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The Impact of Auditor Rotation on  
the Audit Quality:

A Field Study from Egypt

by  
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## Abstract

Lack of audit quality and subsequent audit failures result mainly from a lack of independence which is considered to be a consequence of the extended auditor client relationship. Actually, the results of a questionnaire distributed among auditors in Egypt confirm this hypothesis: The Auditors strongly agree that there is a lack of auditor independence in Egypt. The main reason is that most of the companies are closely held and that there is a lack of existence of code of ethics for auditing practitioners in Egypt. Also, the results indicate that the mostly accepted solution by the auditors to overcome the lack of independence problem is the mandatory auditor rotation. Consequently, the paper suggests that mandatory firm rotation instead of mandatory partner rotation should be applied in Egypt.

## JEL classification

M42; M40

## Keywords

Audit Quality, Auditor Rotation, Auditor Independence, Egypt

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## 1. Introduction

The audit quality is one of the most significant topics in the auditing profession. It is defined as the auditor being capable of detecting and reporting material misstatements existing in the sample being investigated during the audit process (Vanstraelen, 2000). As the auditor is able to detect and report on the existing material misstatements, the audit process is considered as more effective and 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 (Hamilton, 2005). Actually, it was found that the extended auditor-client relationship as defined by the auditor tenure would psychologically impair the auditor independence; a matter which causes the auditor not to be able to perform with full objectivity and non-biasness (Sori and Karbhari, 2005).

A sound solution that has been proposed and applied in different countries, in order 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 (whether audit partner or audit company) is said to be 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 also 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; Wahdan et al. 2005b). As the mandatory auditor rotation, whether partner or firm rotation, has been applied in different countries, this paper proposes the application of the mandatory auditor rotation in Egypt as a solution for the lack of independence problem and as a way that to enhance the audit quality.

This paper intends to identify the main the reasons for the lack of independence in Egypt, and how this serious problem could be overcome. Also, the paper discusses whether the audit tenure improves or deteriorates the audit quality, what the main reasons for a voluntarily change of the auditors are, and, finally, which form of mandatory rotation would be suitable for the Egyptian economical environment. These questions are answered using a survey distributed among audit practitioners in Egypt, where the questionnaire results were analyzed with SPSS.

In the next chapter, the paper will present a literature review concerning three main aspects: The auditor rotation, the problem of the auditor independence, and the audit quality. The third chapter will introduce the model and the discussed hypotheses, followed by the data analysis and a presentation of the findings in chapter four and the conclusion in the final chapter five.

## **2. Literature Review**

### **2.1. The Auditor Rotation**

The idea of the auditor rotation was first introduced and discussed in 1976 (Hoyle, 1986). Auditor rotation can either be mandatory or voluntary. The mandatory rotation pushes all types of 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).

Proponents of the auditor rotation see that the mandatory rotation first, bounds opinion shopping practices by limiting its opportunities (Lu, 2005). Second, it is considered very informative to the outsiders, since the successor auditor gets information from his predecessor who helps him in assessing the firm's financial conditions (Lu, 2005). At the same time this will improve the work of the audit firms/partners as they know that sometime in the future their work will be reviewed by another audit firm or partner when they are rotated (Raiborn et al., 2006; Davis et al., 2009). Third, 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, 1999; Nagy, 2005). Fourth, 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, actually it was found that the auditor rotation costs \$1.2 billion/year as compared to \$460 billion loss in market capital due to audit failures of Enron, Tico and Worldcom (Cameran et al., 2005; Jackson et al., 2007).

