



The Impact of Earnings Management Risks, Corporate Governance Risks on Auditors' Decisions. Perceptions of Egyptian Auditors

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Abstract: This paper aims to investigate the auditors' assessment of the impact of earnings management risk and corporate governance risk on their decisions concerning acceptance client, planning and pricing. A questionnaire was presented to 150 auditors to find out their perceptions toward the impact of both types of risks about their decisions. The results showed that both types of risk affect auditors' decisions concerning accept a new client, audit planning and audit fees. The earnings management risk factors appear to be more important for Egyptian auditors and of these factors, The Egyptian auditors gives big attention to whether there are indications of unusually aggressive or creative accounting practices or no. The results of the paper could provide auditors with practical insights that will prove useful in the course of their work.

Keywords: earnings management, corporate governance, risks, Egyptian auditors.

1. Introduction

This research investigates the perceptions of Egyptian auditors concerning the influence of audit client risks related to earnings management and corporate governance on their decisions, which Earnings management practices and the weakness of governance mechanisms of the audit client consider sources of risk that could affect audit process. It is important for auditors take into account the explicit consideration of governance factors because weaknesses in governance structure are often associated with lower financial reporting quality, earnings manipulation, and financial statement fraud (Cohen et al, 2002: 577). Professional standards and accounting studies indicated that the risks of the audit client consider of the most important factors that affect the auditors' decisions. D'Aquila et al. 2010 stated that to manage the overall risk of an auditor's association with a particular client, is a paramount objective for all auditors, particularly in the Big 4, and Krishnan, et al, 2013 indicated that Successful management of

client risk is important to preserve the auditor's reputation and mitigate the risk of litigation. Johnstone & Bedard, (2005) argued that there are several ways to manage audit risk, and one of these is making decisions on client acceptance, audit pricing and planning for the audit process effort needed to reduce audit risk to an acceptable level (Johnstone & Bedard, 2005: 4). However, the study of direct influence of the earnings management risk and of corporate governance risk on the auditors' decisions did not receive sufficient attention in the Egyptian environment. In addition, there is no interest to get to know the perceptions of the auditors themselves in the factors that may affect their decisions. This paper examines the response of auditor to both earnings management risks and corporate governance risks in the Egyptian environment follow the work of Bedard & Johnstone, 2004, in US environment. The results of the current study show that Egyptian auditors take into their account both earnings management risks and corporate governance risks when making decisions. Such studies can



contribute to enhancing understanding of a key, complex audit activity, impacting ultimately on audit quality. Understanding of the factors that affect the decisions of the auditor can provide useful information to various parties, including the authority to issue regulations and standards, and the auditors themselves.

The earnings management practices consider important risk factor, which Auditors appear to adjust the audit effort or extract risk premiums depending on the direction of earnings management risk (Barron et al. 2001). The risk of earnings management is important because Earnings management is pervasive and costly to investors and thus is of fundamental interest to regulators, auditors, investors, and others (Krishnan, et al, 2013), Theoretically, earnings management practices increase audit risk as they are often associated with a higher likelihood of a financial reporting misstatement (Jones et al. 2008) and accruals which are often used to manage earnings can be difficult to audit because they require auditors to assess the future likelihood of accruals being realized into cash flows (Gul et al. 2003). In addition, earnings management is associated with weaker internal controls (Doyle et al. 2007) and there is lawsuits against auditors are associated with earnings management (Heninger 2001). On the other hand, business literature has increasingly emphasized the need for effective corporate governance to help mitigate financial reporting risks including earnings management risk, which board of directors and audit committees should play an important role in controlling the quality of financial reporting (Dechow et al, 1996; Cohen et al, 2002). The role of corporate governance is increasingly important in a strategic or business system auditing perspective such as that developed by KPMG (Bell et al. 1997). Auditors adjust their decisions according to their evaluation of management integrity in the light of two factors; first, management provides the foundation of internal control and without management integrity, it is unlikely that internal control will be effective in reducing financial statement misstatement, second, auditors rely on management to provide a great deal of evidence during the course of the audit (Kizirian, et al, 2005:50).

This paper is motivated by some reasons; 1) prior studies point to Low level of audit quality and breadth of the expectations gap in the Egyptian environment. In 2002, the World Bank assessed accounting and auditing practices in Egypt as part of the World Bank and International Monetary Fund's Report on the Observance of Standards and Codes (ROSC). The World Bank reported that consultations with auditing practitioners and other market participants revealed that, overall, the quality of audits in Egypt is perceived to be low by the investor community. Also, Wahdan et al. (2005) concluded that there is a compliance gap between auditing requirements and actual practices in Egypt. Dixon et al. (2006) reported evidence of a wide audit expectation gap in Egypt in the areas of auditor responsibilities for fraud prevention, maintenance of accounting records, and auditor judgment in the selection of audit procedures. It can be argued that this low audit quality and expectation gap could partly due to lack of attention directed to analysis the factors of client business risk. 2) Increasing the likelihood of earnings management practices in the Egyptian business environment, Leuz, et al (2003) find that, companies in countries with developed capital markets, dispersed ownership structures, strong investor rights, and legal enforcement engages in less earnings management. Therefore, it can be expected that Egyptian companies engages more in earnings management. 3) Lack of interest in analyzing the perceptions of Egyptian auditors about risk factors related to audit client on their decisions, Bedard & Johnston, (2004) stated that accounting literature is not interested in direct examination of the relationship between auditors' perceived earnings management risk and their decisions. In Egyptian context, the study of Ebaid, (2011) has focused on studying the impact of corporate governance factors on acceptance decision, while the current study is broader.

