditor reputation, the auditor experience, the auditor fees and the earnings management level.

It was found that the extended auditor client relationship would enhance rather than it would deteriorate the audit quality, due to the increased experience with the client’s business and practices. Also, it was found that main cause of the lack of independence problem in Egypt is that most of the companies in Egypt are closely held where the stockholders are the managers of the company.

There is no evidence that the current voluntary auditor rotation in Egypt is for bad reasons such as for opinion shopping or searching for a lower fees auditor, but it would be for good reasons that would improve the audit quality such as searching for a more reputable or more experienced auditor.

Concerning the suitable type of rotation that could be applied in Egypt, the paper finds that the audit clients in Egypt would be more attached to the audit personnel. Even more sometimes they request their re-hiring in the following engagements from their audit firms. Thus, an audit personnel rotation would not be beneficial for the audit process as it will decrease the audit quality. However, firm rotation would be more preferred for two main reasons: first, there are many other reputable and qualified audit firms in Egypt other than the Big Four. Second, audit firms usually assigns audit personnel based on their experience in the client’s business industry, an issue that will promote the audit quality from the two sides, sustaining independence and at the same time promoting quality by assigning experienced auditors to them.

From the findings of both the literature as well as the field study, the paper can carry some recommendations. First, the application of mandatory auditor rotation in general as a solution for the lack of auditor independence problem in Egypt and at the same to make the EAS and regulations coping with the international auditing standards.

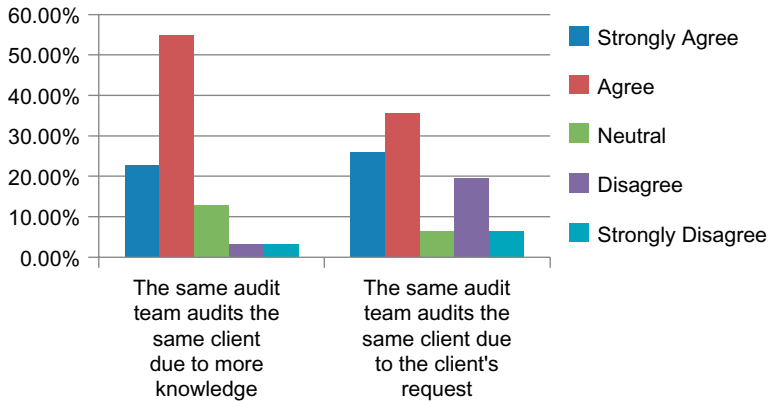


Figure 9.
On what basis do audit firms assign audit personnel

Second, the application of the mandatory audit firm rotation in specific in order to sustain the auditor's independence, to promote the audit quality and to enhance the competition in the audit market. Third, establishing professional organizations to promote the profession. Fourth, designing a code of ethics acting as a guideline for auditors to maintain their independence, objectivity and UN biasness during their conduct.

The study is first limited to measuring the audit quality using the previously selected measures as they are the most commonly used by other studies and mostly supported by literature. Second the sample size is limited to the possible accessibility to auditors working in the Big Four audit firms operating in Egypt rather than those working in local audit firms.

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About the authors

Diana Mostafa Mohamed is an Assistant Lecturer in the Accounting Department of the Faculty of Management Technology in the German University in Cairo. She graduated from the Faculty of Commerce (English section), Cairo University class 2003, accounting major with an honours. She obtained her MSc from the German University in Cairo class 2009 in auditing, with extra majors in finance and economics. She is currently a PhD candidate, she has participated in three international conferences and has published one book in auditing by Lambert for Academic Publishing (LAP) in Germany. Diana Mostafa Mohamed is the corresponding author and can be contacted at: diana.mostafa@guc.edu.eg

Dr Magda Hussien Habib is an Associate Professor in the Faculty of Commerce at Ain Shams University.

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