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 (Davis et al., 2009), that when an auditor is engaged with a new client, the first year start-up cost to that auditor is large as the audit process will be more time- and effort- consuming 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, 1999; Johnson et al., 2002). Actually, it was found by the GAO that audit cost was 17% of the total audit fees of the first year audit (Jackson et al., 2008). 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 amount of time spent or 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, and the auditor is not willing to lose such a source of revenue. If the rotation is mandatory and the auditor knows that he will not sustain the client 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, 1999; Raiborn et al., 2006; Jackson et al., 2008; Nagy, 2005; Davis et al., 2008). Moreover, after the application of the Sarbanes Oxley Act 2002 (SOX) which imposed the rotation of the auditor every five years, it was found that non GAAP earnings management practices have declined, an issue that reflects that when the auditor spends longer tenure with the client, he/she would not allow their managing of their reported earnings practices (Davis et al., 2009).

On the other hand, the opponents to the rotation found that it 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. In order for the auditor to conduct a good audit he has to have enough knowledge about the company's operations, accounting system and internal controls in order to be able to detect material misstatements. 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).

In the coming section of the paper, the audit quality and the different proxies of how it could be measured will be defined, in addition to the assessed impact of the rotation on each.

## **2.2. The Audit Quality**

Audit quality is defined as "the probability that an auditor will both discover and report a breach in the client's accounting system. The probability of discovering a breach depends on the auditor's technical

capabilities while the probability of reporting the errors depends on the auditor's independence" (Vanstraelen, 2000; Deis and Giroux, 1992; De Angelo, 1981). This definition doesn't only reflect the auditor's compliance with the reporting standards and fieldwork standards of the GAAS, but also the degree of the auditor's independence in being able to face the client with his reporting mistakes not fearing to lose him on the current or the potential future engagements. Thus it can be inferred that the auditor's independence is part of the audit quality. Before discussing the model used in the assessment of the audit quality, the reasons for the lack of auditor independence in Egypt that would result in a lack of quality should be explained first.

#### The Reasons for the Lack of Auditor's Independence in Egypt

- 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 discusses and highlights the legal requirements especially those concerning fraud, some auditors and accountants ignore this code and also there is little attention among the practitioners concerning some issues such as the auditor's independence, the conflict of interest and the auditor-client relationship (Wahdan et al., 2005a).
- There is no separation between the auditing and the other management advisory services 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).
- The auditors should normally be paid and hired by the shareholders or as sometimes called the third party; however in Egypt, auditors suffer from the problem of closely held companies which means that the shareholders also 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 BOD and receive compensations after the end of each meeting (Wahdan et al., 2005a).
- The lack of the independence problem is also noticed from the Egyptian Auditing Standards (EAS). In a comparison which was made between the GAAS (The Generally Accepted Auditing Standards) and the EAS, it was found that the latter lacks very important basics that exist in GAAS for enhancing the auditor independence. First, 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 unbiasedness. Second, according to the EAS, the auditor report could be addressed to the board of directors (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. Third, concerning the issuance of a disclaimer audit opinion; in the EAS, an auditor can disclaim his opinion either when there is a scope restriction by the client in providing an amount a highly material piece of information or when there is a scope restriction by circumstances (Ibrahim, 2008, Arens et al., 2001). Only these two reasons are stated by the EAS to allow an auditor to issue a disclaimer opinion, however a very important reason which is 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 management advisory service to the auditee (Arens et al., 2001).

None of these conditions actually exist in the EAS 200, an issue that indicates that the auditor independence is not a concern of the EAS and that also means that the auditing profession in Egypt is lacking its corner stone which is the independence of the auditor. It could be deduced then that the auditor rotation is mainly advocated in the Egyptian auditing and regulatory society so as to sustain the degree of the auditor independence.



### **3. 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, the auditor experience, the auditor reputation, the audit report lag, 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 et al, 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)

#### **3.1. Auditor Report**

A company's financial statements are considered the means to communicating and passing financial information to a third party. Concerning the impact of the auditor rotation on the audit opinion, 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; Lennox, 1998). Also, according to Vanstraelen (2000), the long audit tenure decreases the auditor's willingness to qualify his audit opinion due to the personal attachment that arises with the client, thus the mandatory rotation should be suggested to avoid the collusion between the management and the auditor.

