
The external auditor mandatory changes impact on improving the quality of the auditing process

Ayah Jarallah El-Khozondar

Auditing Department, Palestinian Monetary Authority, Gaza, Palestine

Email address:

akhonzondar@yahoo.com

To cite this article:

Ayah Jarallah El-Khozondar. The External Auditor Mandatory Changes Impact on Improving the Quality of the Auditing Process. *Journal of Finance and Accounting*. Vol. 2, No. 6, 2014, pp. 129-133. doi: 10.11648/j.jfa.20140206.12

Abstract: This study identifies the effect of mandatory rotation of the external auditor in improving the quality of auditing and to confirm his objectivity and independence. A questionnaire has been designed and distributed to a sample of 185 external auditors and managers of corporation at Gaza. The study introduces many results; *e. i.*, there is a relationship of applying the mandatory and its effect on the quality, cost and audit fees, and to improve the quality of auditing and to confirm his objectivity and independence. The study introduces many recommendations; *e. g.*, applying the professional specialization strategy in the client's industry.

Keywords: Mandatory Rotation, External Editor, Quality of Auditing, Independence

1. Introduction

The collapse of the largest American companies raised concern with issues including external auditor independency and audit quality. Enron breakdown has been interpreted to its close relationship with its auditor that affects the reporting objectivity of the auditor and the quality of the auditing process [1]. As a result, the need to reorganize the profession to enhance the objectivity and independence of external auditor has arisen in the U.S. and other countries; *i. e.*, imposing mandatory rotation of external auditor [2] leading to questions concerning auditor tenure, independence, and audit quality [3].

Some studies supported mandatory rotation for the following reason. Firms with long auditor tenure may lead to compassion between auditors and their clients causing loss of external auditor independency and degradation of the auditing quality [1,4].

On the other hand, the opponents to adaption mandatory rotation argued that longer tenure provides higher auditing process quality and auditor independency [5-7].

Other studies recommend that long tenure is not associated with audit quality [8-9]. In a study of the public sector, Schelker [10] argues that the audit quality is lower in the short period and in the long period.

Mande and Son [11] agree with the opinion that returns are positively related to auditor switches subsequent to restatements. Stanley and Dezoort [12] have found that the

audit quality is reduced with low audit fees and shortage of knowledge for short tenure.

In the Palestinian territories, the interest and knowledge of the auditing profession has been increased since the Palestinian National Authority has received the administrative matters. This development is due to several reasons, the most important one of these reasons is the conditions, which imposed by and still imposed by foreign donors for loans and aids, governmental and private ones. These bodies have noticed the lack of reliable accounting systems in the Palestinian economic establishments and considered that the risk of loss of potential investments in this source of economic units, as well as the case of funds that can be made to these facilities, whether in the form of loans or aids. Therefore, these bodies demanded the need to create strong accounting systems and internal controls set in various projects considered in this regard, international accounting principles and American accounting principles as role models [13].

However, the rapid growth of this profession has been accompanied by some important distortions in the audit facilities, resulting in a significant impact on the performance of many of these auditing firms. This motivated some companies to follow mandatory rotation.

The discrepancy in opinions regarding the effect of mandatory rotations in the auditor independence and the

quality of the auditing process has motivated the author to examine the effect of mandatory rotation of the external auditor in improving the quality of auditing and to confirm his objectivity and independence using Gaza as a case study taking into consideration the fact that Gaza recently approved mandatory rotation of the external auditor.

2. Background

The opponents to adaption mandatory rotation argued that longer tenure provides higher auditing process quality and auditor independency Johnson *et al.* [5] find that the report quality improved for firms with long auditor tenure. Geiger and Raghunandan [6] tested the relation between auditor tenure and audit reporting failures and found that the audit failures are more substantial in the short period relation between auditor and his client. They proposed that the auditing process quality is higher for extended auditor tenure. Myers *et al.* [7] support the suggestion that earnings management over discretionary accruals decreases as the length of the auditor tenure increases. This implies that auditor with long tenure give high quality audit service. Ghosh and Moon [14] get similar results supporting longer tenure auditor. Further, Ghosh and Moon [15] determined that observations of earnings quality from earnings response coefficients and stock ranking get larger with prolonged auditor tenure. Mansi *et al.* [16] also support long audit tenure by noticing that the cost of debt declines with longer tenure. Several authors achieved the same conclusions [16-20].

On the other hand, some studies supported mandatory rotations. Zhang [1] concludes that the close relation between auditors and their clients decreases the audit quality. Similarly, Harris [4] shows that audit markets improved by adopting mandatory rotation rules.