The rest of the paper will be continued as the following; second section present literature review, third section present hypotheses development, method was presented in the fourth section. The last section presents the results and conclusion.



2. Literature review

Studies examining the association between risk and auditor's decisions show mixed conclusions between positive association and no association. Some studies show auditor's decisions are responsive to some types of risk, but not another, and that responsive change over time (Johnstone & Bedard, 2005: 6). Auditing standards suggest that auditors should respond to audit risk by altering the nature, timing and extend of audit procedures (SAS No. 99, 2002; SAS No. 107, 2006; SAS No. 110, 2006). Some studies provide results consistent with the recommendations and requirements of auditing standards. Graham & Bedard, (2003) find that all types of fraud risk factors are statistically associated with some form of audit plan. Fraud risk factors which they found are most frequently related to industry/competitive position, management integrity, internal control system quality, financial condition, and pressure to meet financial targets. Johnston & Bedard, (2001), reported positive association between the audit fees and both error risk and fraud risk. Elder & Allen (2003) find a positive association between risk assessment and sample size decision. Blay et al. (2007) reported that auditors plan to collect more evidence when fraud risk is assessed higher.

On the other hand, some studies documented results which not consistent with these recommendations, Bell, et al (2001) argued that in competitive environment audit fees reflect business risk, and they stated that Contrary to the competitive model, auditors from several international firms tell them that there is little correspondence between business risk and audit fees (Bell, et al, 2001: 36). They find that higher business risk increases the number of audit hours, but not the fee per hour, which imply that there is no association between business risk and audit fees. Mock & Turner (2005) report that audit programs are not modified for the majority of clients in their sample, regardless of the level of risk assessed. Fukukawa, et al (2006) show that audit plans are, at best, weakly responsive to client risk assessments and that they differ in their responsiveness to broader risk factors compared to individual risk assessments.

Concerning the relation between both earnings management risks and corporate governance risks and auditors' decisions, Abbott, et al (2006) examined the association between audit fees and earnings management. They find that downward earnings management risk is associated with lower audit fees, and upward earnings management risk is associated with higher audit fees. Larcker & Richardson (2004) examined the relation between audit fees and the choice of accruals measures. They find a negative association between audit fees and accruals.

Sharma et al. (2008) examined the effect of non-mandatory corporate governance practices (the board of directors and audit committee) on a comprehensive set of audit judgments including client acceptance, risk and planning judgments. The results show that strong corporate governance is related positively to favourable acceptance judgment and negatively to control environment risk and the extent of substantive tests. Cohen and Hanno (2000) find that management control philosophy and corporate governance structure affect auditors' acceptance and planning decisions, which auditors were more willing to recommend client acceptance and more likely to reduce substantive tests in the presence of a stronger corporate governance or management control philosophy. Yatim et al. (2006), Abbott et al. (2003) and Carcello et al. (2002) examined the relationship between corporate governance and audit fees, finding that audit fees are positively associated with good corporate governance. Cohen et al. (2007) examined the impact of the role of the board of directors in monitoring management (agency role) and/or the role of the board in helping to formulate corporate strategies (resource dependence role) on the auditors' planning decisions, and showed that auditors respond to the role of the board when making judgments with respect to control risk assessments and the planned scope of audit tests. In Egypt, Ebaid, (2011) investigated the impact of corporate governance practices on the auditor's acceptance decision in Egypt. The results revealed that strong corporate governance is associated with more favourable acceptance judgments than weak corporate governance.



Bedard & Johnston, (2004) examined the relation between auditors' assessment of earnings management risks, corporate governance risks and both planning and pricing decisions. They reported that the heightened earnings management risk is associated with an increase in planned audit effort and with increased billing rates. In contrast, they found auditors planning and pricing decisions are less strongly related corporate governance risk. The current study follows this study in examining the auditors' assessment of earnings management risk and corporate governance risk factors as a whole and each individual factor and the impact on their decisions.

3. Hypothesis development

Prior research suggests that the first stage in client acceptance decisions is the evaluation of client-related risks including: audit risk, client business risk, and auditor business risk (Johnstone and Bedard, 2005; Bell et al., 2002; Johnstone, 2000). Auditors assess audit risk and financial risk, and consider whether audit fees are sufficient to cover current and future expected audit process costs (Johnston & Bedard, 2005; Bedard & Johnston, 2004). Also, international auditing standards (e.g., ISA 315 and ISA 330) indicate to a direct, positive relation between the auditor's understanding and assessment of client risks and the procedures planned in response to such assessed risks.