On the other hand, it was proved that when the tenure increases, the auditor's judgment is improved to give the appropriate audit opinion, this means that mandatory rotation will deteriorate the audit quality by limiting the tenure not the opposite (Carey and Simnett, 2006, Jackson et al., 2008). Also, there was no relation found 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 was affected by the long tenure (Meyer et al., 2007; and 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. From here the first hypothesis is developed.

H<sub>1</sub>: The auditor will be rotated if he didn't issue a standard unqualified audit opinion.

### **3.2. Auditor's Reputation**

The auditor reputation is important for the audit quality as it is well known among companies 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<sub>2</sub>: The auditor will be rotated if it is a Non Big Four audit firm

### **3.3. 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 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 such staleness.

Since the auditor's experience is an indicator a 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<sub>3</sub>: 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).

### **3.4. Earnings Management**

Earnings management is the choice of the adoption of certain accounting policies in order to achieve managers' specific objectives. They are considered important pieces of information released by the company. Such earnings are considered of poor quality if they don't 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). That's why a good auditor should be independent to be able to investigate a company management's financial reporting practices and to be able to find whether they follow GAAP through checking on their earnings management practices (Davis et al., 2000)

In this paper, the degree of allowance of earnings management practices is used as a measure of quality. As 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 didn't approve such practices.

H<sub>4</sub>: The auditor will be rotated if he didn't approve the client's reporting practices.

### **3.5. Audit Report Lag (ARL)**

The ARL is defined as "the period from the company's yearend 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 to make sure that the company's financial statements are free from material misstatements. 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 (Scholoetzer, 2006). Moreover, it was found that the audit report lag is affected by the auditor rotation decision which in return would affect the audit quality .Actually the ARL depends on two factors, the timing of the auditor rotation and the type of auditor rotation, that a shorter ARL is expected in early audit firm rotation since at the beginning of the year there is enough time to help the successor auditor to perform audit smoothly rather than when the rotation occurs later in the year (Lai and Cheuk , 2005). Also according to Lai et al. (2005), it was found that there is a positive and strong association between cross-up audit firm rotation and the ARL while there is a negative relationship between the cross-down audit firm rotation and ARL .This would reflect that when a client rotates from a NON BIG FOUR to a BIG FOUR audit firm, it takes longer time to submit the audit opinion and that it is not the client but the audit firm's specific factors related to the degree of the audit effectiveness that influences the audit process (Knechel and Payne , 2001; Lai et al., 2005), when such a level of effectiveness is achieved neither the excessive audit hours spent nor the extra audit effort exerted will add to the overall audit quality (Krishman and Yung, 2009)

In this paper, due to the importance of the audit report timeliness as a measure of the audit quality, 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.

H<sub>5</sub>: The auditor will be rotated if he produces an audit report lag

### **3.6. 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 and thus, higher audit fees (O'Sullivan, 2000; Ghosh and Pawlewicz, 2008). On the 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 Sarbanes Oxley Act (SOX), total fees to audit firms have increased indicating that total revenues from audit clients will 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).

In this paper, the auditor's fees is considered a measure for the assessment of the audit quality, as it is assumed that high audit fees reflects a high quality especially if the audit is performed by a reputable audit firm. Thus, will a client company decide to switch its auditor if he/she required high fees. This is reflected in the following hypothesis