Some studies show that audit quality deteriorates either with increased auditor tenure [21], or both at the earlier or later part of auditor tenure [20]. Some recent studies examine the interaction between auditor tenure and either fees or auditor specialization. However, seemingly opposite conclusions are reached. One set of studies examined the interaction between auditor tenure and audit fees. Gul *et al.* [22] found that non-audit fees are associated with poorer audit quality in terms of higher discretionary current accruals for firms with short auditor tenure.

In contrast, Stanley and DeZoort [12] documented that audit fees are associated with improved audit quality in terms of lower likelihood of restatement for firms with short auditor tenure. Another set of studies examines the interaction between auditor tenure and auditor specialization, but results differ depending on the proxy for audit quality. Myers *et al.* [7] found no such interaction with discretionary accruals. In contrast, using discretionary accruals and restatements as proxies for audit quality; other studies documented this interaction [12]. Zhang [1] shows that audit quality is affected by closeness in the auditor-client relationship and regulatory intervene may be needed depending on specific setting in terms of auditor type and auditing decisions.

3. Problem of the Study and Its Importance

Auditing is characterized with high level of sensitivity; this is because it is highly based on the services that are offered by the neutral, independent external auditor. I am interested in the presence of a group of factors that affect the independence and the neutrality of the external auditor which in turn affect the quality and efficiency of the whole auditing service. Among these factors is the mandatory change of the external auditor. Additionally, the previous studies have been conducted in several countries, except for the Palestinian territories.

These countries have different economic, social and political environment. Palestine has special circumstances which affects negatively its development. This in turn affects the growth of auditing profession in Gaza. The problem of this study is about studying, analyzing, and assessment of the different issues relevant to the mandatory change of auditors. The main question of this research is "Does the mandatory change of the external auditor enhances the quality of the review process and implements his objectivity and independence in the Gaza Strip? ".

The Importance of this study based on the fact that it assures the continual presence of the auditor negatively affects his independence, objectivity, and efficiency which affects his profession and its development, and weakens the credibility of the reports. Moreover, this study brings together the views of managers of offices, audit firms, and directors of companies in the Gaza Strip.

4. The Study Hypothesis

The study depends on the following hypotheses:

1) There is no statistically significant relationship between the mandatory change of the external auditor, and improvement of the quality of the auditing process and strengthening the objectivity and independence of the external auditor.

2) There is no a statistically significant relationship between the application of the mandatory change of the external auditor, its impact on the further accumulation of experience and knowledge of industry for which belongs to it an audit review client, and between improving the quality of the auditing process and strengthen the objectivity and independence.

3) There is no statistically significant relationship between the application of the mandatory change of the external auditor and its impact on the quality and cost and fees for the auditing process, and between improving the quality of the auditing process and strengthening the objectivity and independence of the external auditor.

5. Methodology

To achieve the objectives of the study, a descriptive analytical method was used depending on the nature of the subject. Also, secondary information was obtained through books, scientific references, previous studies, and research

published in referee specialized journals. Also, preliminary information was collected through the questionnaire that had been prepared for this purpose and analysis of the results has also been made using statistical software (SPSS). I used Pearson correlation test to determine the numerical value of

the strength of the association between the variables in my study for the following reason. Pearson correlation test gives more accurate results than estimating the strength of the link between two variables for the distribution of data.

Table 1. Pearson test to measure the first hypothesis [26].

Areas		Effect of the external auditor survival as an auditor accounts client for more than 5 years in improving the quality of the audit process
Improve the quality of the review process and enhance objectivity and independence	Pearson's correlation coefficient	0.896
	The level of Morale	0.000
	Number of the sample	141

The value of Tabulated r at a degree of freedom "139" and the 0.05 significance level equal to 0.159

The study population is composed of offices and audit firms operating in the Gaza Strip and they are (85) offices and auditing firms based on Palestinian accountants and auditors manual [23]. Also, it includes shareholding companies in Gaza and they are (4119). However, only (1000) companies are considered operating according to the Ministry of National Economy [24].

The study sample includes all offices and audit firms operating in the Gaza Strip, which are (85) offices and auditing companies and 100 shareholding companies operating in the Gaza Strip which comprise 10% [25] of the total number of companies that are operating in the Gaza Strip.