3.1 Earnings management

Abbott, et al (2006) argued that the positive relation between earnings management and audit risk can build on three research pillars; positive relation between income-increasing abnormal accruals—a common proxy for earnings management—and subsequent auditor litigation, annual restatements trigger auditor litigation at a higher rate than bankruptcies, and auditor assessments of litigation risk and planned audit investments are higher when potential errors overstate (Abbott, et al, 2006: 86).

In the context of the relation between earnings management and audit fees, the relation between auditors fees and earnings quality is the focus of considerable of scholarly

and regulatory debate (Larcker & Richardson, 2004: 655). Bedard & Johnstone, 2004 argued that audit firms may charge a higher fee rate to clients with higher earnings management risk as a premium to compensate them for costs related to potential future litigation. The positive relation between audit fees and earnings management risk will be magnified within the greater litigation risk environment, and high price-earnings (P/E) ratio consider an indicator for the greater litigation risk environment (Abbott, et al, 2006: 86). Gul et al. (2003) find a positive association between audit fees and absolute values of abnormal total accruals and Schelleman & Knechel (2010) find a positive association between audit fees and signed current accruals.

The relation between earnings management practices and audit plan may take one of two directions; On the one hand, auditors might work harder if they expect that clients are attempting to manage earnings, On the other hand, clients that intend to manage earnings can anticipate that hard-working auditors are more likely to detect their earnings management attempts and might therefore contract with their auditors to exert less effort (Caramanis & Lennox, 2008: 117). Glover et al. (2000) report that auditors increase sample size and planned audit hours when management has an incentive to misstate the financial statements. Glover et al. (2003) find that auditors need to modify the audit plan when red flags are present.

It can be expected that, if there are clues about the presence of earnings management practices, more audit effort and higher audit fees will be required to reduce detection risk and the overall audit risk. If the risk arising from earnings management is too high to be mitigated by more audit efforts, the auditor is likely to not accept a new client or resign from the current client. Therefore, the following hypotheses are to be examined;

H1a: the earnings management risk factors influence the auditor's decision to accept a new client.

H1b: the earnings management risk factors influence the audit plan decisions.

H1c: the earnings management risk factors influence the audit fees decision.



3.2 Corporate governance

ISA 315 requires auditors to consider the nature of the entity, including its ownership structure and governance, when responding to assessed risks. The strength of corporate governance may affect the risk associated with a current or potential client; therefore corporate governance factors can influence the auditors' risk assessments and clients' acceptance decisions, audit program planning and professional staff allocation decisions (Cohen et al, 2002: 577). Bedard & Johnstone (2004) argued that auditors perceive greater director independence is associated with stronger internal controls and lower risk of financial misreporting. Consequently, auditors are likely to reduce the extent of audit tests. This argument can be explained as the stream of literature uses director independence as a measure of directors' desire to protect their reputation capital, and consequently they demand a more extensive audit to protect their reputation capital and reduce the risk of litigation (Boo, & Sharma, 2008: 54). The adoption of a perspective that goes beyond the audit committee and a monitoring approach may reduce the audit client's overall business risk and in turn may potentially affect subsequent audit risk assessments (Afify, 2009: 68). In addition, a number of studies documented the association between corporate governance mechanisms and earnings management (Wu, 2002; Peasnell, et al, 2004; Cornett, et al, 2009; Lin & Hwang, 2010).

Concerning Acceptance decision, Cohen et al (2002), reported that Auditors consider corporate governance factors to be especially important in the client acceptance phase. Asare, et al (2002), argued that increased risks associated with the governance structure could significantly influence the client acceptance decision.

In the context of the impact of corporate governance on audit fees, corporate governance has an impact on the demand for auditing quality and auditors' fees (Larcker & Richardson, 2004: 629). Abbott, et al (2003) finds that audit committee independence and financial expertise are associated with audit fees. Goodwin-Stewart & Kent (2006) find a

positive association between the level of audit fees and the existence of an audit committee. Boo, & Sharma, 2008, find that the association between audit fees and board/audit committee independence and size are weaker.

With regard to audit plans, the auditor should first recognize and properly assess the strength of corporate governance and, second, appropriately weight and use this evidence to develop an audit plan. If the governance mechanisms are strong, an auditor could potentially reduce sample sizes and thus reduce the extent of costly substantive testing (Cohen, et al, 2002: 580).

If effective corporate governance practices are significantly associated with the quality of the financial reporting process, then it is expected that such practices will influence auditors' assessments of client-related risk and, therefore, influence the client acceptance decision, and If auditors perceive that they cannot rely on corporate governance mechanisms, they may increase audit effort and audit fees (Bedard & Johnstone, 2004). So, the following hypotheses are to be examined;

H2a: the corporate governance risk factors influence the auditor's decision to accept a new client.

H2b: the corporate governance risk factors influence the audit plan decisions.

H2c: the corporate governance risk factors influence the audit fees decision.