H<sub>6</sub>: The auditor will be rotated if he requires large audit fees

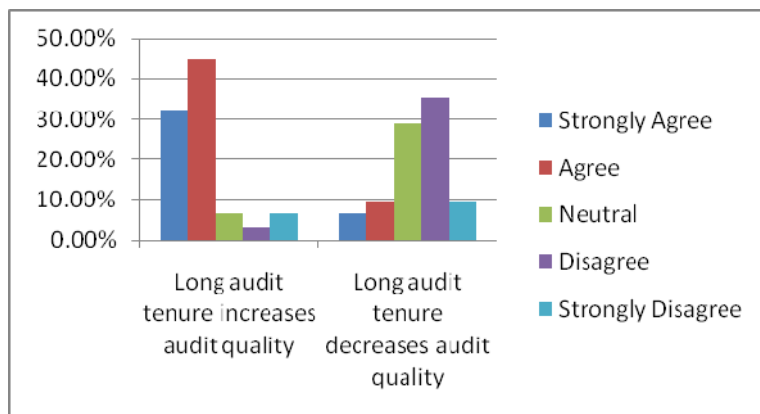
After the determination of the different proxies of audit quality, the paper will now move to the part of the study related to assessment of whether the auditor rotation concept is applicable to Egypt, i.e whether the professionals in the field see that the rotation is really needed in Egypt and whether it will improve the quality as assessed per the previously discussed proxies.

Rotation as a concept has been applied in different countries, the USA, Korea, Italy, France, Singapore and Taiwan to overcome the problem of the lack of auditor independence. Egypt as a country has experienced large business failures and bankruptcies associated with audit failures since the 80s of the last century. The main reason behind it, as will be discussed in the following lines, is due to the lack of auditor independence suffered by the profession in Egypt. According to Eli et al. (2005), the higher the auditor independence, the higher the audit quality as the information asymmetry between the management and the third party is reduced. In Egypt the lack of independence problem is either due to the weak enforcement of the regulation and litigation or due to the deficiencies in the Egyptian Auditing Standards (EAS)

#### 4. Data Analysis and Findings

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 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 5 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 Price Waterhouse Coopers (PWC) and Ernest and Young. Of this sample, only 31 replied representing 62% response rate.

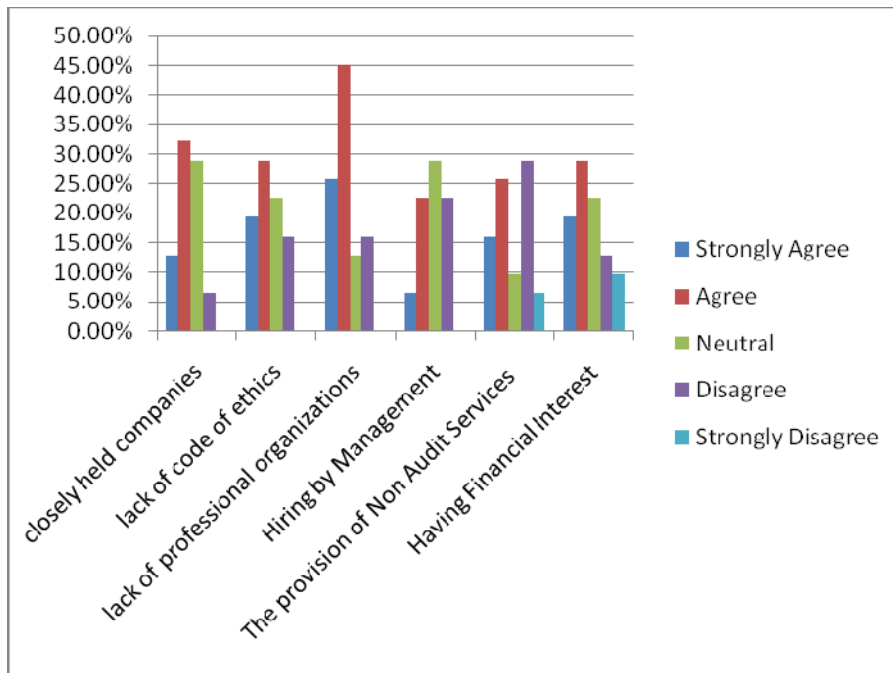
**Figure 1: The Long Audit Tenure**



The frequencies in **Figure 1** show that 82.2% 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% of the participants agree and strongly agree that the long audit tenure negatively affects the audit quality.