6. Analysis and Discussion of the Study Hypotheses

6.1. The First Hypothesis

Pearson correlation test is used to test the first hypothesis. The results listed in Table 1 show that the calculated value of r equals to 0.262, which is larger than the tabulated value of r , which equals to 0.159 at 0.05 levels and the degree of freedom, "139". As well as the level of significance value of this relationship is equal to 0.000 which is less than 0.05. This implies that the hypothesis is rejected. Thus, the results indicate that the mandatory change improves and enhances objectivity and independence of the external auditor and improves the quality of the review process.

That is because the length of the external auditor period may lead to the consolidation of the personal relationship

between the external auditor and the management of the enterprise being audited. These results agree with the results represented by Mansi et al. [16] and Ghosh and Moon [15]. The results disagree with the results of Carey and Simnett [21] who showed that the audit quality decreases with increasing auditor tenure. The results also disagree with Davis et al. [20] who showed that the quality degraded both at the earlier or later part of auditor tenure.

6.2. The Second Hypothesis

The second hypothesis has been tested using the Pearson correlation. The results listed in Table 2 show that the calculated value of r equals to 0.896, which is larger than the tabulated value of r , which equals to 0.159 at 0.05 levels and the degree of freedom, "139". As well as the level of significance value of this relationship is equal to 0.000 which is less than 0.05. This means that the hypothesis is rejected. It can be seen that the results are opposing to the hypothesis, and in favour of the importance of the change is compulsory for the external auditor and its impact on professionalism of the external auditor in the manufacture of the customer, adequate knowledge of his activity nature and industry which he belongs, and the importance of mandatory change of external auditor on improving the quality of the review process and strengthening the objectivity and independence. The results agree with Zhang [1], Stanley and Dezoort [12] who showed that audit quality is affected by the relation between the auditor and his client and the mandatory change is dependent on auditor specialization.

Table 2. Pearson test to measure the second hypothesis [26].

Areas		Effect of the external auditor survival as an auditor accounts client for more than 5 years in improving the quality of the audit process
Extent of application of the mandatory change and its impact on professionalism of the External Auditor in the audit client industry, and sufficient knowledge of the nature of his activity and industry to which he belongs.	Pearson's correlation coefficient	0.262
	The level of Morale	0.002
	Number of the sample	141

The value of Tabulated r at a degree of freedom "139" and the 0.05 significance level equal to 0.15

6.3. The Third Hypothesis

To test the third hypothesis, the Pearson correlation test has been used and the results are listed in Table 3. It is shown from Table 3 that the value of r is equal to 0.925 which is greater

than the tabulated value of r , which has the value of 0.159 at 0.05 level and the degree of freedom, "139". As well as the value of the significance level of this relationship is equal to 0.000 which is less than 0.05. This implies the hypothesis is

rejected. The results were against the hypothesis, backer that the application of the mandatory change has impact on the quality, cost and audit process fees and thus on the quality of audit process, because the contractual period length between the auditor and the client may affect the quality of the auditor

performance. The results agree with Stanley and DeZoort [12] who showed that audit fees are associated with improving the quality of audit process. In contrast Gul et al. [22] showed that non-audit fees are associated with poorer audit quality.

Table 3. Pearson test to measure the third hypothesis [26].

Areas		Study and application mandatory analysis to change the External Auditor, and its impact on the quality, cost, and audit process fees.
Improve the quality of the review process and enhance objectivity and independence	Pearson's correlation coefficient	0.925
	The level of Morale	0.000
	Number of the sample	141

The value of Tabulated r at a degree of freedom "139" and the 0.05 significance level equal to 0.159

7. Conclusion

This study provides insights into the recent debate surrounding auditor tenure, independence, and audit quality by analyzing the relationship between auditor tenure and audit quality. In general, most of the results are consistent with the hypothesis that mandatory rotation has a positive impact on improving the quality of auditing process. The results show that the mandatory change of the external auditor improves and enhances objectivity and independence of the external auditor and improves the quality of the review process. The mandatory change of the external auditor and its impact on professionalism of the external auditor in the manufacture of the customer, adequate knowledge of his activity nature and industry which he belongs improve the quality of the review process and strengthen the objectivity and independence. The application of the mandatory change has impact on the quality, cost and audit process fees and thus on the quality of audit process. Overall, my study suggests that imposing mandatory limits on the duration of the audit-client relationship improves the quality of the auditing process and enhances the auditor independence in the Palestinian companies.