4. Methodology

To investigate the perceptions of Egyptian auditors about the impact of risk factors on their decisions, a new questionnaire was designed in both Arabic and English. The current questionnaire divided into two sections: The first section contains questions seeking general information about the respondent's background profile, including their age, qualifications, and work experience. This is customary for questionnaire development as such questions seek information indicating whether respondents' answers qualify for inclusion (Al-Razeen and Karbhari, 2007). Furthermore, these serve certain aspects of the analysis, such as determining the association between age,



experience and perceptions of auditors.

Another section contains six questions related to the respondent's perceptions regarding the impact of risk factors on their decisions. The risk factors (table 1) were derived from the study of Bedard & Johnstone, (2004) The respondents

were asked to determine the degree of importance of each item using a five-point Likert-type scale, where (1) referred to not important, and (5) to strongly important. Simplicity of questions and good structure of the questionnaire are important factors to consider (Al-Ajmi, 2009).

Table 1: risk factors

<p>Earnings management risk factors related to the following issues:</p> <ul style="list-style-type: none"> • The company has a history of exactly meeting consensus earnings estimates. • The company's stock price is based on an unusually high (stock price / profit) for its industry. • The company has indications of unusually aggressive or creative accounting practices. • The company has a history of inaccurate accounting estimates. • Certain accounting policies may be inappropriate for the business. • The engagement team has nonspecific concerns about earning management. • Management has provided inaccurate representations, or has been less than forthright about financial reporting issues. • There has been a restatement in the last three years, and it was due to intentional manipulation. • The engagement team has concerns about a particular accounting treatment.
<p>Corporate governance risk factors: First, Board of directors risk factors are related to the following issues:</p> <ul style="list-style-type: none"> • There is one person running the posts of Chairman and CEO • There is no written code of conduct. • There are recent problematic resignations of BOD members. • The BOD is insufficiently independent from management. • The BOD does not hold frequent timely meetings with the CFO and accounting officers. • The BOD has not provided sufficient timely information to allow for monitoring of important management behavior. • The BOD has not provided sufficient timely information about sensitive issues.
<p>Second, Audit committees risk factors are related to the following issues:</p> <ul style="list-style-type: none"> • The AC does not have a formal written charter. • The AC does not hold frequent timely meetings with the CFO or other accounting officers. • The AC members are not made up of outside directors. • The AC is insufficiently independent from management. • The AC members are not financially literate. • The AC has not provided sufficient timely information to allow for monitoring of important management behavior.

5. Results

5.1 Descriptive statistics

Of the 150 questionnaires were distributed, only 96 questionnaires (response rate 64%) are returned, and 16 questionnaires were excluded due to lack of answer some questions or to errors in answering such as choosing more than one answer at the same time. Thus the final sample reached 80 auditors. Sample aged between 33 and 52 years and the average age

of the sample about 43 years, and the average length of experience among the sample between 10 and 15 years. Regarding scientific qualifications, the majority ratio of the sample (87.5%) had only a first university degree, while 12.5% have postgraduate certificates. concerning professional certificates, 36 (45%) auditors have professional certificate, and this high ratio can be explained as big audit firms in Egypt require such certificates as a fundamental requirement for admission to employment. The



sample includes 24 auditors (30%) work in the audit firms which representing agents of the big four in Egypt.

5.2 Results

The sample responses showed that, generally, auditors’ decisions have been affected by the governance risk and earnings management risk associated with the client of the audit process. The results show that 86.1% (68 auditors) of the sample stated that their decision to accept a new client is affected by those risks, while a whole sample (100%) agreed that both the planning of the audit process and the decision of determining audit fees is affected by those risks. The results of correlation analysis showed a positive average correlation between perceptions of respondents toward the impact of governance risk and earnings management risk on the decision to accept a new client and both the age of respondents (β 0.548; Sig. 0.000) and experience (β 0.548; Sig. 0.000), suggesting that the increasing of respondents experience increases their interest in governance risk and earnings management risk associated with the client when making the decision to accept a new client. There is no association between the perceptions of respondents toward the impact of risks on planning and determine audit fees decisions with any of the characteristics of the sample.

Concerning earnings management risk factors, table (2) show the mean of the respondents’ perceptions toward the impact of each factor on their decisions. The results of the users’ perceptions show a variation in the importance of the effect of each factor. The results concerning acceptance decision show The company has indications of unusually aggressive or creative accounting practices and Management has provided inaccurate representations, or has been less than forthright about financial reporting issues as the main factors which influence acceptance decision (mean > 4), six factors as being moderate importance (with a mean of 3.0147 - 3.6618), and one factor which appear to not influence acceptance decision (with a mean of 2.7500). In contrast, the results reveal that respondents rated six factors as being great importance (with a mean of 4.0375 – 4.2250) when making audit fees decision, 2 factors as being of moderate importance (with a mean of 3.1750 and 3.7375), and one factor which appear to not influence audit fees (with a mean of 2.9875). Regarding planning decision, the results reveal that respondents rated five factors as being great importance (mean > 4), two factors as being of moderate importance (with a mean of 3.9250 and 3.0250), and two factors which appear to not influence audit planning (with a mean of 2.5500 and 2.4125).