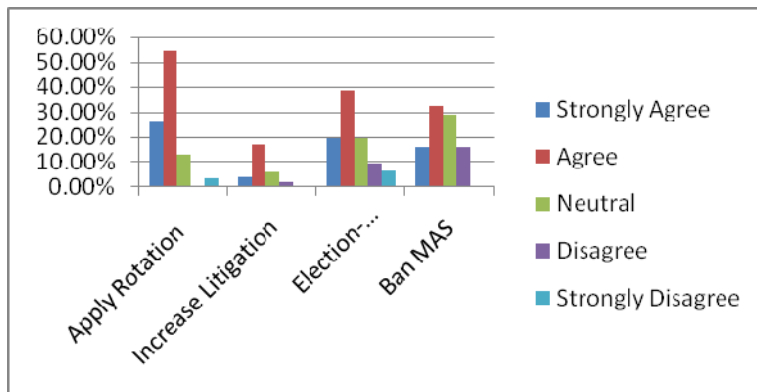
From the mean results, it could be concluded that the long tenure increases the audit quality as it has an average of 2.0. While, the majority was disagreeing towards the concept that the extended tenure deteriorates and decreases the audit quality as its mean was approximately 3.36. This means that the respondents support the concept that extended tenure improves the audit quality due to increased experience rather than supporting that the extended tenure deteriorates the audit quality due to the increased financial and psychological independence on the client.

**Figure 2: The reasons for lack of auditor independence in Egypt**



From **Figure 2**, it was found that more than 50% 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 meaning that the owners or the shareholders are the managers of the company. Also it was found that 56% 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% agree and strongly agree that it was the shortage in existence of professional organization. Also 36% 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% 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% of the participants agree and strongly agree that having financial interest in the client's company affects the auditor's independence. From the mean analysis 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 3: The best ways to enhance the auditor independence**

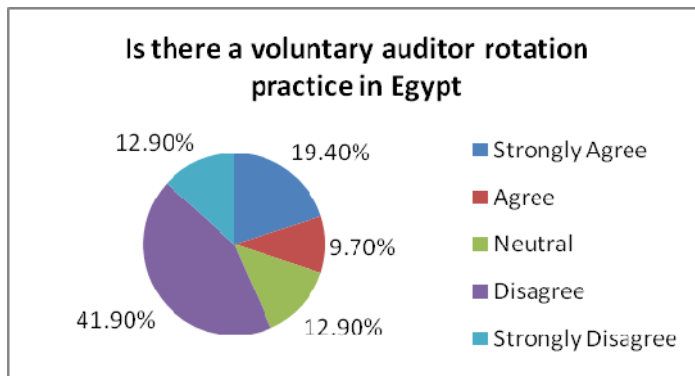


According to **Figure 3**, 83.4% of the participants agree and strongly agree that changing the auditors after a set of years would be the best solution enhancing the auditor independence. The data also revealed that exactly 72.4% of the participants agree and strongly agree that creating a threat to the auditor by increasing the litigation against him would be the best solution to enhance the auditor independence. 62.1% 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% of the participants agreed and strongly agreed to ban the provision of the management advisory services as a solution to improve the auditor independence. Using the mean analysis, 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. It had a mean of 1.96, which means that the majority were strongly agreeing that it is the best solution. 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

From **Figure 4**, it was found that only 30% 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 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.