References

- [1] W. Zhang, Three Essays in Audit Quality. Desertation, University of Alberta, 2011.
- [2] Sarbenes and Oxley, Corporation corrupt in the United States, 2011.
- [3] R. Bricker, "Transparency, independence, technology and the CPA scope of services: New challenges to profession," The Ohio CPA Journal, vol. 4, pp. 48-50, 2002.
- [4] K. Harris, Mandatory audit rotation: an international investigation, Dissertation, UMI 3510857, 2012.
- [5] V. Johnson, I. K. Khurana and J.K. Reynolds, "Audit-firm tenure and the quality of financial reports." Contemporary Accounting Research, vol. 19, pp. 637-660, 2002.
- [6] M. Geiger, and K. Raghunandan, "Auditor tenure and audit quality. Auditing," A Journal of Practice and Theory, vol. 21, pp. 187-196, 2002.
- [7] J. N. Myers, L. A. Myers, and T. C. Omer, "Exploring the term of the auditor-client relationship and the quality of earnings: A case for mandatory auditor rotation?" The accounting Review, vol. 78, pp. 779-800, 2003.
- [8] W. R. Knechel, and A. Vanstraelen, "The relationship between auditor tenure and audit quality implied by going concern opinions," Auditing: A Journal of Practice and Theory, vol. 26, pp. 113-131, 2007.
- [9] J. N. Myers, L. A. Myers, Z. Palmrose, S. Scholz, "Mandatory Auditor Rotation: Evidence from Restatements," University of Illinois at Urbana-Champaign, 2013.
- [10] M. Schelker, "Auditors and corporate governance: Evidence from the public sector," Kyklos, vol. 66, pp. 275-300, 2013.
- [11] V. Mande and M. Son, "Do Financial Restatements Lead to Auditor Changes?" Auditing: A Journal of Practice & Theory, vol. 32, pp. 119-145, 2012.
- [12] J. Stanley, T. Dezoort, "Audit firm tenure and financial restatements, an analysis of industry specialization and fee effects," Journal of Accounting and Public Policy, vol. 26, pp. 131-159, 2007.
- [13] S. R. Al Koni, "The conditions of the auditing profession in Palestine: the current realities and change requirements," Research Report Series, No. 21, Center for Private Sector Development-Palestinian Businessmen Association-Jerusalem, 2004, <http://blogs.najah.edu/staff/saed-koni/article/article>.
- [14] A. Ghosh, and D. Moon, "Does auditor tenure impair audit quality," Working Paper. Office of Economic Analysis, 2003.
- [15] A. Ghosh, and D. Moon, "Auditor tenure and perceptions of audit quality," The Accounting Review, vol. 80, pp. 585-612, 2005.
- [16] S. A. Mansi, W. F. Maxwell, and D. P. Miller, "Does auditor quality and tenure matter to investors? Evidence from the bond market," Journal of accounting Research, vol. 42, pp. 755-793, 2004.
- [17] J. V. Carcello, and A. L. Nagy, "Client size, auditor specialization and fraudulent financial reporting," Managerial Auditing Journal, vol. 19, pp. 651-668, 2004.
- [18] D. Manry, T. Mock, and J. Turner, "Does increased audit partner tenure reduce audit quality?" Journal of Accounting, Auditing and Finance, vol. 23, pp. 553-572, 2008.
- [19] G. Bae, S. Kallapur, J. Rho, "Departing and Incoming Auditor Incentives, and Auditor-Client Misalignment under Mandatory Auditor Rotation: Evidence from Korea," Available at SSRN 2281127, 2013.

- [20] R. L. Davis, B. Soo and G. "Trompeter, Auditor tenure and the ability to meet or beat earnings forecasts." *Contemporary Accounting Research*, vol. 26, pp. 517-548, 2009.
- [21] P. Carey, R. Simnett, "Audit partner tenure and audit quality," *The Accounting Review*, vol. 81, pp. 653-676, 2006.
- [22] F. Gul, B. Jaggi, G. Krishnan, "Auditor independence, evidence on the joint effects of auditor tenure and non-audit fees," *Auditing: A Journal of Practice and Theory*, vol. 26, pp. 117-142, 2007.
- [23] Palestinian accountants and auditors manual, Second Edition, Prepared by: Office of the Commission Accounting and Auditing, Association of Palestinian Accountants and Auditors
- [24] Report by Abdallah Abo Rooda, Ministry of national economy
- [25] T. Yamen, *Statistics: An introductory analysis*, 2nd ed., New York: Harper and Raw, 1967.
- [26] A. J. Al-Khozondar, The impact of the mandatory changes for the external auditor in improving the quality of the review process and strengthen the objectivity and independence. Unpublished thesis. Islamic University of Gaza, 2008.