Table (2): the impact of earnings management risk factors on auditors’ decisions

Factors	Acceptance decision		Fees decision		Planning decisions	
	Mean	rank	Mean	rank	Mean	rank
1. The company has a history of exactly meeting consensus earnings estimates.	2.7500	9	4.1125	3	4.1500	3
2. The company’s stock price is based on an unusually high (stock price / profit) for its industry.	3.6618	3	4.1125	4	4.2375	2
3. The company has indications of unusually aggressive or creative accounting practices.	4.1618	1	4.2250	1	4.1000	4
4. The company has a history of inaccurate accounting estimates.	3.0147	8	2.9875	9	3.0250	7
5. Certain accounting policies may be inappropriate for the business.	3.2059	6	4.0375	6	2.5500	8
6. The engagement team has nonspecific concerns about earning management.	4.0588	2	3.7375	7	3.9250	6



Factors	Acceptance decision		Fees decision		Planning decisions	
	Mean	rank	Mean	rank	Mean	rank
7. Management has provided inaccurate representations, or has been less than forthcoming about financial reporting issues.	3.4853	4	3.1750	8	2.4125	9
8. There has been a restatement in the last three years, and it was due to intentional manipulation.	3.4559	5	4.2125	2	4.3750	1
9. The engagement team has concerns about a particular accounting treatment.	3.1765	7	4.1000	5	4.1000	5

With regard to governance risk factors (table 3), they have been divided into two categories; first, factors linked to the board of directors, second, factors associated with audit committees. Concerning board of directors' factors, the results show The BOD has not provided sufficient timely information to allow for monitoring of important management behaviour as the main factor (mean > 4) which influences both acceptance decision and fees decision. In the context of acceptance decision, the respondents rated three factors as being moderate importance (with a mean of 3.1471 – 3.7941) and three factors tend to have no influence on acceptance decision (mean > 3). Regarding audit fees, the results reveal that respondents rated five factors as being moderate importance (with a mean of 3.0000 - 3.9375) and one factor which appear to not influence audit fees (with a mean of 2.2125). In the context of audit planning, only one factor (The BOD is insufficiently independent from management) which appear to greatly influence (mean > 4) planning decisions and the remaining

factors appear to have no influence on planning decisions (with a mean of 2.1000 - 2.8500).

With regard to Audit committees' factors, contradictory to expectation, the results show that these factors in a general have a

moderate or no influence on audit decisions. In the context of acceptance decision, only one factor (The AC does not have a formal written charter) which appear to have no influence on acceptance decision (with a mean of 2.1176) while the remaining factors appear to have moderate importance (with a mean of 3.0735 - 3.9701). Concerning audit fees, the results reveal that respondents rated four factors as being moderate importance (with a mean of 3.1875 - 3.7375) and two factors which appear to not influence audit fees (with a mean of 2.8875 and 2.9250). Regarding audit planning, the results reveal that respondents rated three factors as being moderate importance (with a mean of 3.1250 - 3.6125) and three factors which appear to not influence audit fees (with a mean of 2.2000 - 2.8000).

Table (3): the impact of corporate governance risk factors on auditors' decisions

Factors	Acceptance decision		Fees decision		Planning decisions	
	Mean	rank	Mean	rank	Mean	rank
Section one: factors associated with the board of directors						
1. There is one person running the posts of Chairman and CEO	2.8382	5	3.6250	3	2.1000	6
2. There is no written code of conduct.	2.6912	7	3.0500	4	2.1500	5
3. There are recent problematic resignations of BOD members.	2.7794	6	2.2125	7	2.1000	7



Factors	Acceptance decision		Fees decision		Planning decisions	
	Mean	rank	Mean	rank	Mean	rank
4. The BOD is insufficiently independent from management.	3.7206	3	3.9375	2	4.0750	1
5. The BOD does not hold frequent timely meetings with the CFO and accounting officers.	3.1471	4	3.0500	5	2.8500	2
6. The BOD has not provided sufficient timely information to allow for monitoring of important management behavior.	4.0758	1	4.0125	1	2.8250	3
7. The BOD has not provided sufficient timely information about sensitive issues.	3.7941	2	3.0000	6	2.7000	4
Section two: factors associated with the audit committee						
1. The AC does not have a formal written charter.	2.1176	6	2.9250	5	2.2000	6
2. The AC does not hold frequent timely meetings with the CFO or other accounting officers.	3.3824	3	2.8875	6	2.7375	5
3. The AC members are not made up of outside directors.	3.4706	2	3.7000	3	3.4500	2
4. The AC is insufficiently independent from management.	3.1176	4	3.7125	2	3.6125	1
5. The AC members are not financially literate.	3.0735	5	3.7375	1	3.1250	3
6. The AC has not provided sufficient timely information to allow for monitoring of important management behavior.	3.9701	1	3.1875	4	2.8000	4

5.3 Analysis and Discussion

The results, in general, show that Egyptian auditors pay attention to audit client risk factor related to both earnings management risks and governance risks when making their decisions, which support to a large extent the hypotheses of paper. It appears that auditors are more interested in earnings management risk indicators (which a mean of respondents' perceptions concerning all earnings management factors 3.6498) than governance risk indicators (which a mean of respondents' perceptions concerning all corporate governance factors 3.1267). Also, it appears that audit fees is the most decision influenced by risk factors, followed by acceptance decision, then audit planning.