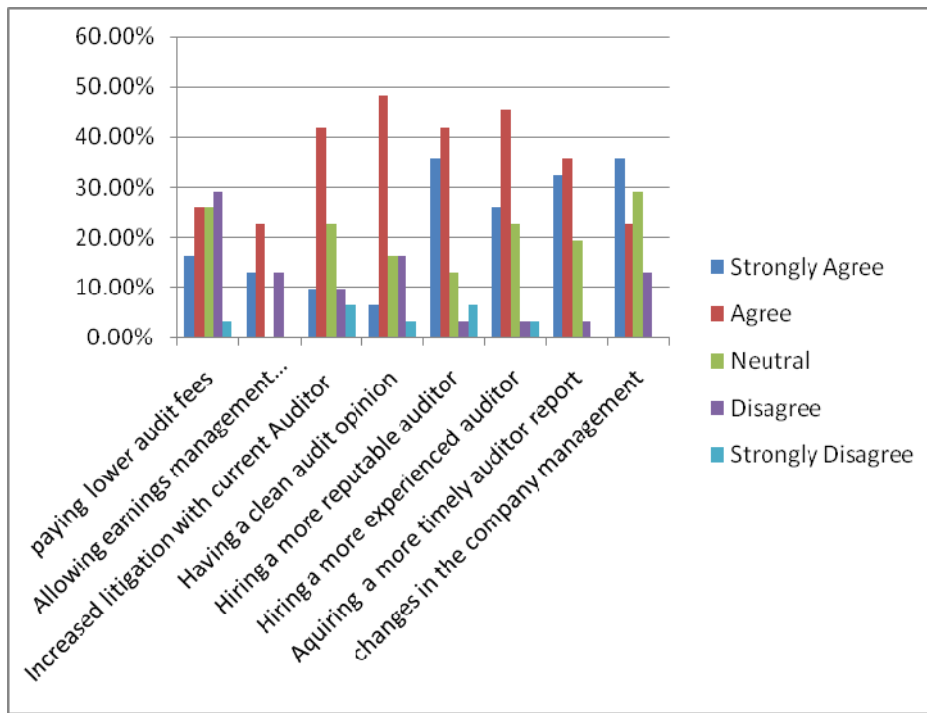


**Figure 4: The frequency of auditor rotation**



From **Figure 5**, it can be seen that 75% 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% of the participants agree and strongly agree that clients switch their auditors to search for auditors with better reputation. It was found that 71% 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% 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% 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% 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% 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% of the participants agree and strongly agree that clients change their auditors searching for others who take lower fees.

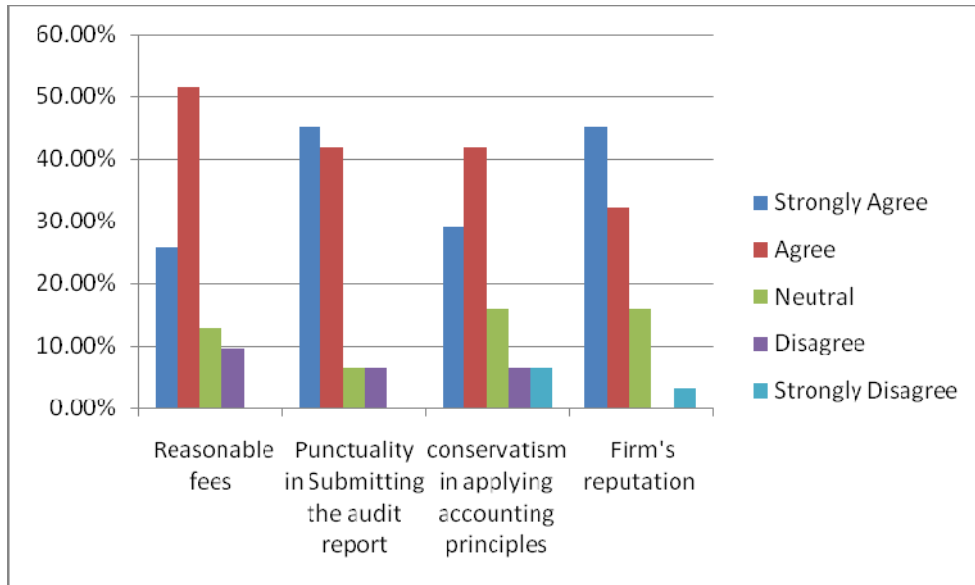
**Figure 5: The main reasons behind auditor switching**