The importance of earnings management risk for auditors is consistent with the implications of some studies such as Heninger (2001) which find a positive association between income-increasing abnormal accruals and ex post auditor litigation, Houston et al. (1999) and Lee & Mande (2003) which concluded that auditors incorporate the magnitude and direction of discretionary accruals into their litigation risk assessments. Also, it's consistent with the view of Abbott, et al (2006) which argued that due to asymmetric litigation effects, audit fees decrease (increase) with a client's risk of income-decreasing (increasing) earnings management risk.

- Concerning Earnings management risk factors, it can be noted that the following factors influence all auditors' decisions;



- The company's stock price is based on an unusually high (stock price / profit) for its industry.
- The company has indications of unusually aggressive or creative accounting practices.
- The engagement team has nonspecific concerns about earning management.
- There has been a restatement in the last three years, and it was due to intentional manipulation.
- The engagement team has concerns about a particular accounting treatment.

earnings management risk indicators can be arranged according to their importance for all audit decisions, which the Egyptians auditors seem to be more interested in the presence of indications of unusually aggressive or creative accounting practices, followed by whether There has been a restatement in the last three years, and it was due to intentional manipulation, and less interested in whether Certain accounting policies may be inappropriate for the business. The indicator that whether the Company's stock price is based on an unusually high (stock price / profit) for its industry influence all auditors' decisions, and it is a third factor according to its importance. This is consistent with the argument that a client's propensity to manage earnings upward will be magnified for clients within greater litigation risk environments (Barron et al. 2001), and high price-earnings (P/E) clients categorized as those facing greater litigation risk. High P/E clients likely have incentives to inflate their earnings to meet earnings growth expectations (Bedard & Johnstone 2004; Richardson et al. 2002; Dechow et al. 2000).

From the standpoint of audit decisions, audit fees appear to be more affected by earnings management risk factors followed by audit planning, then acceptance decision. Concerning acceptance decision, auditors appear to be more interested in whether the company has indications of unusually aggressive or creative accounting practices, and less interested in whether the company has a history of exactly meeting consensus earnings estimates when they decide whether to accept a client or not. Regarding audit fees, most influential factor in this decision is whether the Company has indications of unusually aggressive or creative accounting practices, and the least influential factor is whether the company has a history of

inaccurate accounting estimates. In the context of audit planning, the most important factor is whether there has been a restatement in the last three years, and it was due to intentional manipulation, and the least important factor is whether Management has provided inaccurate representations, or has been less than forthright about financial reporting issues.

With regard to corporate governance risk factors, it appears that Egyptian auditors pay little attention to these factors, and they are more interested in risk factors related to audit committees than risk factors related to board of directors. This result is consistent, to some extent, with the context of previous results which documented a relation between corporate governance and instances of fraud. The auditors more interested in factors related to audit committee than board of directors factors, which inconsistent with Carcello et al. (2002) which find that board characteristics rather than audit committee characteristics are associated with higher audit fees. But it is consistent with stream of accounting literature which linked audit committees to audit process.

Concerning risk factors related to board of directors, there is one factor that influences all decisions, the insufficiently independence of the board of directors from management, and one factor which appear to not influence any decision There are recent problematic resignations of BOD members. These factors can be arranged according to their importance, which The BOD is insufficiently independent from management is the most important factor followed by The BOD has not provided sufficient timely information to allow for monitoring of important management behavior, while There are recent problematic resignations of BOD members appear to be less important.

The importance of independence of the board of directors is consistent with Prior studies which reveal that the effectiveness of the board of directors' oversight role can be influenced by attributes such as board size, board independence (percentage of outside directors on the board), board members' expertise, and meeting frequency. Outside directors have an incentive to monitor management because the value of their human capital is partially



determined by the effectiveness of their monitoring performance (Fama and Jensen, 1983). Therefore, independent (outside) directors are more willing to provide effective oversight. Xie et al. (2003) suggested that greater independent outside representation on the board, background in the corporation, finance, or law, and meeting frequency were related to a lower level of discretionary accruals. Ebrahim (2007) suggested that earnings management was negatively associated with the independence of the board of directors and its audit committee. Chen, et al (2006) finds that the proportion of outside directors, the number of board meetings, and the tenure of the chairman are associated with the incidence of fraud.

Egyptian auditors appear to be not interested in the problem of role duality, which The presence of one person running the posts of Chairman and CEO influence only audit fees, which consistent, to some extent, with Peel & Clatworthy (2001) which indicated that auditors may perceive the risk of audit failure to be higher where the roles of chairman or chief executive are combined, since it can be argued that there is more scope for concealment or misstatement of relevant facts, and even fraud to be perpetrated. Also, it's consistent with Dechow et al. (1996) who found that firms whose CEO also chaired the board of directors were more likely to be subject to accounting enforcement actions by the SEC for GAAP violation.

With regard to risk factors related to audit committees, they are more important than risk factors related to board of directors and this attention of audit committees is consistent with what expected and context of prior studies, Kaplan et al., (2009) found that the audit committees of US public companies with effective operating procedures help to minimize the likelihood of fraud, Law, (2011) indicated that the audit committee effectiveness, internal audit effectiveness, the tone at the top management level, and ethical guidelines and policies are positively associated with a lack of fraud within Hong Kong organizations. Within these factors The AC members are not made up of outside directors appears to be the most important factor for Egyptian auditors followed

by The AC is insufficiently independent from management, While, The AC does not have a formal written charter appear to be the least important.

The auditors' concern about the independence of audit committees can be understood in the context of stream of studies which documented the association between audit committees characteristics and quality of financial reporting. Uzun,et al (2004) find that as the number of independent outside directors increased on a board and in the board's audit and compensation committees, the likelihood of corporate wrongdoing decreased. Abbott et al. (2000) found that firms that had audit committees composed entirely of independent directors meeting at least twice annually were less likely to be sanctioned by the SEC for fraudulent or misleading financial reporting. Carcello and Neal (2000) found that the greater the percentage of affiliated directors on the audit committee in firms experiencing financial distress, the lower the probability the auditor would issue a going-concern report. Klein (2002) suggested a negative relationship between audit committee independence and abnormal accruals. Abbott et al. (2004) found that the audit committee's independence, the presence of at least one member with financial expertise, and meeting at least four times per year exhibited a significant and negative association with the occurrence of the restatement. Anderson et al. (2004) found that an independent audit committee was associated with increased accounting report integrity and therefore a lower cost of debt financing. Krishnan (2005) and Zhang et al. (2007) found that firms were more likely to have internal control weaknesses if their audit committees were less independent and had less financial expertise or, more specifically, had less accounting financial expertise and non-accounting financial expertise. DeZoort et al. (2008) found that audit committee support for an auditor-proposed adjustment was significantly higher in the post-SOX period and that greater audit committee member support for the proposed adjustments was higher for members who were CPAs than members who were non-CPAs.



From viewpoint of auditors' decisions, audit fees appear to be more affected by corporate governance risk factors, followed by acceptance decision, then audit planning. Concerning acceptance decision, the most influential factor is The AC has not provided sufficient timely information to allow for monitoring of important management behavior and the least influential factor is The AC does not have a formal written charter. Regarding audit fees, the most influential factor is The AC members are not financially literate and the least influential factor is The AC does not hold frequent timely meetings with the CFO or other accounting officers. In the context of audit planning, The AC is insufficiently independent from management appear to be most important factor and The AC does not have a formal written charter appear to be less important.

Conclusions

This paper investigated the perceptions of Egyptian auditors about the impact of earnings management risk and governance risk on their decisions. The results showed that both types of risk affect auditors' decisions concerning accept a new client, audit planning and audit fees. The earnings management risk factors appear to be more important for Egyptian auditors. The Egyptian auditors give big attention to whether there are indications of unusually aggressive or creative accounting practices or no. Also, Egyptian auditors' perceptions are consistent with stream of academic studies which reported the importance of independent directors and they have expressed great attention to independence of the board of directors and audit committees.

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Appendix A: questionnaire

First part: PERSONNEL INFORMATION

Name:

Age:

Occupation:

Educational qualifications:

Bachelor	Master	PH.D.	Professional	Other

Experience:

Less than 5 years	Between 5 and 10 years	Between 10 and 15 years	Between 15 and 20 years	More than 20 years

Second part

First question

Is your decision to accept a new client influenced by the earnings management risks and the corporate governance risks that related to this client?

<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> One of them	
		<input type="checkbox"/> earnings management risks only	<input type="checkbox"/> corporate governance risks only

Second question

If the answer to the previous question is yes, please specify the extent of the impact of the following factors that determine the earnings management risks and the corporate governance risks on your decision to accept a new client:

Factors	Extent of the impact of these factors on the decision to accept a new client				
	Very strong	Strong	Weak	Very weak	No influence
First, factors associated with earnings management risks					
1. The company has a history of exactly meeting consensus earnings estimates.					
2. Company's stock price is based on an unusually high (stock price / profit) for its industry.					
3. The company has indications of unusually aggressive or creative accounting practices.					
4. The company has a history of inaccurate accounting estimates.					
5. Certain accounting policies may be inappropriate to the business.					



Factors	Extent of the impact of these factors on the decision to accept a new client				
	Very strong	Strong	Weak	Very weak	No influence
6. The engagement team has nonspecific concerns about earning management.					
7. Management has provided inaccurate representations, or has been less than forthright about financial reporting issues.					
8. There has been a restatement in the last three years, and it was due to intentional manipulation.					
9. The engagement team has concerns about a particular accounting treatment.					
Second, factors associated with corporate governance risks					
Section one: factors associated with the board of directors					
10. There is one person running the posts of Chairman and CEO					
11. There is no written code of conduct.					
12. There are recent problematic resignations of BOD members.					
13. The BOD is insufficiently independent from management.					
14. The BOD does not hold frequent timely meetings with CFO and accounting officers.					
15. The BOD is not provided sufficient timely information to allow for monitoring of important management behavior.					
16. The BOD is not provided sufficient timely information about sensitive issues.					
Section two: factors associated with audit committee					
1. The AC does not have a formal written charter.					
2. The AC does not hold frequent timely meetings with the CFO or other accounting officers.					
3. The AC members are not made up of outside directors.					
4. The AC is insufficiently independent from management.					
5. The AC members are not financially literate.					
6. The AC is not provided sufficient timely information to allow for monitoring of important management behavior.					