According to the mean analysis, 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 reason rank 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 third hypothesis, the fifth hypothesis and the second

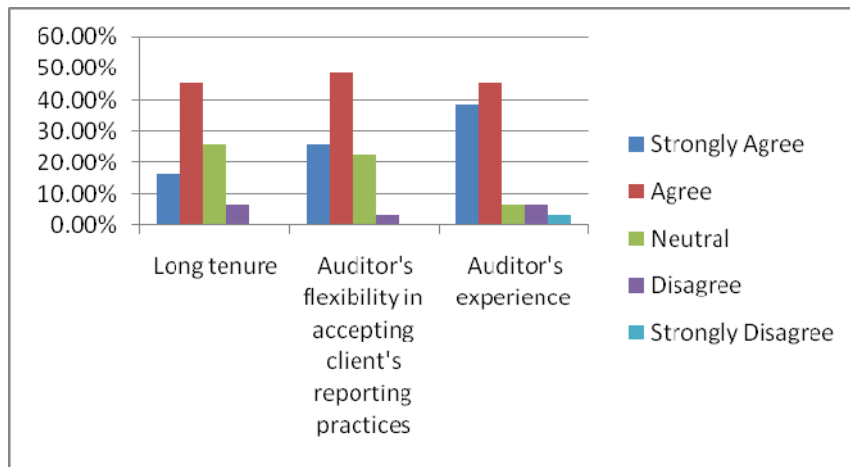
hypothesis are supported. However, the first hypothesis, the fourth hypothesis and the sixth hypothesis are not strongly supported.

**Figure 6: The client attachment to the audit firm**



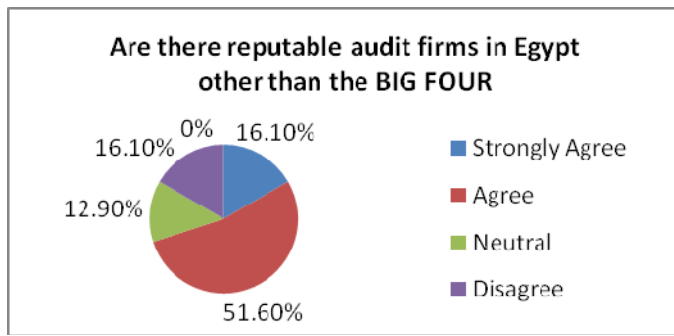
**Figure 6** shows that 80% of the participants strongly agree and agree that when the audit firm is more reputable whether according to size or rank, the client becomes more attached to it. The data also shows that 87.1% of the participants strongly agree and agree that when the audit firm is able to 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% of the participants agree and strongly agree that a client is more attached to the audit firm for its lower fees. Finally, the results also showed that 70.9% 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, 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 7: The client attachment to the audit personnel (audit partners)**



From **Figure 7**, 83.9% 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% 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% of the participants agree and strongly agree 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, it was found that participants gave the lowest mean of 1.90 to the experience. 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).

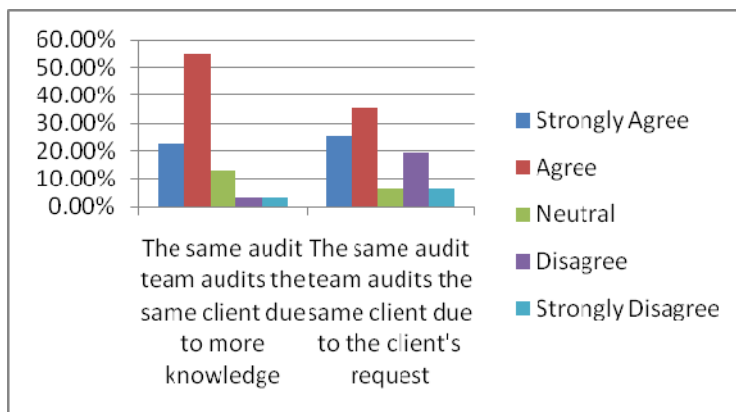
**Figure 8: Presence of other audit firms than the big four**



**Figure 8** reveals that 70% of the participants agreed and strongly agreed that there are many reputable and qualified audit firms in Egypt.