Third question

Is your planning of the audit process influenced by the earnings management risks and the corporate governance risks that related to this client?

<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> One of them	
		<input type="checkbox"/> earnings management risks only	<input type="checkbox"/> corporate governance risks only

Fourth question

If the answer to the previous question is yes, please specify the extent of the impact of the following factors that determine the earnings management risks and the corporate governance risks on your planning of the audit process:

Factors	Extent of the impact of these factors on the decision to accept a new client				
	Very strong	Strong	Weak	Very weak	No influence
First, factors associated with earnings management risks					
1. The company has a history of exactly meeting consensus earnings estimates.					
2. Company's stock price is based on an unusually high (stock price / profit) for its industry.					
3. The company has indications of unusually aggressive or creative accounting practices.					
4. The company has a history of inaccurate accounting estimates.					
5. Certain accounting policies may be inappropriate to the business.					
6. The engagement team has nonspecific concerns about earning management.					
7. Management has provided inaccurate representations, or has been less than forthright about financial reporting issues.					
8. There has been a restatement in the last three years, and it was due to intentional manipulation.					
9. The engagement team has concerns about a particular accounting treatment.					
Second, factors associated with corporate governance risks					
Section one: factors associated with the board of directors					
1. There is one person running the posts of Chairman and CEO					



Factors	Extent of the impact of these factors on the decision to accept a new client				
	Very strong	Strong	Weak	Very weak	No influence
2. There is no written code of conduct.					
3. There are recent problematic resignations of BOD members.					
4. The BOD is insufficiently independent from management.					
5. The BOD does not hold frequent timely meetings with CFO and accounting officers.					
6. The BOD is not provided sufficient timely information to allow for monitoring of important management behavior.					
7. The BOD is not provided sufficient timely information about sensitive issues.					
Section two: factors associated with audit committee					
1. The AC does not have a formal written charter.					
2. The AC does not hold frequent timely meetings with the CFO or other accounting officers.					
3. The AC members are not made up of outside directors.					
4. The AC is insufficiently independent from management.					
5. The AC members are not financially literate.					
6. The AC is not provided sufficient timely information to allow for monitoring of important management behavior.					

Fifth question

Is your decision to determine the audit fees influenced by the earnings management risks and the corporate governance risks that related to this client?

<input type="radio"/> Yes	<input type="radio"/> No	<input type="radio"/> One of them	
		<input type="checkbox"/> earnings management risks only	<input type="checkbox"/> corporate governance risks only

Sixth question

If the answer to the previous question is yes, please specify the extent of the impact of the following factors that determine the earnings management risks and the corporate governance risks on your decision to determine the audit fees:



Factors	Extent of the impact of these factors on the decision to accept a new client				
	Very strong	Strong	Weak	Very weak	No influence
First, factors associated with earnings management risks					
1. The company has a history of exactly meeting consensus earnings estimates.					
2. Company's stock price is based on an unusually high (stock price / profit) for its industry.					
3. The company has indications of unusually aggressive or creative accounting practices.					
4. The company has a history of inaccurate accounting estimates.					
5. Certain accounting policies may be inappropriate to the business.					
6. The engagement team has nonspecific concerns about earning management.					
7. Management has provided inaccurate representations, or has been less than forthright about financial reporting issues.					
8. There has been a restatement in the last three years, and it was due to intentional manipulation.					
9. The engagement team has concerns about a particular accounting treatment.					
Second, factors associated with corporate governance risks					
Section one: factors associated with the board of directors					
1. There is one person running the posts of Chairman and CEO					
2. There is no written code of conduct.					
3. There are recent problematic resignations of BOD members.					
4. The BOD is insufficiently independent from management.					
5. The BOD does not hold frequent timely meetings with CFO and accounting officers.					
6. The BOD is not provided sufficient timey information to allow for monitoring of important management behavior.					
7. The BOD is not provided sufficient timey information about sensitive issues.					



Factors	Extent of the impact of these factors on the decision to accept a new client				
	Very strong	Strong	Weak	Very weak	No influence
Section two: factors associated with audit committee					
1. The AC does not have a formal written charter.					
2. The AC does not hold frequent timely meetings with the CFO or other accounting officers.					
3. The AC members are not made up of outside directors.					
4. The AC is insufficiently independent from management.					
5. The AC members are not financially literate.					
6. The AC is not provided sufficient timely information to allow for monitoring of important management behavior.					

Any comments about questionnaire or the point of search please specify.