**Figure 9**, showed that 80% 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% 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 would impair their independence and makes the audit partner rotation suitable in the Egyptian market.

**Figure 9: Assignment to Audit Engagements**



## 5. Conclusion

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, audit report lag, the auditor reputation, the auditor experience, the auditor fees and the earnings management level.

The long tenure or as referred to in the paper as the long auditor client relationship, is assumed to would negatively affect the audit quality by impairing the auditor independence, due to increased familiarity, closeness and loyalty to the client, which in turn would impair the auditor's objectivity and professional judgment. However, from the analysis of the questionnaire, 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.

From the results 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. Theoretically, this would increase psychological dependence and attachment of the auditor with the client fearing from being fired or not re-hired for future engagements. Other causes were found for the lack of independence of auditors in Egypt were ranked as follows; the lack of existence of a code of ethics that can act as a guideline for the auditors during the audit. Then came the absence of a professional organization that can govern the duties, responsibilities and rights of auditors, followed by the hiring by management problem and finally came the provision of MAS and having financial interest in the client's firm. As solution for such lack of independence problem, the auditor rotation was suggested as solution to enhance the auditor independence.

Concerning the reasons for voluntary auditor switching and rotation in Egypt, there was no evidence that client companies decided to rotate their auditors for opinion shopping reasons. Concerning switching due to experience, it was found that one of the main reasons that forces clients to rotate their auditors is searching for another one who is more specialized in the client's field of industry as it was found that the specialized auditor has more experience than the non specialized one and this improves the audit quality. As for the earnings management proxy of quality, it was found that the earnings management practices are practiced by companies operating in Egypt for financing purposes and that the auditors accept such practices and consider them as not violating the GAAP. This means that the financial reporting quality in Egypt as based on the sample would be lowered by such allowed practices. It was also found that a client becomes attached to the audit personnel (partner or team) because they are flexible in allowing such non GAAP reporting practices. However there was no evidence that in Egypt, clients switched their auditors to search for another auditor that

would allow their reporting practices unacceptable by the GAAP. Concerning the ARL, it was found that the most important reason for switching is to search for an auditor who would provide the client company with a timelier audit opinion. As for the auditor reputation (as measured by the audit firm size) it was found that there are many reputable audit firms in Egypt and that the auditor switching exists to have a more reputable auditor. The last audit quality measure, was the audit fees, it was found that there was no evidence that one of the reasons that forced the clients to rotate their auditors is searching for a lower fees one. From all of the previously stated factors, we can assess that 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 (i.e. partner or team) due to their experience with them which increases as the audit tenure increases, thus increasing the audit quality. 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, it was found that the respondents see that there are many other reputable and qualified audit firms in Egypt other than the BIG FOUR, this means that there are enough potential substitutes of the same quality for an existing audit firm. Second, it was also found that the 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 Egyptian auditing standards and regulations coping with the international auditing standards. 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 which would work on promoting the auditor's profession through well educating auditors about their duties, responsibilities and restrictions on the engagement. Fourth, designing a code of ethics acting as a guideline for auditors to maintain their independence, objectivity and UN biasness during their conduct. Finally, banning the ownership of stock by auditors and also their employment in their audit client firms as in the Sarbanes Oxley Act. However if not banned, the mandatory rotation would also limit the effects of the conflict of interests that would arise to the auditor from such employment or ownership, as he/she will be mandatory rotated.

In further research, it could be useful to investigate the effects of actually applied mandatory firm rotation to a number of companies in Egypt and determine the level of independence of auditors and the audit quality associated



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